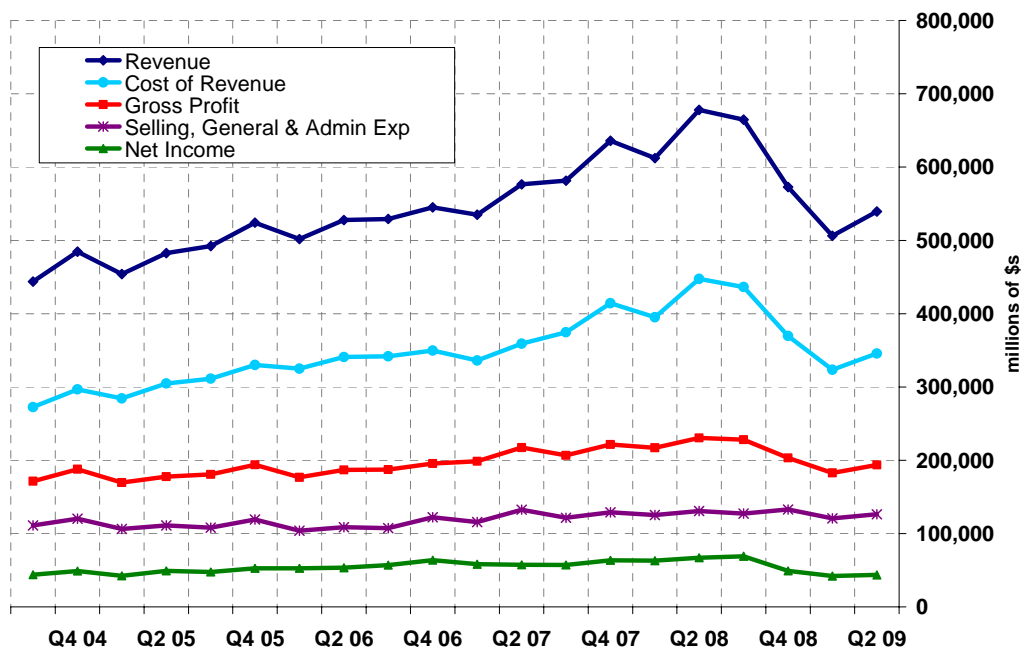


**Trends in U.S. Corporate Earnings
Sales and Earnings Recovery**
October 8, 2009

As we enter season for reporting third quarter earnings, we take a look back at what corporate sales and earnings looked like through June 30th to get an idea of how companies coped with the recession through the second quarter and what to look for in the weeks ahead. For the purpose of this analysis, we look at a relatively small, but representative subset of the U.S. stock market, the twenty-six non-financial companies in the Dow Jones Industrial Average (the “Dow 26”). In aggregate these twenty six-companies account for more than \$2 trillion of sales annually.¹

Judging by the aggregate sales, expenses, and earnings of the Dow 26, the recession may have ended in the first half of 2009. Figure 1 shows the major components of the Dow 26’s aggregate quarterly earnings over the past five years. Second quarter 2009 levels for aggregate sales revenue, expenses, and income all recovered from first quarter troughs.

Figure 1
Components of the Aggregate Earnings of the Dow 26



Source: Bloomberg and Advisor calculations

Figure 1 clearly shows the sharp decline in total sales revenue from the second quarter of 2008 (Q2 2008) through the first quarter of 2009 (Q1 2009). Total revenues peaked at \$678 billion in Q2 2008 and troughed at \$506 billion in Q1 2009, a decline of 25.3%. Note that sales peaked two

¹ The twenty-six companies are 3M, Alcoa, AT & T, Boeing, Caterpillar, Chevron, Cisco, DuPont, Exxon Mobil, General Electric, Hewlett-Packard, Home Depot, Intel, IBM, Johnson & Johnson, Kraft Foods, McDonald’s, Merck, Microsoft, Pfizer, Proctor & Gamble, United Technologies, Verizon, Wal-Mart, and Walt Disney. The Dow Industrial Average also includes four financial companies not included in this study, American Express, Bank of America, JPMorgan Chase, and Travelers.

quarters after the start of the recession in December 2007. Sales recovered modestly between the first and second quarter of this year from \$506 billion to \$539 billion, an increase of 6.5%. The recovery in sales was broad-based across the Dow 26. Only two companies, Caterpillar and Microsoft, failed to show a recovery in sales revenues.

Although aggregate sales rebounded 6.5%, the increase in aggregate earnings was more modest. Earnings on the Dow 26 peaked at \$69.1 billion in the third quarter of 2008 before declining to \$42.1 billion in the first quarter of 2009, a decline of 39.1%. Between the first and second quarter of 2009, aggregate earnings increased \$1.5 billion or just 3.6%. The rebound in earnings was not as broadly distributed among the Dow 26 as the increase in sales revenues. Nineteen of the companies saw earnings increase from recent lows, but seven of the companies reported their lowest recent quarterly earnings in their second quarter 2009 reports including Chevron, Cisco, Exxon Mobil, General Electric, Hewlett-Packard, Intel, and Proctor & Gamble.

The Q2 2009 earnings recovery of the Dow 26 was driven by increased sales and not by expense reductions. Figure 2 shows the net aggregate profit margin for the companies since the third quarter of 2004.² The Q2 2009 net profit margin of 8.1% was the lowest in five years. A sustainable recovery in stock prices will require an increase in corporate profitability, which may be difficult to achieve with the weak pricing power companies have in the current economic environment. On the other hand, weaker pricing may translate into a lower cost of sales and an increasing gross profit margin.

Figure 3 shows the trend in aggregate gross profit margin. Since the start of the recession, a very modest increase has occurred in this margin, from 34.0% in Q2 2008 to 35.9% in Q2 2009, which has helped to offset the impact of declining sales on net income. Despite this near-term improvement, a longer-term downward trend appears evident with margins declining from more than 36% in 2004 and 2005 to less than 36% since 2008. Although the percentage change is small, the magnitude of the change is large since 1% of more than \$2 trillion in annual sales is more than \$20 billion, which if valued at 15 times earnings (after taxes) could translate into a change in market value of more than \$200 billion or more than 5%. Third quarter reports will help indicate how the balance between sales revenues and cost of revenues is being affected by erosions in pricing power. On balance, we expect profitability to be eroded.

Despite the modest increase in the gross profit margin, aggregate gross profits declined from a peak of \$230 billion in Q2 2008 to \$183 billion in Q1 2009 – a decline of \$48 billion or 21% – before recovering to \$194 billion in Q2 2009.

Figure 4 shows the limited extent to which the Dow 26 were able to offset depressed sales revenues and lower gross profits with reduced operating expenses. Companies were not able to reduce sales, general and administrative expenses (SG&A) on anywhere near the order of magnitude required to offset reductions in sales and gross profits. SG&A expenses peaked at \$133 billion in the fourth quarter of 2008 and declined to \$121 billion in the following quarter – a drop of only \$12 billion or 9% – compared to declines of \$172 billion in sales (-25%) and \$48 billion in gross profits (-21%). Reductions were even less compared to the level in Q2 2008 when sales revenue and gross profits peaked.

Figure 5 looks at the components of earnings from a different perspective. It shows aggregate sales revenue, cost of revenue, gross profits, SG&A, and net income relative to levels five years

² Figure 2 and all subsequent figures are shown on pages 4 through 6 of this report.

ago. Most notable is the fact that 2Q 2009 aggregate net income was only 99% of the level five years ago, while all other components were higher. The long-term secular decline in the gross profit margin is the primary reason for aggregate net income being less than five years ago.

Earnings and valuations reported on a per share basis reflect the same patterns as in the aggregate data. Figure 6 reports earnings on a per share equivalent basis for the Dow 26. Per share quarterly earnings peaked in Q3 2008 at \$0.83 before declining sharply to \$0.51 in Q1 2009 – a decline of 38.6%. Per share earnings made a modest recovery to \$0.53 in Q2 2009.

Figure 7 reports quarterly aggregate market value per share for the Dow 26 along with the ratio of the market value to the current quarter's diluted earnings annualized. The market value per share of the Dow 26 peaked at \$47.51 at Q3 2007, concurrent with the rest of the stock market. It declined to \$29.46 at Q1 2009 – a drop of 38%. From the end of the first quarter to the end of the second quarter, the market value increased nearly 8%.

Despite declining sales and earnings, earnings valuations increased from Q3 2008 through Q2 2009 as reported in Figure 7. At the end of the second quarter, the aggregate market value of the Dow 26 was equivalent to 15 times the current quarter's earnings annualized. Although this valuation level was higher than the 11.8 level it fell to at the end of Q3 2008, it is below the level observed for most of the past five years.

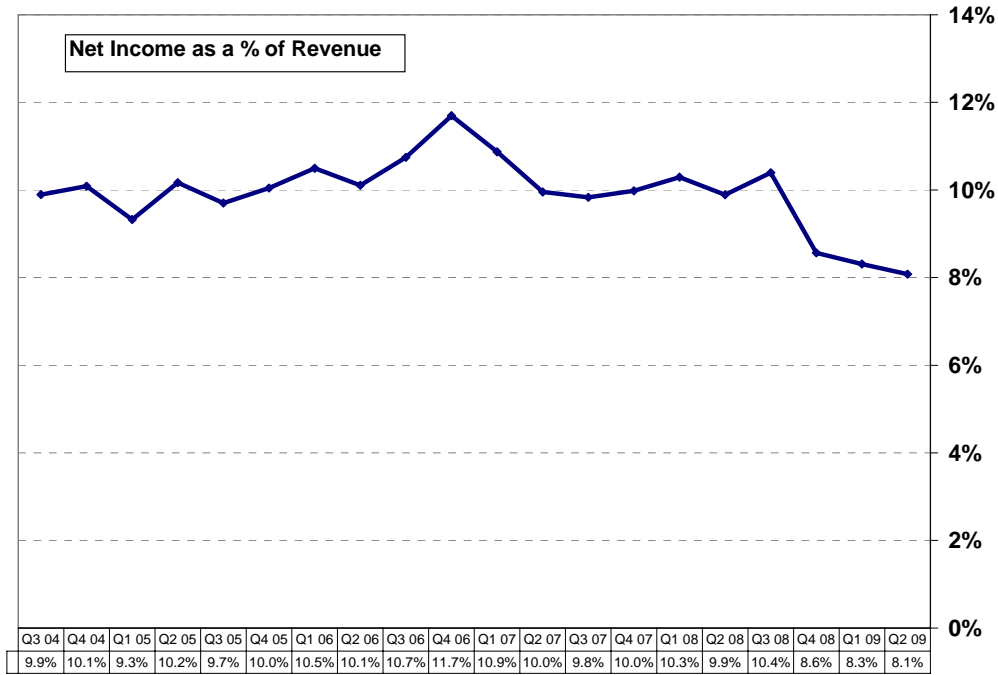
Second quarter results from the Dow 26 provided a fairly clear sign of a recovery in sales and net income. Investors will be looking to the third quarter results to get a measure of the rate at which sales revenues, gross profit margins, and corporate earnings are changing as the recession ends. Despite large job losses, the American economy has proven to be surprisingly resilient. Increases in sales, profit margins, or net income will be reason for optimism regarding future stock returns. Investors are well advised, however, to temper their enthusiasm and their future expectations, as it is not likely that pre-recession levels of sales and earnings will be achieved for several years for reasons we have explored in our commentary on the economic outlook earlier this year (see “The Uncertain State of the Economy” or the April 2009 Economic Outlook at www.aametrics.com/feature_capital_markets.htm).

We will revisit this analysis at the conclusion of the third quarter earnings reporting season.

Albert J. Brenner, CFA

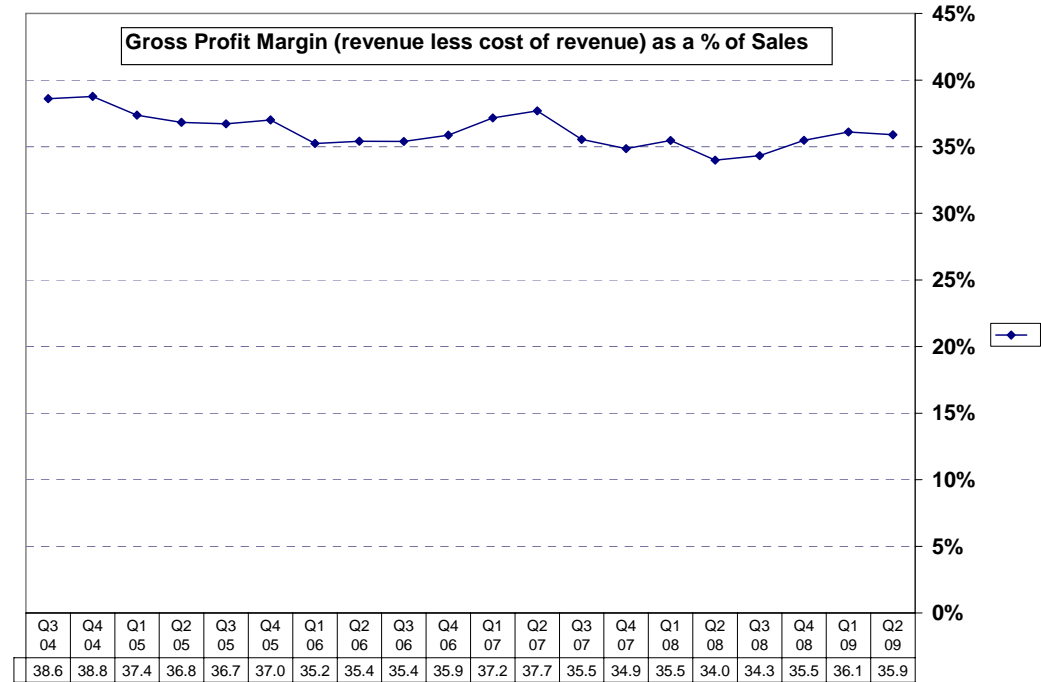
With the assistance of Puneeth Kumar and Andrew Pastor

Figure 2
Aggregate Net Income of the Dow 26 as a percent of Sales Revenue



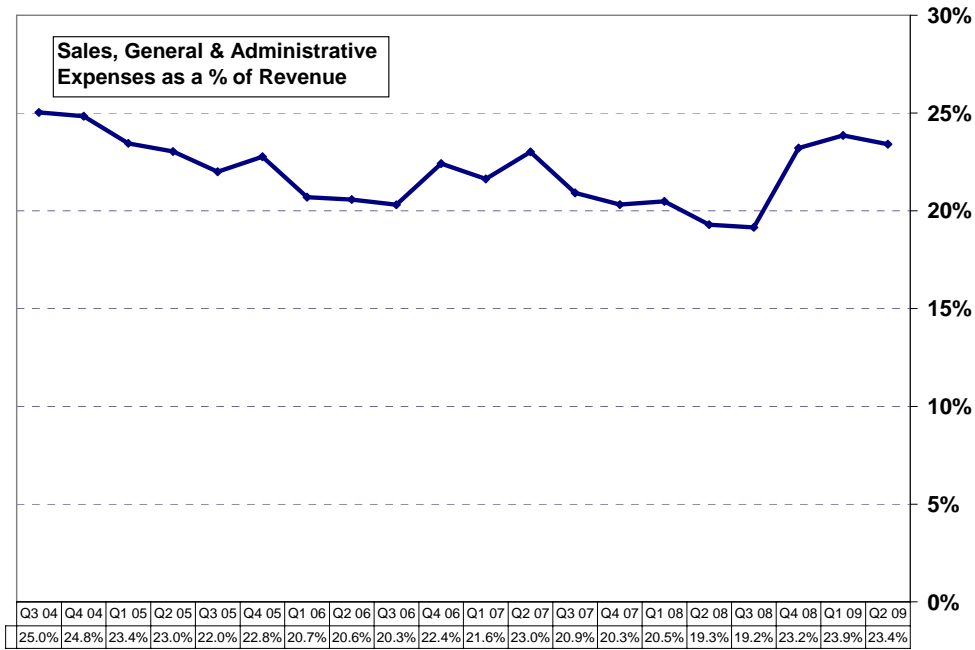
Source: Bloomberg and Advisor calculations

Figure 3
Aggregate Gross Profit Margin of the Dow 26



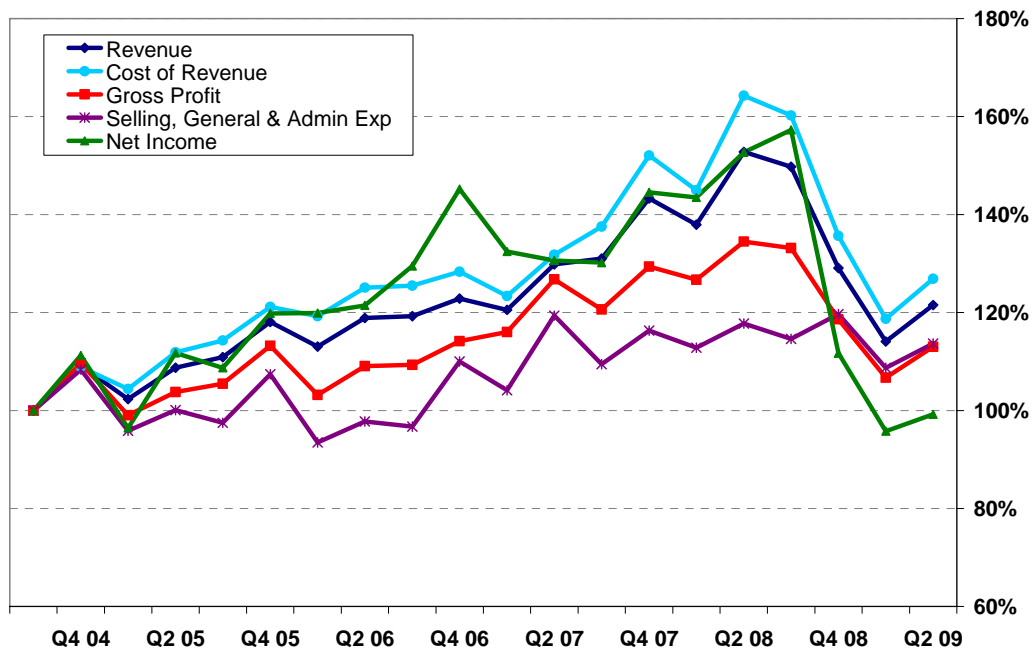
Source: Bloomberg and Advisor calculations

Figure 4
Aggregate Sales, General and Administrative Expenses as a percent of Revenue



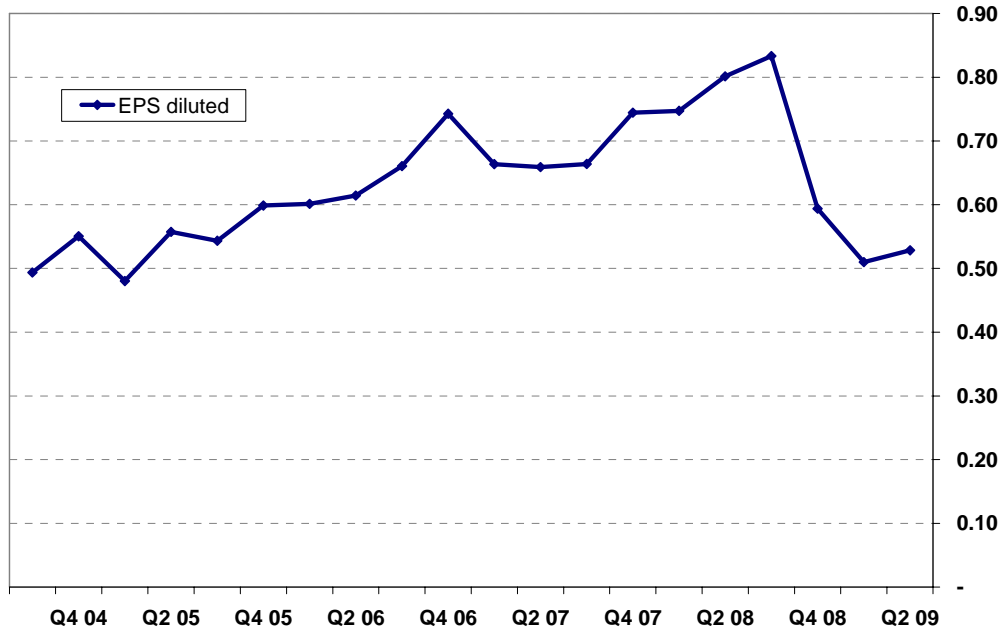
Source: Bloomberg and *Advisor* calculations

Figure 5
Components of the Aggregate Earnings of the Dow 26, percent of Q4 2004



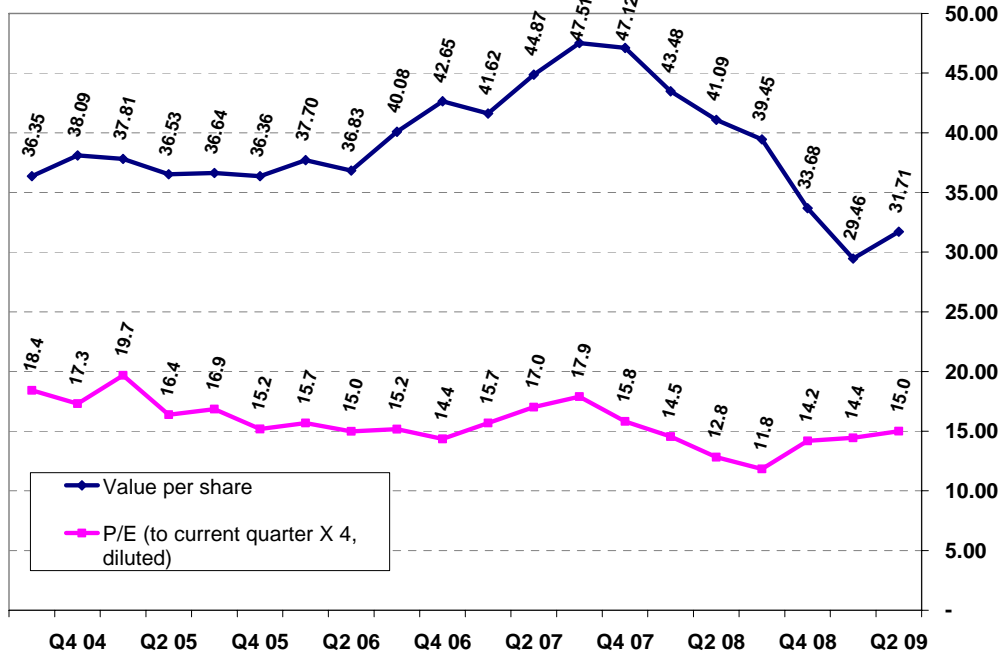
Source: Bloomberg and *Advisor* calculations

Figure 6
Dow 26 Aggregate Net Income per equivalent share, fully diluted



Source: Bloomberg and Advisor calculations

Figure 7
Dow 26 Market Value and P/E ratio per equivalent share



Source: Bloomberg and Advisor calculations