How Enduring Companies Build Earnings Power in a Declining Market

Ross Johnson, CFA, Management, Equity Investments

People tend to prefer the bad news first, so here it is: even with every major index in bear market territory, the economic environment for businesses appears more likely to deteriorate than improve for the foreseeable future. Inflation and interest rates have roiled the financial markets, but their impact on demand and corporate profits has yet to be fully felt.

With inflation permeating the economy, all areas of discretionary spending will be heavily scrutinized, which will likely pressure the demand and margins of companies that have ridden a stimulus-induced wave of demand since 2020. To the extent those businesses also rely on debt to finance their business, rising interest expenses may further dampen profitability. Regardless of whether the Federal Reserve achieves a soft landing for the economy, it appears increasingly likely that these ongoing demand and profitability challenges will result in an earnings recession.

The good news? An earnings recession in aggregate does not mean earnings declines for every company. In fact, certain businesses distinguish themselves most in tepid economic environments because they remain capable of building earnings power. These companies can be found across sectors, market caps, and geographies, but many display one or more of three key attributes.

First, such businesses provide essential products and services. Said another way, the activities supported by the company's solutions are always necessary, regardless of the broader economic climate. For instance, if Americans scale back on vacations as their budgets tighten, even at lower occupancy rates hotels will continue to perform pest control, sanitize rooms, and pay their employees. Generally, providers of such mission-critical services will see more stable demand than many of their customers across a business cycle.

Second, they make their customers more efficient. Being an enabler of customer efficiency becomes particularly attractive as economic growth and access to capital declines. In today's tight labor market, the importance of doing more with less has been further amplified. Many modern vertical software companies fall into this category, driving efficiencies for finance and accounting teams, mechanical engineers, pharmaceutical sales reps, insurance companies, and call centers, to name just a few. With the time savings and productivity enhancements far outpacing the cost of such solutions, their value proposition may even be enhanced in a choppier environment.

Finally, they possess sustainable pricing power. In the past two years of strong economic growth and high inflation, many companies have been able to pass along rising costs quickly and easily to customers in the form of price increases. As demand cools, companies with little to no competitive differentiation and many alternatives will likely have to reduce prices to maintain demand, putting meaningful pressure on their margins. Those with strategic competitive advantages and a strong value proposition, on the other hand, will retain price flexibility and be in a better position to maintain profitability and high returns on invested capital.

At Riverbridge, we seek these attributes in our portfolio companies regardless of the economic environment. One longtime holding we believe embodies all three is Tyler Technologies (TYL), a provider of software exclusively to state and local governments. Tyler's solutions embody the definition of essential as they address both the administrative and consumer-facing side of every function undertaken by municipalities, counties, and states – budgeting, public safety, courts, taxation, public works, etc. Furthermore, Tyler's core vision is to connect siloed agencies and functions to streamline the delivery of government services; they literally exist to make their customers more efficient. Finally, the company provides modern technology to organizations which notoriously struggle to attract top technology talent, acting as not only a software provider but a strategic partner to drive implementation and adoption. As a result, while they are far from the cheapest option, the breadth and quality of Tyler's offerings make it the clear market leader with 98 percent customer retention and an ever-growing list of capabilities.

Though challenges abound, we firmly believe businesses with differentiated offerings, steady demand, and self-financed operations can continue to build earnings power in the months and years ahead. Earnings power is an engine for enduring growth, and companies with earnings power make for an enduring investment.