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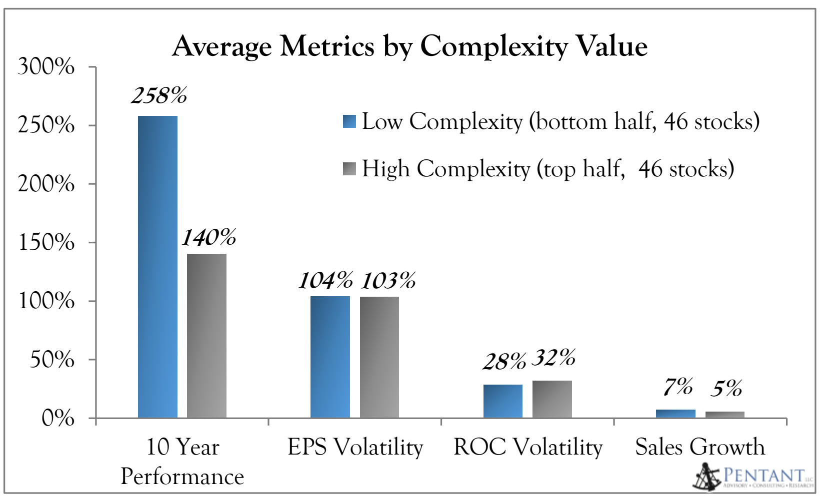
Corporate Complexity – Less Is More

Executive Summary

Isolating corporate complexity as an explanatory factor for stock valuation is difficult, but performance results over the past 10 years indicate the most complex companies have underperformed their less complex peers despite roughly equivalent levels of earnings volatility, return on capital volatility, and sales growth. Companies argue that a more diverse portfolio mutes cycles and brings greater consistency to earnings, but within Industrials and Materials in general this is not the case. The only thing that excessive complexity appears to bring is significant underperformance.

Our rudimentary Complexity Index is determined by dividing the number of reported corporate segments by the percentage of sales in the US (adjusting for geographic segments) – the value increases with the number of segments and foreign sales.

Within sectors we can see several examples of an apparent "complexity penalty" – for companies with similar comps, high complexity names have underperformed low complexity names. This does not appear to be a sector specific problem, although we have not tested the thesis outside of Industrials and Materials.



Further refining the group into quartiles based on complexity index values reveals that as complexity increases so does management optimism which tends to lead to poor performance and poor returns on capital. See our prior work on the value destruction relationship to [management optimism](). It is not clear which is the chicken and the egg; do optimistic managements favor more complex portfolios because they are confident that they can drive more growth/earnings; or is the information/strategy required to run a complex company so hard to understand that managements tend to over-estimate possible returns, resulting in poor capital allocation.

Complex companies with poor performance and overly optimistic managements become ripe for activist interest – DOW and DD have already been targeted.

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Pentant Disclaimer and Sources

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Sources:
All of the data shown in the charts in this report and mentioned through the text were obtained from publicly available sources and corporate reports, much of it aggregated through Capital IQ. We also use Bloomberg, IHS and government data bases.

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