JAG
CAPITAL MANAGEMENT LLC

Debt and Growth Don't Mix

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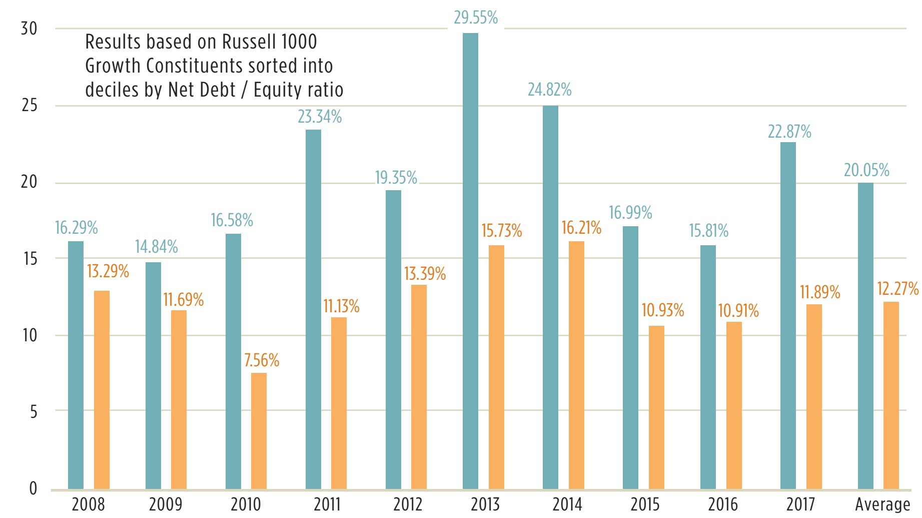
Companies that can sustain their own growth through positive free cash flow have long been prized on Wall Street. However, early stage companies and companies growing rapidly may not always be capable of realizing their growth opportunities without external financing. Finance professionals are trained to be indifferent between equity and debt as long as the relevant enterprise is able to achieve the lowest possible cost of capital. While the finance department may be agnostic as to capital structure, growth investors should pay close attention to how companies are financed. Growth firms with low debt-to-equity grow more quickly, attract a higher multiple, and appreciably outperform their peers.

Debt-to-equity is one of many ratios often included in measures of "Quality" as a quantitative factor. Quality factors frequently include some measure of profitability, return on assets or return on equity, and subjective assessments of either accounting or management. Along with the variables themselves, weights of these variables within Quality factor compositions are disparate. Our assertion is that studies of quantitative Quality factors are inconsistent in their construction and muddied by multiple inputs. Despite the factor construction anomalies, Quality has been tested to consistently show a positive statistical correlation with growth, and high quality is traditionally seen as supportive of higher valuations. Using a singular variable, (low) debt-to-equity, JAG produces comparable results to quantitative Quality factors. We believe debt-to-equity to be a singular powerful Quality factor for growth investing.

- >> **Firms with Low Debt Grow Faster than Those with High Debt.**
- >> **The Market Pays More for Growth Stocks with Low Debt.**
- >> **Growth Firms with Low Debt Outperform Those with High Debt.**

Data from Bloomberg arranged by JAG Capital Management displays that companies with net debt/equity have maintained higher long term EPS growth rates than those with higher net debt/equity. Over the past decade, the median long term EPS growth rate for low debt/equity companies is near 16%, while the median long term EPS growth rate for high debt/equity companies is near 11%. A five percentage point difference in annualized growth (45% spread) is meaningful in our opinion. As a potential explanation, it follows that companies with lower debt service requirements (interest payments) would have more cash to invest in growth initiatives. Managements operating lower debt companies may also be able to make decisions with less influence from bond holders. Whatever the motivation, low debt companies grow faster.

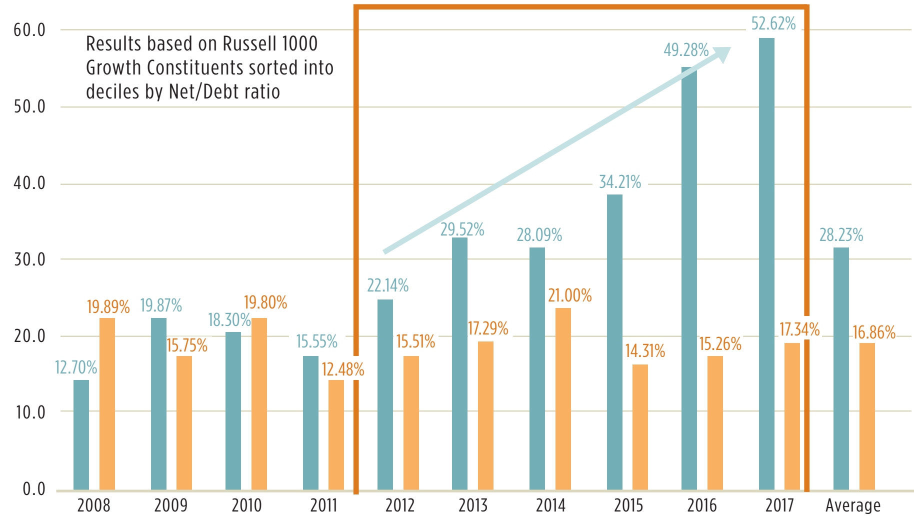
Bloomberg Estimated Long Term EPS Growth Rate Low Net Debt / Equity (blue bars) vs. High Net Debt / Equity (orange bars)



Source: Bloomberg, JAG Capital Management

While low debt/equity companies have grown at a sustainably higher rate than high debt/equity companies for a decade, the market has recognized that fundamental difference more recently. After four years of parity crossing the turn of the decade, the price-to-earnings ratio (PE) that the market has afforded low debt/equity companies has expanded for the past six years. In the most recent full year, investors paid almost 53 times earnings for low debt growers compared to just over 17 times earnings for high debt growth index constituents. Low debt exposed growth companies are increasingly highly valued by the stock market. This phenomenon is not an intuitive one as interest rates have declined over that six year time period. Lower interest expense would lead to higher earnings for high debt/equity companies, yet market participants have coalesced to pay less for low interest rate enhanced earnings. In our research, the market does pay more for "quality" as measured by low debt/equity, and the premium for quality is increasing in recent years.

Bloomberg Estimated Forward Twelve Months P/E Ratio Low Net Debt / Equity (blue bars) vs. High Net Debt / Equity (orange bars)



Source: Bloomberg, JAG Capital Management

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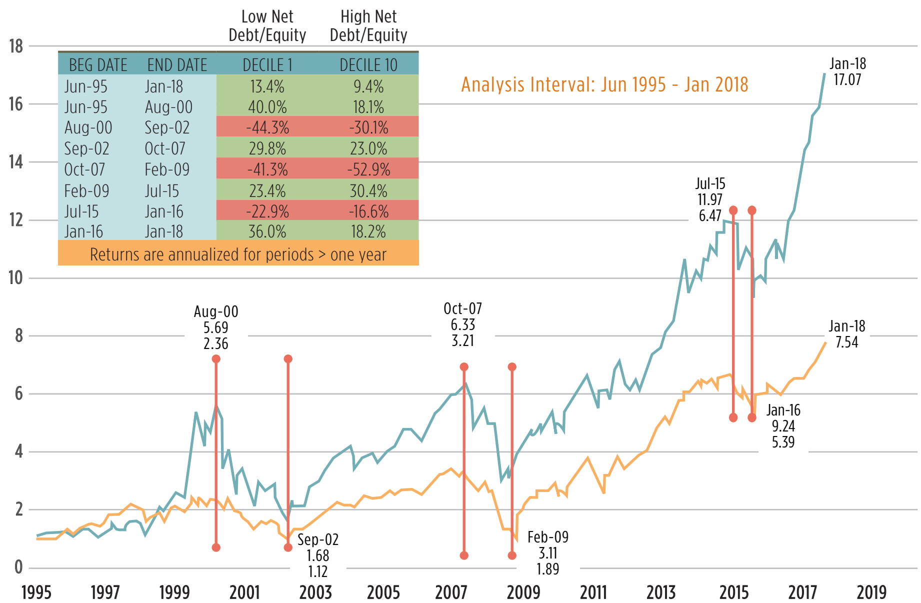
Since low debt companies, on average, grow faster than their peers and they attract higher multiples than their peers, it may come as little surprise that the low net debt/equity growth stocks outperform their peers. The cumulative magnitude of the performance difference over 23 years is significant, 17.1% annualized for low debt growth as compared to 7.5% annualized for high debt growth. The frequency is also significant as low debt growth stocks beat-out high debt growth stocks in 19 of the 23 years measured. Growth stocks with low net debt/equity decidedly outperform their high net debt/equity counterparts.

Cumulative Return for Russell 1000 Growth Firms with Low Net Debt / Equity* (blue line) **vs. High Net Debt / Equity** (orange line)



		Low Net Debt/Equity	High Net Debt/Equity
BEG DATE	END DATE	DECILE 1	DECILE 10
Jun-95	Jan-18	13.4%	9.4%
Jun-95	Aug-00	40.0%	18.1%
Aug-00	Sep-02	-44.3%	-30.1%
Sep-02	Oct-07	29.8%	23.0%
Oct-07	Feb-09	-41.3%	-52.9%
Feb-09	Jul-15	23.4%	30.4%
Jul-15	Jan-16	-22.9%	-16.6%
Jan-16	Jan-18	36.0%	18.2%
Returns are annualized for periods > one year			

*Low Net Debt / Equity = Russell 1000 Growth constituents in top decile (D1) when sorted by net debt / equity

*High Net Debt / Equity = Russell 1000 Growth constituents in bottom decile (D10) when sorted by net debt / equity

Source: Bloomberg, JAG Capital Management

Powerful Singular Quality Factor For Growth Stocks

JAG Capital Management utilizes a factor model as a tool for investment decision making. Debt-to-equity has been a factor for many years, and our statistical back-tests further confirm the data charted above, that it is a strong, singular quality factor. Moreover, debt/equity has proven to be one of our best performing factor model inputs over time. We weight it appropriately. Low debt/equity growth companies grow faster, attract higher multiples, and perform better than peers. Not only that, those same companies may have lower risk.

ABOUT JAG

JAG Capital Management is an independent, 100% employee-owned registered investment advisor headquartered in St. Louis, Missouri. The firm provides portfolio management services for institutions, individuals, investment advisory firms and corporations. In addition to managing the JAG Large Cap Growth mutual fund, equity and fixed income separate accounts are also offered.

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