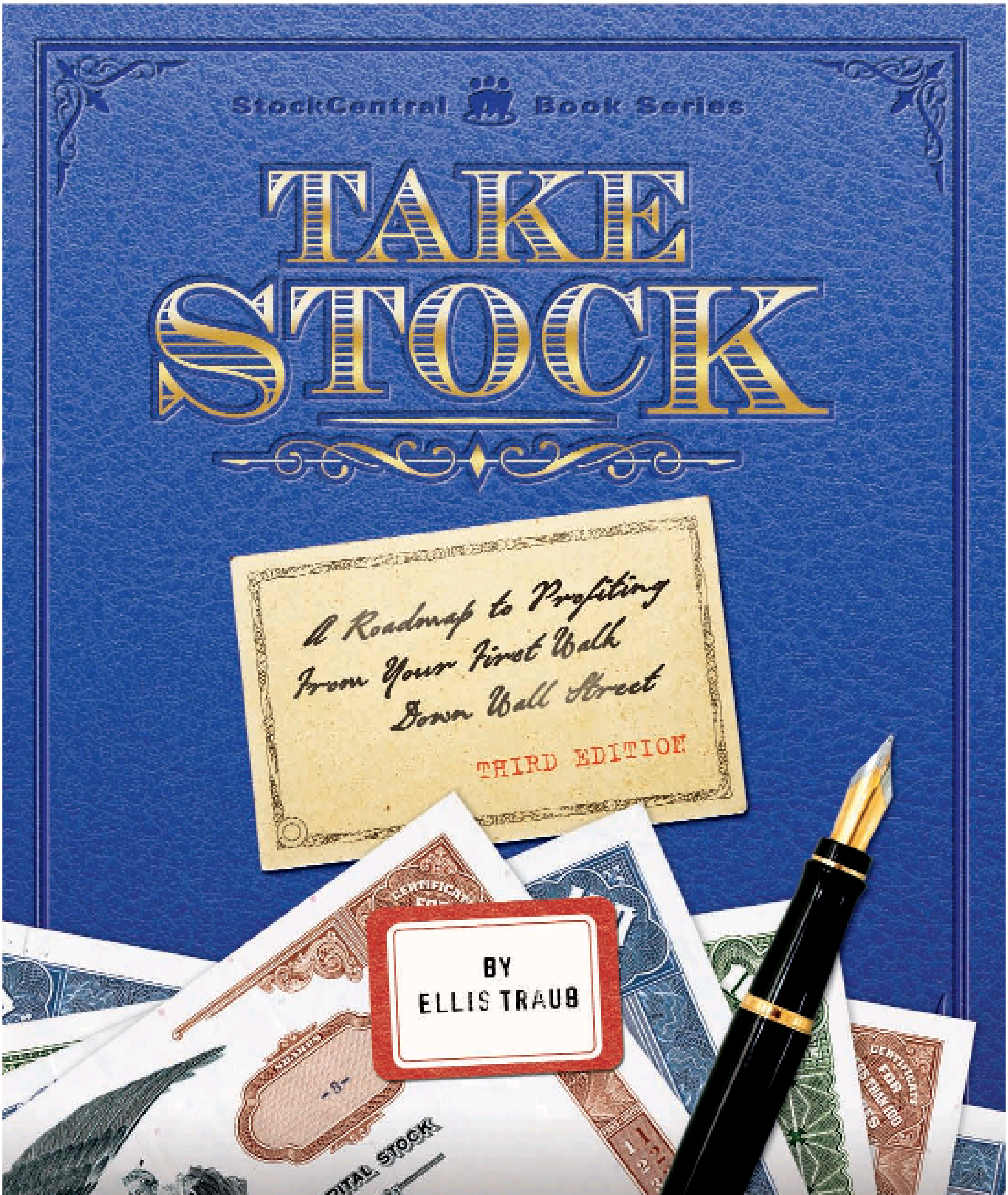
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A Roadmap to Profiting
from Your First Walk
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THIRD EDITION
BY
ELLIS TRAUB
CAPITAL STOCK

CHAPTER 5

Understanding Growth

Growth can be defined as an increase in whatever data you're looking at over a period of time. When you study a company, you're looking for the results of management at work — an increase in sales and earnings, quarter after quarter, year after year. This is the basis for your confidence in a company and its ability to grow and make money for you. Remember: Your investment performance is directly related to the company's ability to generate a consistent increase in its earnings. As its earnings grow, so will its price. And the value of its shares is best measured by the multiple of earnings (P/E) investors are willing to pay for them.

Sales Growth

Although it's the growth of earnings that promises to double the value of your stock over a five-year period, earnings can't grow without sales growth. It's the growth of sales, after expenses have been deducted, that generates the profit. And it's the profit retained by the company to increase its assets that produces the growth in equity. Without sales growth there can be no growth in earnings to increase the value of your stock — at least over the long term.

There are only a few ways sales can grow, and the quality of growth varies with those sources. Let's go back to Lucy's Lemonade Stand so this will be easy to understand.

In order for her sales to grow, Lucy has to sell more lemonade each passing week. To do this she can sell more lemonade to her regular customers, increase the number of customers she sells lemonade to, add cookies or some other products, or pursue a combination of those options. She can also make more money from each customer by raising her prices.

To increase the number of customers, she can put flyers in neighborhood mailboxes. She can pay her playmate Charlene to open another stand on the next block. If this puts her in competition with Peter, two blocks away, and she takes some of his customers, she might even be willing to take over Peter's stand for a share of the profits because he's decided he'd rather play baseball.

Adding new products makes sense because she already has the stand, the location, and the customer base. They like her lemonade and will probably try her cookies. And she can experiment with additional products — limeade, raspberry coolers, or whatever — to see whether it makes sense to offer them. Or she can raise prices — but only if she has no competition and if her customers will support it.

There's little or no difference between this and what a big company does to grow, but what management must do to accomplish these things is a bit more complicated.

Probably the healthiest growth in revenues is referred to as organic growth — growth that is generated by either marketing or by research and development.

Successful marketing will add new users for the product from among those who have never used such a product before, or it will take customers (market share) away from competitors that sell a similar product. This activity might include creating new markets geographically — abroad, perhaps. Or the company might expand its customer base demographically — maybe marketing a product to older or younger users than were targeted before.

Research and development will add more products or services to put in the marketplace. In the best case, these will be related to the company's existing products or services and will not be outside of the company's customary business domain.

Peter Lynch calls such unrelated expansion "deworsification." It wouldn't be smart for Lucy to offer pet food when her success is based upon her gustatory delights for the human palate.

Also effective, but perhaps less healthy, is the acquisition of other companies. A strong company gobbles up the weaker ones in the same or similar businesses. Where allowed by the government, it eliminates competition, adds the acquired companies' sales to the top line, and with luck finds some economies of scale and some synergies that will benefit the bottom line as well.

What makes acquisition riskier than organic growth is that the acquiring company will likely inherit not only the acquired company's assets and additional business but also the problems that made the company weak enough to grab.

Labor problems can be easy to turn around, given an enlightened corporate culture and the eagerness of the labor force to cooperate with a new and benevolent management. But plant and equipment obsolescence, bad brand reputation, or other more deep-rooted, long-term problems can be harder and costlier to overcome.

Another means of growing the top line is to raise prices. This is a very risky step that works only in certain situations. Competition generally limits those possibilities and, even if there's virtually no competition, the price doesn't usually go up without some decline in the units sold. There are some cases, though, where price increases add substantially to a company's revenues without a sacrifice at the bottom line. For example, consider a drug company that enjoys the protection of a patent for each new product as it emerges from its pipeline. It can take advantage of that unique protection from competition and push prices up with little fear of decline in units sold.

When you look at a company and consider it for investment, it's a good idea to ask yourself where the company's growth comes from. Is the growth organic, or is it coming from acquisitions? Is the company adding products or invading new markets? How aggressive is the company's international business, and is there a potential to expand there? What, if any, are the company's barriers to competition (sometimes referred to as its "moat")? If you can't answer these questions at first, don't worry! You'll learn as you go along. And as you will soon discover, you can do an excellent job of picking your stocks without going into detail about such things. You should know something about the product and its market, though, if only on a basic consumer's level. Commonsense issues can and should influence you when it comes to feeling at home with your candidates.

Earnings Growth

Where can earnings growth come from? Let's look at Lucy's Lemonade Stand again.

Lucy has taken over Peter's stand. Charlene runs another stand next to the playground. Lucy financed this growth primarily from profits, but also by hitting up Uncle Harry for 30 bucks in return for a piece of the action. "By now," Lucy's dad had told Harry, "she's up to about $50 a week and her business is growing pretty fast."

To be sure, earnings should be growing as fast as sales because it's her sales that produce the profit — after taking into account the cost of lemons and sugar and the 50 cents an hour she pays Charlene and little Benjamin, who runs Peter's old stand.

Aside from the volume of sales — the source of earnings and the basic generator of growth — why might earnings grow any faster or slower? We'll look at that issue in greater detail in Chapter 13. For now I'll just cover the high points.

There are only two other factors that will affect earnings: expenses and outstanding shares. We'll consider expenses first because they're easier to understand.

Lucy's lemon cost can rise or fall. It can rise because the cost of lemons at the store rises (a bad season in California) or because she has to pay someone to go to the market to get them. Her lemon cost can fall because the store's produce manager gives her a special volume price.

Lucy's labor cost can rise. Charlene had been working for a quarter an hour, but someone put a bug in her ear and told her she should be getting three times as much. She demanded 75 cents, but Lucy talked her friend back down to a half dollar.

Lucy has now started making enough money that her dad's going to have to help her file her own tax return. She's going to have to start saving up to pay for the taxes. So she figures out the profits each week and puts aside a percentage of that to send with her return the following April.

Uncle Harry's share is just like common stock: He simply put money into the business, never expecting Lucy to pay it back. But he is entitled to a third of the profits.

If Uncle Harry had simply lent her the $30 with the expectation that she would pay him back in a year, it would have been a loan, and Lucy's expenses would have included paying him interest on that loan. Harry would then have held a bond rather than a share of stock. The downside to Lucy would have been the requirement that she pay Uncle Harry even when a spell of rainy weather kept the stand closed. The upside would be that she would owe Uncle Harry no more in good times than in bad. All of the extra money she might make from the money Uncle Harry lent to her would belong to her and her father — her original stockholder. Again, this is leverage: making money by using OPM (other people's money).

Lucy might have worked out yet another deal with Uncle Harry for the 30 bucks. He could have given her the money with no requirement that she pay him back. There would be two conditions, though. She would have to agree to pay him a fixed dividend every month as long as she stayed in business. And if the lemonade business folded, Uncle Harry would have first crack at whatever could be salvaged to recover his investment — even before her dad would. But as her profits rose, her payments to Uncle Harry wouldn't. This is the nature of preferred stock. Even though these preferred dividends represent a distribution to a shareholder, they are considered an expense, much as interest is, and they would be paid before Lucy or her dad or any other common stockholders would be entitled to their shares.

But as it is, Lucy now has to split the take not only with her dad, but also with Uncle Harry. So whereas every dollar's worth of profit meant 50 cents each to Lucy and her dad before Uncle Harry came along, it now represents a little more than 33 cents. But thanks to Uncle Harry, the business is now bringing in many more dollars of profit than it would have without his participation, so she's happy to split the profit with Uncle Harry, too.

Any of these things can cause the earnings per share (EPS) to grow at a faster or slower rate than sales. And all of them simply require common sense to understand. Let's apply them to a large company.

As we said, earnings growth is first a function of sales growth. Earnings, over the long term, can grow no faster than sales. Remember, when you look at a company, it's a good idea to understand where that sales growth comes from.

Earnings growth is a function of one of three things: sales growth, expenses, and shares outstanding. (Although tax is an expense as any other, it's dependent upon profits. When you evaluate growth, you'll find it of more significance to consider the profits before taxes have been paid. This will let you look more closely at how management handles the things over which it has some control.)

Expenses

As with Lucy's Lemonade Stand, a large company's variable and fixed expenses can fluctuate up or down for many reasons. Material costs can increase, the cost of labor can rise — all are expenses related to producing the product or service.

In addition, there are fixed expenses, things such as rent, interest on bonds, insurance, management's salaries, equipment leases, and the cost of replacing equipment that has become obsolete or worn (depreciation).

As would have been the case with Lucy if she had borrowed the money from Uncle Harry, fixed expenses have to be paid no matter how good or bad business is.

All of these expenses affect the bottom line. The profit margin is simply the percentage of sales that remains after all of these expenses have been paid. It represents the number of pennies out of every dollar of sales the company gets to keep, to either plow back into the company (retain to equity) or pay out in dividends to the shareholders.

Shares Outstanding

Earnings per share — your portion of the company's profits — are what drive the value of your investment. So, in addition to considering an increase or decline in the profit margin, you must look for earnings growth or decline based on the number of shares among which the profits are divided.

Before Uncle Harry got involved, Lucy had only her father to share the profits with. Now she and her dad have to share them with Uncle Harry, the new shareholder. This is called dilution, because the amount of profit going to each shareholder is diluted when it must be split among additional shares.

If a company sells additional shares, the existing shareholders will see an increase in the equity of the company as the money paid for the stock goes in the bank. But the book value per share will not change very much if at all because the number of shares has increased, diluting the value of that equity for each share. And when the income statement comes out at the end of the period, they will find that the earnings per share will have declined from what it might have been had the shares not been issued.

The issuing of convertible debentures is another consideration. These are instruments that are purchased as bonds — the money is lent to the company — but that may, at a later date and at the discretion of the holder, be turned in for common stock. There's a potential for greater dilution here. When someone decides to exercise the conversion option, the company's obligation to repay the loan will be over, so it will be the same as if the stockholder had purchased the stock earlier. The money is in the bank. Again, however, the number of shares among which the profit must be allocated will have grown to whatever extent those bonds have been converted.

Another source of dilution, especially with new, high-tech companies, has been the practice of issuing stock options as compensation. To be competitive in the labor market, more and more companies have had to offer employees an opportunity to cash in at a later date on the company's growth. However, in recent times, there has been a movement for companies to show these stock options as an expense to the company. This, plus the desire of employees to enjoy the security of a regular paycheck in the aftermath of all the company failures early in the 2000s, has substantially reduced the incentives to follow that practice.

Earnings must be reported both as basic and as diluted earnings. You're interested in the diluted earnings — as are most analysts — because they reflect the result of distributing earnings among all possible shares. This offers the worst-case view of earnings and represents the most conservative approach to assessing the company's performance.

Many times earnings will show growth despite the fact that neither sales nor profit margins have grown. In fact, either or both may have declined. When this happens, there is only one explanation: share repurchase. If a company has repurchased its shares, the opposite of dilution takes place as the company's profits are distributed among fewer shares. You'll find out later how to tell at a glance when share repurchase has caused earnings to grow without accompanying sales growth.

You will also learn how to diagnose at a glance the reasons that earnings and sales are growing at different rates. For the time being, suffice it to say that any difference in the rates of growth can't last forever.

The two must settle into a state of equilibrium eventually, or the company will go out of business. If earnings grow faster than sales, the cutting of costs or the buying back of shares cannot go on forever. If earnings grow at a slower rate than sales, the company will die if management isn't capable of stanching the outflow of money in expenses. And, of course, there's a limit to how much stock a company can issue when earnings per share are declining.

✓ CHECK LIST

Let's Take Stock of What You Need to Know About Growth

- ✓ The value of a stock is measured by the multiple of earnings (P/E) that investors are willing to pay for it.
- ✓ The value of your investment grows when the company's earnings grow at a rate that increases the value of the stock at approximately the same rate.
- ✓ The rate of earnings growth depends upon the rate of sales growth but can, for a limited period, vary above or below it.
- ✓ Earnings per share are affected by expenses and by changes in the number of shares outstanding.
- ✓ You are interested in finding companies that are capable of producing earnings growth sufficient to double your investment about every five years.
- ✓ With this understanding of growth under your belt, let's go on to learn how to identify the companies that can deliver the growth you're seeking.

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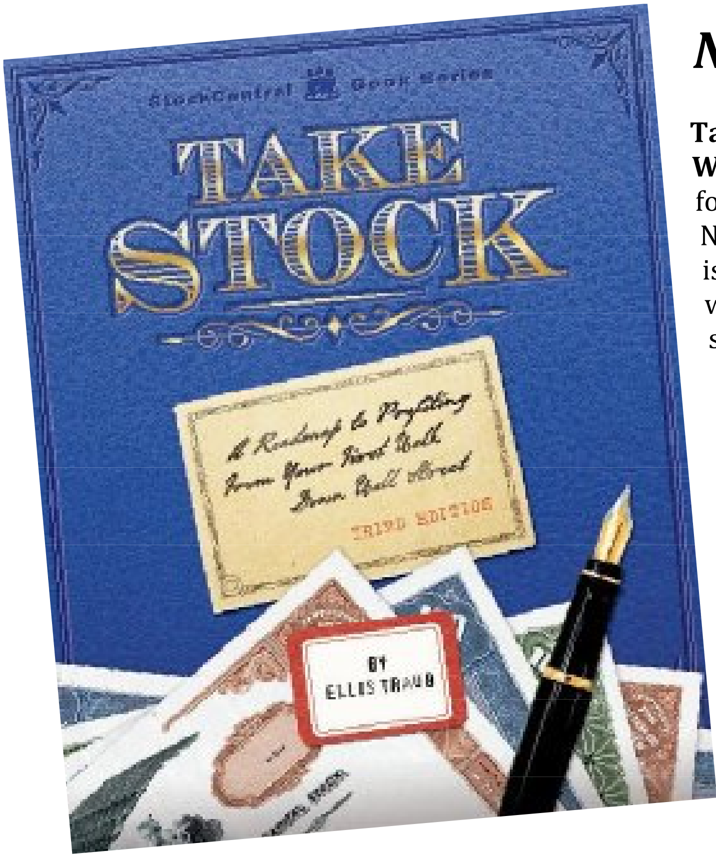

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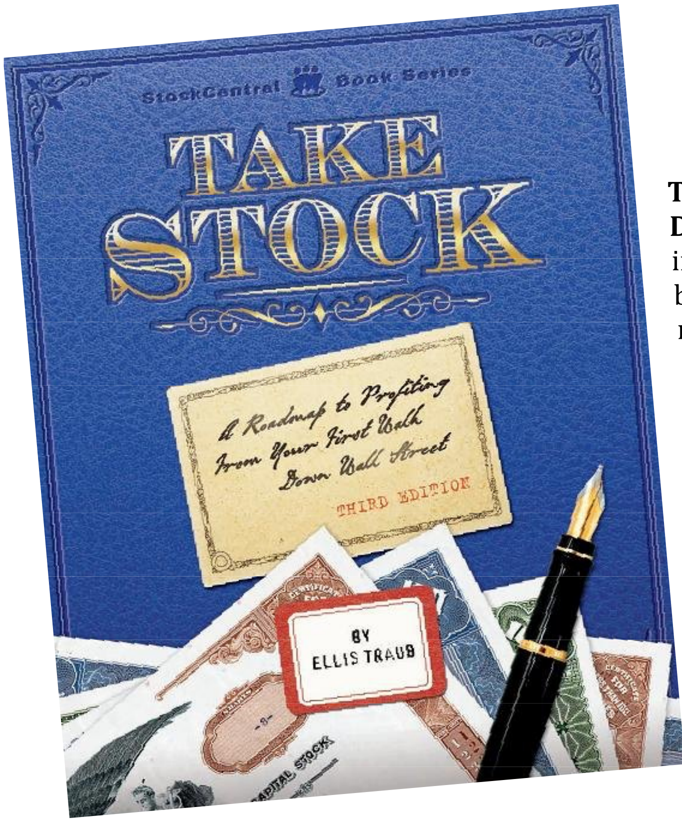

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