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Investor Education Centre

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Beware of growth potential and stick to firms turning real profits

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Last weekend, respected market commentator Bryan Gaynor suggested that the NZ stock exchange needed reinvigoration. He went on to list six stocks "with a strong growth orientation" and suggested that "their success would give a big boost to investor confidence and the NZX".

He concluded that "we need more of these companies listed on the NZX".

I'm all for having more companies list on the NZX. My problem with last week's commentary is that only one of the six profiled companies was profitable.

All the rest had reasonable revenues, and they expected those revenues to grow, but they were nonetheless loss-making. I don't believe that the NZ stock exchange needs more loss making companies to reinvigorate it ... quite the contrary.

Over the years I have seen countless companies with growth potential and a great story that never quite translated into profitability.

One of the first things any investor should look at when valuing a company is its profitability. Without profits, how is an investor to value a business? If you can't determine what a business is worth, how will you know whether it's good buying and how will you know when it is overvalued?

If your valuation is based on what you think a company's worth, the only way you'll make money is by selling to someone whose estimate is higher than yours.

Legendary investor Benjamin Graham (who trained the equally legendary Warren Buffett) reckoned you should look for a company that you can buy for a price lower than the value of its sustainable profits. That way, you'll have a margin of safety and will be more likely to get decent returns.

There are different methods to determine sustainable profits, but essentially you want to estimate what level of earnings you think a company can earn forever. You shouldn't focus just on the bumper years, or the bad years, but consider what a business might earn year in and year out.

Some analysts are content with trying to value a business based on its revenues. They are happy to buy a company if its revenues are growing, on the basis that, all going well, profit growth will ultimately follow. Problem is, profits don't always follow revenues. If a company's expenses continue to rise faster than revenues, then profits will never emerge.

The dot com bubble of 1999/2000 featured internet companies that grew at a spectacular rate and investors valued them at crazy multiples, wanting to get on to the exhilarating technology wave. Few of these companies were profitable or even close to becoming profitable, but their share prices nevertheless reached giddy heights before collapsing.

There is now talk that the future listing of social network companies could precipitate another such bubble, with loss-making Twitter being valued at \$10 billion and Facebook said to be worth more than Ford. But that's another story altogether.

Bottom line, investors and therefore stock exchanges, need profitable businesses. It is easy to get excited about growth potential, but you can't bank hope. You can only bank profit.

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