Next Big Things

Recent excitement surrounding a number of newly-listed or yet-to-be-listed internet stocks has been met with comparisons to the TMT Bubble of the late 1990s. Given the relatively confined nature of the phenomenon, such comparisons appear somewhat exaggerated. However it should be clear to all that the stock prices of companies such as **LinkedIn** or **Pandora Media** embed expectations of exceptionally high rates of growth. LinkedIn traded at $95 a few days after its listing, valuing the company at $9bn, 37 times historic revenues or 19 times estimated 2011 revenues. At $17 per share and $2.7bn in market cap, Pandora Media is valued at 20 times historic revenues and 10 times estimated 2011 revenues. Conservative investors will appreciate the danger inherent in making the growth-assumptions required to invest in any company at a price of 10 or more times revenues. To be clear: there is nothing dirty about growth. Companies with opportunities to invest profitably for growth likely deserve a value-premium. However, few companies are capable of delivering on such a seemingly easy premise.

It is remarkably difficult for a business to maintain high rates of growth for prolonged periods. There are a multitude of economic challenges conspiring against the growth company. Target markets can become quickly saturated; competition can intensify as others seek to share the spoils; and management can struggle to maintain control over the enlarged organisation as it grows rapidly. These and other factors can exert significant downward pressure on high rates of growth. Another crucial consideration is often overlooked: the cost of growth. Companies need to invest incremental capital to grow (additional fixed assets and working capital, etc) and thereby need to retain earnings or incur liabilities to fund these investments. This funding represents an implicit drain on shareholders and as such the investment requires an adequate return to justify. Companies like **Sees Candy** are remarkably rare; most companies will achieve only a cost of capital return on investment and therefore most growth is a neutral (or even a negative) contributor to value. All told, investors face multiple hazards when required to assume that high rates of growth can be sustained.

As always, the conservative investor should concern oneself with ensuring, inasmuch as possible, that one is not paying excessively for the investment and that the performance expectations for the business embedded in the share price are not unreasonable. This is, of course, far easier to articulate than to establish in practice. There are myriad challenges faced by the investor during this process. Notwithstanding this, perhaps simply remembering that high growth is difficult to sustain and that it may not add to shareholder value, can be of assistance to the investor.

This author remembers quite vividly a fairly recent example of a "growth-stock-gone-wrong": **Nobel Biocare**. A brief description of this example might be instructive.

Nobel Biocare claims to be the world's leading producer of dental implants. These are essentially screws covered with a prosthetic tooth that are surgically implanted in the gum to replace lost teeth. The results are spectacular. Not only do the "new teeth" look wonderful, they are essentially fully-functional and supposedly offer health benefits as the presence of the implant allegedly limits bone-loss, which tends to occur after an individual loses a tooth. Technological developments over time have reduced the duration of surgery and made the procedure less invasive thereby speeding patient recovery. The market opportunity expanded greatly and consequently from 2000 to 2004 Nobel's net profits grew at a compound rate of over 50% p.a. Furthermore, the growth potential appeared enormous. Even today, Nobel's closest competitor, **Straumann** claims that within the OECD only 15% of people seeking treatment for tooth-loss are treated with an implant.

I can remember researching the stock in autumn 2004. At this time, dental implant stocks were seen as having amongst the best growth opportunities in the market. Although I admired the company and was enthusiastic about its prospects, the price tag (circa 40 times earnings) seemed steep, so I moved on. From August 2004 to June 2005, the stock added 45%, as earnings continued to increase rapidly. I vividly remember one stock-broker's scorn for my declining his advice to buy the stock, claiming its success had been obvious and that the stock would continue to rise. Yet as of June 2005 the stock was trading at about 45 times prior year earnings and, again trying to be as objective as possible, I couldn't justify investing at that price. The company continued to go from strength to strength and in the two years from 2004 to 2006, sales grew by a compound 24% p.a., with net profits up by 31% p.a. By the end of March 2007, the stock had added a further 70% from the level achieved in June 2005 – the level that I believed had been too lofty. All in all, from when I first reviewed and declined to invest in the company, the stock had risen by about 150%.

At such times, psychological self-flagellation is virtually unavoidable ("*how could I have been so foolish to have missed out?*"). Around the same time an increasingly exasperated peer mentioned to me something along the lines of *"the next time that stock falls 10% I am buying it"*. He had undertaken thorough research but it appeared as though valuation was becoming less of a consideration for him. Hindsight bias (the "I knew it all along" syndrome) can greatly distort one's thinking in such instances, just as it did the scornful broker's. The fact that the business and stock had continued to perform well since the initial analysis was undertaken makes it difficult for an individual to contemplate how an alternative (unfavourable) scenario could possibly have occurred, and by implication, how such an unfavourable scenario could occur in the future. However, the valuation remained extremely high and I still could not justify investing at the prevailing price. In March 2007, valued at about 45 times 2006 profits, clearly the market was expecting the continuation of rapid profit growth. A research note from Goldman Sachs from February 2007, titled "Nobel Biocare: Best in Class Growth to continue in 2007" captured the prevailing mood well, as I remember it.

However, the party was about to end. In the final three quarters of 2007, Nobel's stock declined by more than 30% as it became clear that the profit growth rate was decelerating. In 2007, sales and net profits increased by "only" 11% and 5% respectively. And as underlying weakness in the global economy became more apparent, the stock continued its freefall, losing another 60+% in the course of 2008. Nobel's business performance had deteriorated dramatically, with sales in 2008 down 7% from the 2007 result, and net profit down by more than 30%. From December 2008 to August 2010, the stock declined by a further 20+%, as the business continued to perform poorly. 2009 sales declined by 6% and net profits by about 3%. Worse was to come in 2010 with profits falling by over 50%. Unsurprisingly, the operational deterioration was reflected in the share price. From its approximate peak in March 2007 to June 2011, the stock has declined by about 80%. This roughly coincided with a cumulative decline in sales and profits over the four years from 2006 to 2010 of about 4% and 70% respectively. In the circa seven years since my initial research into the company the stock has declined by about 50%, compared to an overall decline in net profits of about 40%. Contributing to this outcome were significant, value-destructive share buybacks in the 2005-2007 period as the stock was approaching its highs. Some growth opportunity, eh?

What had caused the significant deceleration in growth at Nobel Biocare? There are probably multiple reasons. The global recession undoubtedly impaired customer demand. Perhaps increased competition from rivals exacerbated this. The restricted availability of cheap credit may have had some detrimental impact post 2007. There is also evidence of deficiencies in the marketing strategy and management instability[1] (the company has had three different CEO's during the 2004-2011 period). In one sense, the reasons are not important. For most companies, growth can be derailed by any number of factors. If the price an investor pays to acquire an interest in a company necessitates the continuation of a rapid rate of growth, then one should have very good reasons for believing why the growth is sustainable, and that it will come at a cost that is not unreasonable. Otherwise one is placing capital at undue risk.

The example of Nobel Biocare is not designed to boast: I had no great insights into the business and was certainly not to know what would happen to the business or the stock. It is just one example and does not prove anything. However it does illustrate what *can* happen when business results fail to match the high expectations of investors.

Those fortunate enough to have bought and sold Nobel Biocare before the unravelling may well have made a sizeable profit. However this apparent success was likely due to fortuitous timing rather than skill and such luck cannot provide a sustainable benefit to investment returns.

In my opinion, the stock market, like life, is filled with uncertainty. For each company considered by the investor there are almost infinite potential outcomes and attached probabilities. The challenge for the analyst is that not only does he not know what the probabilities are; he doesn't even know what each of the potential outcomes are. For this reason every single investment brings risk to capital. We can probably best try to protect capital by conducting thorough research, satisfying ourselves that that the economics of the business are reasonable and that the price of the stock reflects expectations that are not excessive. It is then that we are perhaps best positioned to attain a margin of safety. This approach should apply whether the company in question is growing or not.

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[1] Bloomberg interview with former CEO Scala, Feb 11th 2008