Get down, dig for a fortune

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It is virtually impossible for any company to attract new investors if it offers absolutely no earnings growth. Growth is the drug of the market and once a company loses its earnings growth, it has effectively lost its appeal. Investors will dramatically de-rate the company, selling its shares and heading to the exit door en masse.

Matthew Kidman. **Photo: Michele Mossop**

For a company to be recognised as a growth stock, the market must feel comfortable that, over the long term, the company can grow its revenues and profits at a much higher rate than the prevailing general economy and the overall market. Commonly, growth stocks post revenue and profit growth of around 20 per cent, or possibly higher, each year.

Most investors who buy these stocks have great expectations that this level of expansion will continue into the foreseeable future, and so they are willing to pay for this by placing a steep price-earnings multiple on the stock.

A growth stock can come from anywhere in the market, but it tends to emerge from industries that have low barriers to entry (such as retail, or industries where a company has a niche, such as in medical devices or technology).

The best time to get into a growth stock is before the rest of the market has had time to discover it. That sounds great in theory but it is harder to achieve in reality.

To achieve this goal you must be prepared to get down and dirty, and look at stocks that are much smaller than many of the blue chip names that your financial adviser is willing to recommend. In addition you must have a sense of vision, because you are banking on growth down the road, which most of us find difficult to see. This kind of investment also has a large degree of risk attached.

Over the years, most growth stocks I have discovered in Australia have been nestled in the retail or technology markets.

In the retail game the headline acts in recent years have been electronics group JB Hi-Fi, car parts outfit Super Retail, and discount company The Reject Shop. Investors love these stories because you can accurately extrapolate earnings into the future. Once a retail chain has a footprint of stores and the concept is proven, investors can then work out how many shop fronts the company can roll out across Australia and possibly New Zealand.

For example, a company may have 50 stores operating when it lists on the sharemarket. The management tells everyone that it can deliver 300 stores over the course of the next seven or eight years without having to raise any new capital from the market. Investors listening to the story will try to work out whether the concept is sustainable, and then wait for some financial results for confirmation of the story.

If the company's earnings meet, or even beat, prospectus forecasts, investors will start to get on board. They begin to believe in the concept and figure that if the company can earn $10 million from 50 stores they should be able to earn six times that with 300 stores. Investors also start to build into their financial modelling store revenue growth of 4 per cent a year, which gives earnings a nice little kicker. That all adds up to a major re-rating of the stock.

As the company rolls out its stores and shows profit growth of 25 per cent a year, the P/E can go from its starting position of 8 to 12 and eventually 20, by the time the whole market has woken up to the fact that a party is going on. For an investor, this is the sweet spot because you are getting the double whammy of earnings growth and P/E expansion.

Initially the company earned $10 million and traded on a P/E of 8, meaning it had a market capitalisation of $80 million.

Five years on, the company prints a profit of $60 million and its P/E has ballooned to 20, and the market capitalisation will inflate to $1.2 billion – a gain of 1500 per cent for those who were set in the stock at the beginning.

Once the P/E ratio ratchets up to nose-bleed territory, investors should be aware that further multiple expansion will be tremendously difficult to achieve.

This story has unfolded on numerous occasions in the Australian sharemarket. Despite knowing the life cycle drill I have managed to miss some eye-popping performers, such as JB Hi-Fi, Flight Centre and Super Retail. One stock that I do remember fondly, though, was furniture retailer Fantastic Furniture.

Fantastic floated in 1999 after the company was bought out of administration by Julian Tertini and Peter Brennan, both experienced and sharp operators in the retail sector. The company's float was being underwritten by small Perth-based stockbroker Hartley Poynton at the top of the tech boom.

The market was extraordinarily volatile at the time, and no one was really interested in companies that didn't have a whiff of technology, media or telecommunications. Because Fantastic was a manufacturer and retailer of what was categorised as cheap and nasty furniture, it was forced to list on a P/E ratio of just 8, compared with the overall market rating of around 15.

In a bid to muster institutional interest in the float, Hartley Poynton organised a site visit to Fantastic's manufacturing facility in the west of Sydney.

My contact at Hartley Poynton told me that around 10 institutional investors from Sydney and Melbourne would be on the trip and insisted that I be on time, as the bus would be chock-a-block and it was a tight schedule. Taking his advice, I arrived 10 minutes before departure time, even before the bus had arrived. Eventually the bus turned up with two people on board.

Both were from the underwriting stockbroker firm. I clambered on board to get a prime seat up front so I could try to avoid my motion sickness affliction. I sat and waited and just as the departure time arrived, another fund manager – Graeme Burke from Colonial First State – arrived.

An hour later we arrived at the site. We met the managing director, Julian Tertini, and his offsider, Peter Brennan, who were both pleasant and seemed to have detailed knowledge of the discount furniture market. We then went down to the factory and watched the company workers assemble lounges that were being made to be trucked off to one of 20 or so retail stores across NSW.

While it seemed like a somewhat backward, manual process, we were stunned to learn that a lounge could be built from start to finish in just seven minutes. Graeme Burke and I looked at each other without saying a word, but nodding as if acknowledging how impressive the whole process was.

During the walk around the factory, Julian made it clear that they would have to consider putting on a second production shift because demand for Fantastic's products was firming.

On the way back to the city I scanned the numbers in the prospectus and saw the following. The company had net cash on the balance sheet; a return on equity well above 20 per cent; and an ability to roll out four times the number of stores over the next five to 10 years. This inviting combination was being floated on a P/E of just 8 times prospective earnings.

If memory serves me correctly, only two Australian institutional investors, including us, were on the register when the company announced its top 20 shareholding to the market. The rest was made up of management, staff and retail investors. The company went to market with an issue price of 50¢ a share, only to slump in the first two weeks of trading to 42¢ a share. Market sentiment had turned sour and new floats in that arena usually were being spurned by investors, who thought the furniture was ghastly, unable to comprehend who would buy it. In addition there was no corporate history to rely on.

I have found over the years that professional fund managers are poor judges of what sells to the general public, mainly because they spend their money on products generally out of reach of the average family.

Fantastic's P/E ratio fell below 7 and we decided to buy more on the proviso that my boss Geoff Wilson could meet up with management, which I organised with alacrity.

Soon afterwards, market sentiment improved and the stock managed to climb back up to its issue price as sellers took time out.

The love affair with technology was souring and investors were seeking out value in the industrial market for the first time in several years.

In the coming days we met the management team and Geoff agreed with me that they seemed like good operators and the stock was cheap. He shocked me by deciding to buy more shares. Eventually the company released its first set of results and, while they didn't shoot out the lights, they were slightly ahead of the prospectus numbers. That is all it took. With the tech wreck in full swing, investors had turned 180 degrees and were desperate to discover cheap industrial stocks that actually earned a decent return on capital.

Suddenly Fantastic was on the radar. In the end we were able to sell most of our stock at around $1.40 a share, happy with the result and in deep gratitude to the management team that did a fabulous job.

The share price kept motoring along to hit $2.80 as the market became enamoured with the store rollout and the returns being generated (see graph).

The company was trading on a P/E of close to 20 within a couple of years, and I still regret that we sold so early.

Matthew Kidman is a former analyst, portfolio manager and chief executive with Wilson Asset Management and author of two books: Masters of the Market and Master CEOs.

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