A SELECTION OF PUBLISHEDARTICLES

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NOTE TO READERS:

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Improve Your Investing Decisions

By Zeke Ashton
September 4, 2001

Investing is one of those activities that can be deceptively simple. There are probably as many different investment approaches as there are investors, and there are, of course, an infinite number of factors, opinions, and analytical tools that one can use or ignore in making investment decisions.

But no matter what investment style and philosophy you follow, it may be helpful on occasion to take a step back from the information overload of the media and the cacophony of the market and remember that at its very essence, investing is about taking control. To my thinking, there are only four things about investing that you can control. Three of these control variables are concerned with buying. Only one of them has to do with selling. Before discussing further the ramifications of these four control elements for investors, let me first lay them out for you.

1. Which stock to buy
The first variable is the choice of which company to invest in. There are over 10,000 choices on the major U.S. exchanges, ranging from heavyweights like **Coca-Cola** (NYSE: KO) to struggling upstarts such as **Amazon.com** (Nasdaq: AMZN) and everything in between. Of course, one can also choose to buy baskets of companies -- rather than individual ones -- through index funds, mutual funds, or any of the other investment vehicles available out there. And of course, one can decide not to invest as well. Nevertheless, the first decision takes place when an investor decides on a stock he or she wants to buy.

2. What price to pay
The second decision an investor makes is at what price he or she would be willing to buy that company. Note that if the answer is anything other than "the currently quoted price," you have no control over whether you will actually get to act on this decision. Nevertheless, you are in control. The company may never hit your predetermined price, in which case you may either decide to do nothing or to modify your price. If the company you've decided you want to buy hits the price that you've determined you are willing to pay, there is one final variable in the buying process.

3. How large a position to take
How much money should you allocate to this company at this price? Whether you are running a $100 million mutual fund, a $100,000 IRA, or a $10,000 portfolio in your Ameritrade or Datek account, this is a key decision. Whether you think of it in terms of dollar amounts ("I'll take a $500 flyer" or in percentage terms "I'm comfortable with 10% of my portfolio) you need to decide how much of a plunge to take.

Those are the three buy-side decision variables. Once you've decided upon the company, the price, and the amount, you've navigated 75 percent of the investing decision cycle. At this point, there is only one further action you can control.

4. Hold or sell at the current price
Whereas on the buy side you can choose to buy *if* your company hits a certain price, thus providing you with control (i.e., I will buy at Price X, I will not buy above Price

X), the sell side is different. You already own the stock. Therefore, your control over the sell decision is limited to whether or not you will sell at the prevailing market price. Sure, you can set a theoretical price target by saying "I will sell when it goes up to $75." But the price may never get there, and if it doesn't, at some point you will be forced to make another decision: to continue holding in the hope that the stock will actually ever make it to the price target that you've set, or to sell at the current price. Therefore, once you own the stock, you really have only two choices: to hold it with the expectation that it will go up at some point, or to sell at the prevailing market price.

Now that we've identified the four decision factors that make up the full investing cycle, what can we gain from them? First of all, I'd guess that many investors are stronger in one or two particular areas, but may be undermining their success to some degree by being weak in another. Accordingly, I encourage you to do a postmortem analysis of some of your recent investment decisions.

Do you seem to be prone to investing in companies that appear to have promising prospects but then fizzle away, leaving you with little or none of your original investment? You may need to spend some time learning to identify high-quality companies. You may be a sucker for a good story, or quick to pull the trigger on a company with promising technology but not the best business prospects.

Maybe you pick strong companies that are among the leaders in their markets, but always seem to buy them at close to the 52-week high price. You may need to work on valuation issues, the dynamics of business cycles in a particular industry, or simply on being patient and waiting for your price.

If it appears that you aren't getting optimal returns because you invest too little in the companies that go up and too much in the companies that go down, you will probably find it helpful to spend more time thinking about how much of your portfolio to allocate to each new purchase.

Finally, if you are prone to selling due to fear or boredom, or if you find yourself holding stocks long after it has become apparent that your original investing thesis was flawed, you may need to spend time to create a sell strategy that you are comfortable with. Careful review of how you make decisions in each phase of the investing cycle should allow you to improve your overall investing results. I have found this "back to basics" approach to be very helpful in creating an investment process that I can trust. I hope you find it helpful as well.

Zeke wrote this column after six months of intensive shock therapy with that psychologist from the TV series "The Sopranos." Or maybe that was one of his frequent hallucinations. Zeke doesn't own shares in Coca Cola or Amazon.com. The Motley Fool is investors writing for investors.

Buy Cash Flow

By Zeke Ashton
January 28, 2002

In this space, we spend a lot of time writing about how to invest in small-cap growth companies. But you should know that the Motley Fool strategy is just one way of investing in small capitalization companies. For one thing, the TMF criteria are so heavily weighted towards growth in sales and earnings that only the very fast-growing companies with a lot of stock price momentum will ever make the list. These tend to be risky stocks, but if you are lucky enough to find one of those big percentage winners every couple of years, it makes up for a lot of dogs.

Perhaps like many of you however, I find myself less inclined to run such a high-risk portfolio these days. Oh, I still look for (and occasionally find) high-growth small companies that I think are worth taking a position in. But I have also found that investing in small-cap companies that don't feature the eye-popping growth but that do generate a lot of cash and grow that cash flow consistently often sell for much more reasonable prices than their high-flying counterparts. It's also my conviction that these companies offer much less risk, both in terms of the risk of overpaying for the stock and operationally. Even better, if you pay a low multiple to that cash flow, you're going to have a good chance of getting a decent return on your investment.

It's important to remember that when discussing cash flow, I'm talking about free cash flow -- that's the cash from operations minus any capital expenditures that the company needs to make to maintain and grow their businesses. This information is found on the statement of cash flows, which most companies still don't put on their quarterly press releases, but which you can find in their quarterly 10-Q filings, and which are also now available in the company profile on Yahoo! Finance.

The operating cash flow can be found in the total labeled as "cash from operating activities." The capital expenditures can be found under "investing activities," and will usually be labeled as "additions to property and equipment" if the term capital expenditures is not used. Just subtract the capital expenditures from operating cash flow, and you've got free cash flow. You'll want to check cash flow for the last couple of years to make sure that the most recent reporting period is representative of the company's true cash-generating capability.

Cash-on-cash returns
Say you find a company with a market cap of around $100 million. If you look at that company's cash flow statement, and you find that it is generating $10 million a year in free cash flow, then the cash return on that investment is 10%. Now, 10% is probably the minimum that you would expect from your stock market investments over time, so that's a pretty good place to start.

If you can find a company that consistently generates free cash of $10 million and only has a market cap of $50 million, that's a 20% cash-on-cash return. Of course, companies that are growing rapidly probably won't be selling for 10 times free cash flow, while companies that aren't growing at all may sell for less. The best deal of all is when you come across a company that a) generates a lot of free cash flow, b) is growing that cash flow at a reasonable rate, and c) is available at less than 10 times annual free cash flow.

Also, you have to remember that unless the company pays out all that cash flow to investors in the form of a dividend, you the investor aren't going to see the cash directly. However, if the company's management has any ability at all, they will be able to use that cash to increase the value of the business by re-investing in the business or by making small acquisitions. Alternatively, good managers may elect to return the excess cash to shareholders by paying dividends or by repurchasing stock.

Mission impossible?
Sounds impossible, huh? Such bargains don't exist, right? Well, I think you'd be amazed at how often such stocks pop up. The problem is that most of the time the companies will be very small -- most likely in the sub- $150 million market cap range.

This is true because a company with that kind of cash flow at such a bargain price wouldn't be able to escape the eyes of institutional investors for long, and therefore the price will be bid up very quickly once discovered. But just as the best fast-growing small caps are purchased at low daily dollar volume levels, which make them too illiquid for all but the smallest institutional players, the best bargains in small-cap cash flow generators are going to be in the smaller market cap ranges.

The risk of small companies
Most of us just assume that a small company is a riskier investment than a large company. Intuitively, it just seems like it would be easier for a tiny company to run into problems and go under than it would for a larger one. There is some truth to this; I personally believe that smaller companies have higher business risk than many larger companies.

The beauty of buying cash flow is that it is very difficult for a company to totally implode if there is more cash coming in than going out. If there is a lot of cash coming in, then even the poorest management almost can't help but figure out some way to increase the value of the business. Even if they use a lot of it to give themselves big raises, throw lavish parties, and commission oil portraits of themselves for the company boardroom, they will usually at least raise the dividend a bit or buy back some shares to keep shareholders off their backs. If company management owns a decent percentage of the company stock, then chances are even better that the cash flow will find itself coming back to shareholders in one form or another.

In short, buying cash flow at good prices by finding small-cap companies that trade at less than 10 times their demonstrated annual cash earning power will diversify and most likely lower the risk of your small company portfolio.

When Your Stock Gets Clobbered

What should you do when your favorite stock loses 30% or more in one day? While the temptation to sell first and ask questions later is sometimes strong, don't panic. First, gather information on why the market is selling your stock. Next, re-assess the business in light of the new stock price -- you might find that your best move is to buy more.

By Zeke Ashton
November 12, 2001

If you invest long enough, you'll experience one of those days. A stock in your portfolio, one you researched long and hard, one that you've grown to love, gets absolutely hammered one day. I don't mean the 10% drops. I'm not talking 15%, or even 20%. I am talking about those days when the market just drops your stock like a hot rock on news that you never saw coming.

Usually it's a press release, sharing the news that sales won't be what management forecast so confidently just a couple of months before. Or maybe it's a new drug that was sure to be the next big growth driver for the company -- delayed, not approved, or with sales that disappoint. Or a one-time charge for something that had never even been discussed in a conference call -- an investment gone bad, some mysterious "one-time" charge that will just murder earnings, or some such. Sometimes it's information shared at the quarterly earnings call -- guidance for future revenue slashed, or news that a corporate partnership deal isn't panning out.

It can be an infinite number of things. And the result is panic selling -- and your stock is down 30%, or 40%, or even 50% in one day. What do you do?

Don't panic
The first piece of advice I have for you is the same as you'll hear in any stressful situation -- don't panic. Don't sell just because you see that you've lost a third of your money in four hours -- the market often makes snap judgments about new information -- selling first and asking questions later. Selling might be the absolute worst thing you can do.

Gather information
Try to get as much information as possible about the situation -- this is the first step. If the information that caused everybody else on the planet to sell your stock was released during a quarterly earnings call or press release, then by all means, read the release. Carefully. Listen to the conference call for clarification. How did the company managers communicate the information? Are they answering it in an informative way? Do you get the feeling they should have seen it coming? If the information was released as an earnings warning, without additional information, I again recommend carefully assessing the information. Often, these are the most frustrating cases, because there often isn't enough information presented to determine exactly what the long-term damage will be.

Re-assess the business in relation to the new stock price
This is the most important step. Before your stock imploded, you had a business that

you (hopefully) understood well, and the stock was (hopefully) trading at a price that you felt was reasonable and allowed substantial room for appreciation. (If neither of these two conditions applied, you had no business holding the stock!)

Now, you have a business with some new information -- you must make the effort to incorporate the new situation into your assessment of the business. Is the recent event short-term in nature, or does it reflect a fundamental deterioration of the business?

Sometimes, the stocks of all companies in a similar industry or sector get hammered because of bad news that is not specific to your company. This "sympathy" effect can be hard to evaluate -- if your stock is down on bad news for the industry as a whole or on news of a competitor, you have to come to some conclusion about whether (and how much) that hurts your company's prospects. Often, these scenarios that aren't specific to your company are those where the biggest opportunities are presented.

Once you've reviewed the business and made your judgment on the effect of the new information to the value of that business, it's time to look at the new stock price. Was the sell-off an adequate reflection of the value lost by whatever development that took place, or is it an over-reaction?

Forget what you paid for the stock -- would you buy it at today's price?
Now we come to the hardest part -- forgetting what you originally paid for your shares. That's no longer relevant, but psychologically it's tough to get past. You have to, though -- otherwise, you cannot objectively evaluate the "new" stock idea; same stock, different circumstances, different price. You can be sure that there are many investors that make a lot of money by identifying stocks that the market has over-sold over short- term worries.

Pretend you are looking at the stock for the first time -- if you would buy it at today's price (if you didn't already own it), then you should hold on to your shares. If you would sell it at today's price, then go ahead and sell (at least you may get some tax losses to offset your gains). The toughest decision is whether to buy more. If the stock is now a tiny percentage of your portfolio and you are convinced that it's a great investment, go ahead and add to your position. If the stock (even after the haircut) still represents a large percentage of your portfolio, then it's probably a good idea to hold off adding to your position.

No matter what you do, remember this isn't an exact science. Take your time, be rational, and most of all, don't let your emotions get the best of you.

Zeke Ashton writes for The Motley Fool Select and the Foolish 8 column. The Motley Fool has a disclosure policy.

FOOL ON THE HILL

Beware the Grand Theory

Many smart investors and money managers employ theories adapted from physics, biological systems, chaos theory, and other complicated top-down methods in an effort to beat the market. Often, this only results in making the difficult task of finding great investment ideas only harder. The great investors, such as Warren Buffett and Walter Schloss, spend their time looking for cheap stocks, not cosmic theories, to beat the market averages over time.

By Zeke Ashton
May 22, 2002

One of my favorite mutual fund companies is called IPS, which manages a small family of three funds. But it's not their stock-picking prowess that interests me -- I don't have a dime invested in any of their funds. And it's not because I've learned a lot about investing from their website (though it is extremely informative.) Rather, it's because they are *funny*.

If you don't think it's possible that a mutual fund website can be every bit as entertaining as a good *Saturday Night Live* skit, take a minute to head over to their home page. Click on one of the funds, and hit the link that says "Risk Disclosure: Human Language." Prepare to bust a gut laughing -- no, really, this stuff is *hilarious.*

The website is very different from those of most mutual funds. For one thing, the portfolio manager posts a diary describing what he is buying and selling and why. There's a lot of other good stuff on the site as well. IPS projects a smart yet fun-loving image, and makes an effort to really include their investors and make them feel almost like a part of the organization. They've even got a fund where they let the customers make the investing decisions. I've got to say, it's darn refreshing.

I bring up IPS Funds today because, while I am entertained and charmed by the company's website, I don't think the IPS funds will be better investments than your average mutual fund. The head honcho at IPS Funds is a likeable guy named Robert Loest, who has a Ph.D. in biology and likes to rollerblade. Here's his bio from the site.

Robert Loest is a biologist and models the economy using **Complex Adaptive Systems *(CAS)*** *theory. A good analogy of a CAS is a biological ecosystem. Such systems tend to behave in very different ways than those predicted by classically trained economists and financial people who view the economy as a complicated machine. Applying CAS to stock selection often results in radically different ways of understanding the economy, the behavior of securities in the economy, and in understanding and explaining the process of value creation.*

Here's a little more about how IPS looks at things from their "Philosophy and World View" section, which begins with:

When you buy a stock, you are placing a bet on the future. *A manager without a view of the future is handicapped from the start.* ***IPS Funds'*** *management believes its view of the future is the major determining factor in its performance, and that you should understand it before you invest with us.*

That sounds reasonable enough. But it gets a little bit complicated after that. Due to space constraints, I'm going to have to edit out some stuff here, as dangerous as that might be. Here are some selected excerpts from the company's explanation of how they view the capital markets.

We believe the world is entering a period of rapid transition to a higher level of "connectedness." We believe this phase shift will be more extreme, and occur far faster, than any previous change in history. We expect new, complex, emergent behaviors to result from this phase shift. We believe that extensive, broadband connectedness in our civilization has attained a momentum that makes similar complex, emergent behavior in humans inevitable. For those who see this coming, there are obvious investment implications.

*Our view of the world is conditioned by the models, metaphors, or paradigms we employ to interpret reality. Most money managers, in our opinion, use models that are rapidly becoming obsolete. At **IPS Advisory** we believe that classical economics, and many investment assumptions that derive from it, are based on a fatally flawed model, that of Newtonian mechanics, that assumes a universe where things are predictable, unchanging or static, reductionist and mechanical, where output is proportional to input. It is only due to an accident of history that economists adopted such an inappropriate model. The biological model first described by Darwin is, we believe, far more appropriate in describing economic systems, but was unavailable at the founding of economic theory.*

*We use what we have termed **Evolutionary Ecosystem Mechanics (EEM)** to describe how we view economic systems (*ecosystems*!). The advantages of this model over classical economics are overwhelming. Classical economics does not explain how corporations move up the learning curve, which is a biological concept. It doesn't explain how this can determine the dominant companies during periods of rapid technological change when many industries have been forced back to the beginning of new learning curves. **EEM** describes the interactions of human societies and economics much better. For example, unlike classical economics, **EEM** predicts complex, dynamic, evolving systems with multiple, interdependent feedback loops. Such systems typically are highly stable, but dynamic and uncontrollable. When such systems are perturbed, they respond in unpredictable ways, but always attain a new equilibrium. A natural property of these systems is that they move toward greater complexity and interdependence, which is what we are seeing in most industrial sectors today, from airlines to Internet software companies. Classical economics does not predict such dynamic, evolving systems, and is especially useless during times of rapid change.*

OK, I think you get the idea. If this weren't complicated enough, IPS also incorporates Stern Stewart's Economic Value Added analysis in their investment decisions. As you can see, these guys use some impressive-sounding theories to help them figure out where to invest money.

I used to be really impressed by brilliant people with impressive sounding theories of investing (maybe because I've never come up with one.) Now I'm just skeptical. The results of these impressive theories are often less than impressive. Readers should carefully consider the case of Victor Niederhoffer who, back in the mid-'90s, wrote a best-selling book. It was mostly about how smart he was and how he used theories of biological systems or physics or modern game theory or some such mumbo-jumbo to make bets in the capital markets. Everyone seems to agree that Niederhoffer is a real smart guy, but real smart guys have a tendency to make investing more complex than it needs to be -- and that can get them into a lot of trouble. Niederhoffer blew up his hedge fund in 1997 and lost everything. He now writes investing articles, the best of which share a common theme of how hubris leads to bad endings, though he is still tinkering with some atomic theory of markets (or something).

The problem is that layering one of these multi-variable cosmic theories like Complex Adaptive Systems or Atomic Theory or whatever over the already difficult task of finding great investments is just so... well, *hard.* Let me quote from a section of the IPS Millennium Fund's 2001 annual report to shareholders:

The strength, and the major weakness, of our management style is that we rely normally on adverse stock price movements that are at odds with publicly available information, management statements, and favorable analyst opinions, as an early warning that something is wrong with a company. Historically this has often gotten us out of stocks well ahead of the eventual negative news, and saved us a great deal of money. Unfortunately, drastic and rapid market declines such as we experienced in 2001 mask the signals that we normally rely on to get out of stocks before disaster strikes. We did not recognize that worse was to come, and failed to move our sell stops up soon enough to avoid some major losses in our aggressive stocks.

See what I mean? Complex Adaptive Theory, or whatever it is, may be perfectly valid, but it's probably really, really hard to apply to the stock market.

Everything I have ever read about Warren Buffett suggests to me that he spends his time looking for undervalued companies and doesn't spend much time thinking about cosmic theories or trying to predict interest rates or other economic variables. Another of my investing heroes, Robert Olstein, has a great saying: "Spending ten minutes a year predicting economic variables is a waste of ten minutes."

Value investing legend Walter Schloss has spent almost 50 years buying dirt-cheap stocks and compounding money at 20% annually. I've never met the man, but I'd be willing to bet that Walter Schloss hasn't spent the past 50 years trying to detect some mysterious signals that might indicate that it's time to get out of stocks before he loses money. Instead, he buys stocks so cheaply that it's almost impossible to lose a lot of money.

The stock market is a pretty complex system. Those who have beaten it have generally used simple approaches that require discipline and patience, but not grand theories. As for IPS, I'd like nothing better than for them to succeed. But I suspect that if they do, it will be because they learn how to buy undervalued stocks and not because they understand complex adaptive systems.

Zeke Ashton did not own shares of any IPS mutual fund at the time this article was written. The Motley Fool is investors writing for investors.

FOOL ON THE HILL

Trust This Fund

Finding a good mutual fund isn't easy. Hidden fees, manager turnover, and the irrational behavior of other shareholders can really hurt returns. But there are some great funds out there. The Longleaf Funds has a strong track record and a business philosophy that forges a long-term partnership with investors.

By Zeke Ashton
September 25, 2002

I'm not big on mutual funds, as a general rule. You have to look out for hidden fees: Redemption fees, 12b-1 fees, loads, and transaction costs all take a cut out of your hard-earned investment money.

Index funds are often a better choice. On the one hand, at least you'll get the market average grade without paying all the frictional costs. On the other hand, I'm not sure people are going to be very happy with the average stock market grade for the next several years.

As you might imagine, I am a big believer that the serious individual investor has a great chance, especially in this environment, to outperform most large, actively managed funds. But not everybody has the time, temperament, or interest to do the amount of work it takes to run a 10- or 20-stock investment portfolio. Even for those who do like to manage their own investments, it's not a bad thing to have some money allocated to a good mutual fund or two. Fortunately, there are some great mutual fund companies out there, if you look hard enough.

The Longleaf Partner fund family, managed by Southeastern Asset Management, is one mutual fund company that gets it right. Southeastern Asset Management was founded in 1975 by its current chairman, Mason Hawkins, along with three partners. For the next dozen years, the company built a reputation as shrewd value investors by managing large, private-client portfolios with a value-oriented philosophy.

It now offers three funds: the large-cap Longleaf Partners Fund, the Small-Cap Fund, and the International Fund. All have been outstanding performers over the years, and all are ranked four stars or above by Morningstar.

A mutual fund should be a partnership
You get an inkling that this is a better kind of mutual fund when you open the Longleaf prospectus. Instead of boilerplate language, it first describes the company's investing philosophy and process in two paragraphs of plain, easy-to-understand English. Then investors are treated to Longleaf's governing principles. And, really, these principles tell you pretty much all you need to know about the Longleaf Funds. Here are the first two:

- We will treat your investment in Longleaf as if it were our own.
- We will remain significant investors with you in Longleaf.

Southeastern Asset Management introduced its Longleaf Partners Fund in 1987 in order to allow its managers to invest alongside its clients. According to Hawkins, fund investing "should be a partnership between the people managing the money and the people investing in the funds." It is a cornerstone of the company's philosophy that their own money ride beside their investors'. And this isn't just talk.

Here's another excerpt from its prospectus.

To align our interests with those of shareholders and prevent conflicts of interest, our Code of Ethics requires all employees to limit their investments in equities to Longleaf Partners Funds, unless granted clearance by a compliance committee.

Another sign of its commitment to invest along with its shareholders is that its employees are also required to invest 100% of their bonuses and profit-sharing payments in the firm's funds. This is beyond extreme, but many large mutual fund companies have been fined by the SEC over the years as a result of portfolio managers making trades in their personal accounts that created alleged conflicts of interest.

As you might imagine, Southeastern Asset Management isn't one of them. And the employees don't seem to mind the restrictions. Today, Southeastern Asset Management has over $18 billion in assets under management, and employees have over $175 million invested in the three Longleaf Funds.

I believe that it is hugely important for a fund manager to have his or her own skin in the game. Not only does this provide a strong incentive for the manager to perform, but just as importantly, there is a strong disincentive for poor performance or excessive risk.

Making money with investors, not from them

Another Hawkins saying is that a mutual fund manager should "make money with its clients, not from them." Of course, every mutual fund needs to charge a reasonable asset management fee from its investors. But many funds are loaded with hidden charges.

Here's another principle of the Longleaf Funds:

- We will not impose loads, holding periods, exit fees, or 12b-1 charges on our investment partners.

Many of you have had the experience of calling to redeem shares in a mutual fund, only to find out that your fund takes one last cut of your money just for the privilege of giving you your money back. In addition to eliminating such hidden charges, Longleaf has actually reduced its asset management fees as its assets have grown. Each of the Longleaf Funds started out with a 1.5% total expense limit, which included asset management fees of 1.00% annually. Today, the Longleaf Partners Fund total expense ratio is less than 1.00% annually, of which asset management fees comprise around 0.77% per year.

Looking for the right investors

A fund's performance is almost as dependent upon the composition of its shareholder base as it is on its managers' skills. The next four principles of the Longleaf Funds are concerned primarily with attracting and cultivating long-term investors and discouraging "hot money" investors and market timers who jump from fund to fund.

- We will discourage short-term speculators and market timers from joining us, the long-term investors in Longleaf.
- We will continue our efforts to enhance shareholder services.
- We will communicate with our investment partners as candidly as possible.
- We will consider closing the Funds to new investors if closing would benefit existing shareholders.

Again, what's important here is not that the company writes this stuff down in a prospectus somewhere and forgets, but that these principles are taken to heart.

Southeastern Asset Management is one of the few fund groups that hold an annual meeting (just like a publicly traded company). Shareholders are given a chance to talk to the people who manage their hard-earned money and to ask questions. The company's shareholder reports are straightforward and informative, and investors are given every opportunity to understand the fund's investment approach.

It doesn't hesitate to close its funds to new investors when it is having trouble finding attractive investments. The Longleaf Partners Fund has been closed at times in the past, and the Small-Cap Fund has been closed to new investors since 1997. The company also monitors its investor base carefully for signs of short-term flippers. If an investor of size sells within three months of buying, that investor is not permitted to buy Longleaf Funds again.

A consistent investment approach
There isn't much turnover at Southeastern Asset Management. There are only eight investment analysts and portfolio managers, and most have large ownership stakes in the business. Its investing philosophy hasn't changed much in the past 25 years: They look for good businesses, run by good people, and won't pay more than 60% of what they think the business is worth.

Of course, like all mutual funds, the Longleaf Funds don't beat the market every year. But they do beat it over time. More importantly, the funds have set a standard for treating shareholders like partners, and the company's success is a great example for the professional money management industry to follow.

Zeke Ashton is a former full-time analyst and writer at The Motley Fool, and is now the managing partner of Centaur Capital Partners, LP, a money management firm in Dallas, Texas. Please send your feedback to zashton@centaurcapital.com. At the time of publication, Zeke did not have an investment in any Longleaf Funds.

Managing Cash Flow

There are several ways good managers can return capital or increase shareholder value. Bio-Technology General's management doesn't appear to be focused on creating value for shareholders. In this case, a share buyback is the right prescription.

By Zeke Ashton
August 19, 2002

I'm a shareholder of **Bio-Technology General Corp** (Nasdaq: BTGC), a biotech company that, as I wrote in a recent article, can't seem to shake its bad luck. Recently, I mentioned Bio-Technology General to a fund manager who's also a medical doctor. The argument that I gave for owning the stock is that Bio-Technology General has generated a total of $110.6 million in operating cash flow over the past five years, has over $100 million in net cash, eight marketed products, and a decent pipeline of drugs in clinical trials. At a recent market cap of under $250 million, this stock looks awfully cheap.

The find manager was intrigued and researched the company. "It's a good little company, and the management seems honest and hardworking, but none of that cash is likely to be returned to the shareholders," he said. Essentially, all the cash generated by operations will be reinvested in the business, and he has little confidence that it will find its way back to the shareholders in the form of a higher stock price. This got me wondering how to evaluate whether or not this is likely to happen.

Evaluating management effectiveness
In stock investing, a critical component of the process is judging whether the management team is ethical, competent, and shareholder-oriented. A company manager’s first job is to ensure that the business generates cash rather than consumes it. This seems obvious, but companies sold on our publicly traded markets have been consuming cash for decades. Until they generate cash, they're living on borrowed time.

Management's second job is to ensure the proper investments are made to maintain the business, so that it can continue to generate cash flow in the future. Some companies don't have excess cash available, beyond what's required for maintenance of the business, and therefore true value creation is quite difficult. For a consistently profitable company that generates cash above what's required to maintain the core business, the excess cash requires careful allocation by the management team. How this cash is used will determine whether per-share value increases.

This excess cash flow can generally be used to build value for shareholders in one of four ways:

- The company can invest the cash to grow the company's value organically. This could involve hiring new sales personnel or increasing advertising spending to grow sales of existing products, investing in research and development of new products, adding additional manufacturing capacity, or improving the company in any number of other ways.

- The company can make acquisitions, which will only add value if the company receives more than a dollar in value for each dollar they spend.
- The company can return the cash to the shareholder in the form of dividends, by either raising the dividend (for a company that already pays them) or by declaring a special dividend.
- The company may repurchase its stock. Note that this will only benefit ongoing shareholders if the price at which the company repurchases the shares represents a discount to a conservative estimate of the company's true value. The bigger the discount to a company's true value, the more economic value per share will be transferred to the loyal shareholders from the departing (or selling) shareholders.

Back to Bio-Technology General
Given the above, I decided to get out my collection of old Bio-Technology General annual reports and see if I could figure out how well the company has allocated the cash generated from operations. First of all, a certain amount of maintenance capital expenditures need to be deducted from the operating cash flow, which I'd estimate at about $5 million per year for Bio-Technology General. This may seem light, but remember that the company spends about 20% of revenues each year on research and development. This expense is already baked into operating cash flow. So I'll take that $110.6 million in operating cash flow and subtract five years of maintenance cap-ex at $5 million per year. That's $25 million, which leaves about $85.6 million left in excess cash. Where has this money gone? Here's what I found:

- In 1999, Bio-Technology General began constructing a new, state-of-the art manufacturing and research facility in Israel. According to the 2001 annual report, this facility is now operational at a total cost of approximately $40 million.
- In early 2001, Bio-Technology General acquired Myelos, a development stage company with a promising drug in Phase 2 clinical trials. The cost of the acquisition was $35 million.
- Also in early 2001, Bio-Technology General made a strategic investment in a company called Omrix Biopharmaceuticals. The total investment was $5 million. In the fourth quarter of the same year, Bio-Technology General wrote down the investment by $3 million.

That's a total of $80 million, which accounts for most of the last five year's worth of excess cash flow. Whether the company will get a decent return on its investment in the manufacturing facility is hard to say. But the stock market certainly isn't going to give it credit until the investment begins to translate into financial results. We likely won't be able to evaluate the acquisition of Myelos for some time -- though clearly this investment needs to result in a commercial product for Bio-Technology General to see a return. Again, the market isn't giving the company credit for this investment now. The Omrix investment has already been marked down to 40 cents on the dollar.

For 2002, Bio-Technology General announced it would increase R&D expense by about 40%, or $15 million. This will decrease operating cash flow by a like amount, and the results of this investment likewise won't be seen for a while. The company also noted it would be investing heavily to increase the sales force, thereby increasing selling and marketing expenses by about 20% over the previous year (or about $3.4 million.) This should result in increased sales of current products. We should be able to see short-term results here; management is already saying that prescription trends are improving.

A simple prescription

Clearly the market shares my friend's skepticism that Bio-Technology General's cash flow will find its way back to shareholders, at least in the near future. The stock has spent much of this year trading below $5, a level last reached in 1999. More disturbing, despite obvious improvement in the business, the stock is trading at the same price it was back in 1992. There are two ways to view this: Either the stock is an incredible value now, or the company hasn't increased its per-share value much in 10 years.

On the most recent quarterly earnings call, CEO Sim Fass was asked why he'd recently purchased some 67,000 shares of company stock and whether the company would buy back some shares. Fass responded that the board will consider share buybacks. As for his own purchase, Fass noted that at the recent price, "I thought it was an eminently smart thing to do."

My prescription for Bio-Technology General is this: Management should take advantage of the current low valuation and buy back $10 or $20 million worth of shares. I believe the stock's undervalued, and that a repurchase would be the best use of the company's cash. Even a modest share buyback would send a strong message that management is determined to return cash to shareholders and increase the company's per-share intrinsic value. With over $100 million in cash sitting around, it certainly shouldn't affect the company's liquidity in any major way.

Now *that* would be eminently smart.

Zeke Ashton has been a long-time contributor to The Motley Fool. Zeke is also the managing partner of Centaur Capital Partners, LP, a money-management firm in Dallas, Texas. At the time of publication, Zeke owned shares of Bio-Technology General. Please send your feedback to zashton@centaurcapital.com. The Motley Fool is investors writing for investors.

The High Cost of Bad Management

By Zeke Ashton
October 28, 2002

I have made it a habit to regularly review the annual and quarterly reports issued by some of my investing heroes, in search of any insight that will help me to become a better investor. I wrote an article last month praising Southeastern Asset Management, the folks who run the Longleaf family of mutual funds, for their consistent investment style and their behavior towards their investors as long-term partners.

But, of course, these qualities wouldn't be worth mentioning if the funds didn't perform well over time. Over the long term, performance is what it's all about, and Longleaf has an enviable investing record. I believe part of this success is due to their investing philosophy, which is short and sweet: For the past 25 years, its managers have looked for three things: business, people, and price. As it says in its prospectus, "What we are looking for are good businesses operated by trustworthy, capable, shareholder-oriented managers." All at a great price, of course.

After reviewing my own investments over the past couple of years, I realized that I typically spend an awful lot of time trying to identify great businesses and figuring out what to pay for them, but often don't put nearly the same effort into attempting to assess the quality and integrity of their managers.

In looking at my worst investment decisions, I discovered something important: My worst investments haven't been because I totally blew the call on the business, or that I made a bad judgment on the price I paid. Rather, I didn't emphasize enough the value of good management or, conversely, the high cost of bad management. In fact, I have been guilty at times of making excuses for poor management simply because I liked the business or thought the stock was cheap. I have paid the price virtually every time.

Differentiating the good from the bad
Determining whether a given company's management is honorable, capable, and shareholder oriented is one of the most difficult, and most important, elements of the investing decision. I have resolved to look for the following four qualities before purchasing any stock in the future:

- Reasonable compensation and meaningful share ownership
- Demonstrated ability to handle the nuts and bolts of the company's business
- A history of intelligent capital allocation
- Honest and regular communication to the business and investor community, and corporate action that is consistent with pro-shareholder orientation

In a 1997 interview in *Barron's,* Mason Hawkins, Longleaf's chairman, explained that there are two skill sets required in managing a publicly traded company: traditional manager skills and the ability to allocate capital. He also noted that Longleaf likes to see people who are vested through their ownership of the business and have proper incentives. "We like owner-operators. When we go to the proxy statement, we prefer to see significant ownership and small cash compensation. And we have found that, over time, there is an almost direct link to really good performance in vested ownership positions."

The best source for insight into management compensation is the proxy statement, which is filed annually with the SEC and mailed to shareholders along with the annual report. When you get your copy, ask yourself the following: Does management pay itself reasonably, or does it transfer a lot of the company's value to themselves by way of lavish salaries, fat bonuses, perks, and overly generous stock option grants? Also, beware of management teams that award themselves large bonuses based upon reported earnings, which can motivate them to use aggressive accounting to distort and magnify current income. Instead, look for reasonable salaries and meaningful stock ownership.

Judging a management team's ability to handle the basic blocking and tackling of the business is always somewhat subjective. Obvious operational problems and the lack of a coherent strategy are two warning signs. For example, the recent spate of operational and strategic problems at **Bristol-Myers Squibb** (NYSE: BMY) is a textbook example of a management team that has lost its way.

Next, evaluate how well management has allocated capital for the past several years. This can be done by reviewing previous year's annual reports (and 10-Ks) to look for past uses of capital. How has the company fared with past acquisitions? Have they bought back shares when the stock was cheap, or do they like to pay a dividend? Make the effort to determine whether the company has made good use of the capital that has been entrusted to them by analyzing the information available.

Then, review previous annual reports, conference calls, and regulatory filings to determine whether the management team has been consistent and honest in its communication to shareholders. Does the story change from year to year? Are past mistakes swept under the rug, or do the managers take responsibility for them? Does the company issue a press release every time something good happens, but then only discloses negative developments in small print in the back of its 10-K and 10-Q filings? Do the managers overly promote the stock? And most importantly, are managers painting a rosy picture while they themselves are selling their shares?

I remember listening to the Webcast of an annual meeting for **Visible Genetics** (Nasdaq: VGIN), a stock I wrote about not long ago. I had sensed that its management was in over its head, but I certainly should have hit the eject button after hearing the way the CEO Richard Daly defensively snapped at some already angry and disappointed shareholders during what was a very contentious meeting. Anybody who treats his shareholders with such obvious disrespect doesn't deserve their capital.

My recommendation to you is this: Look for honorable, capable, and shareholder-oriented managers in the companies in which you invest. Tolerate nothing less.

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The Power of Buybacks

Growing revenues and earnings isn't the only way companies can grow per-share value. Intelligent capital allocation can create growth in intrinsic value even for companies that aren't getting any bigger. Significant share buybacks at discounted prices is one of the best ways for companies to pass value on to shareholders.

By Zeke Ashton
November 18, 2002

When most of us think of small-cap growth stocks, we envision relatively young companies with new products or services that are growing sales at a fast rate, typically 20% to 25% per year or higher. Growing revenues at a fast clip is usually the surest route to growing earnings, and earnings growth is what it's all about, right?

In today's column, I'd like to introduce you to a company that has taken a much different route to growing shareholder value. **Utah Medical Products** (Nasdaq: UTMD) makes high-quality, specialized medical devices and tools. It also makes a ton of money. Utah Medical has been growing earnings per share at an average of over 20% for the past five years. This growth has not gone unrewarded by the stock market, even during this particularly nasty bear market. Since the end of March 2000, Utah Medical stock has increased from $7.50 per share to $18.42 as of Friday's close, an increase of some 145%. In comparison, the Nasdaq index has declined from 4,572.83 to 1,411.14 in that time span, a loss of 69% in value.

What differentiates Utah Medical from most small-growth companies is that virtually all the company's earnings-per-share growth has been due to two factors: improving profitability and share buybacks. Its revenues haven't grown much at all, declining from an all-time high of over $42 million in 1995 to $24 million in 1997 before rebounding slightly to just under $27 million in 2001. Starting from 1997, revenues have grown by a cumulative 11%, while earnings per share have increased from $0.51 in 1997 to $1.14 in 2001, a 124% cumulative increase in the same span.

Its increasing profitability has played an important role in this impressive growth. Gross margins have increased from 51.9% in 1997 to 57.1% in 2001, and that additional 5% of gross profits has worked its way to the bottom line, improving the net profit margin from 17.9% to 22% in that time. These expanding profit margins resulted in Utah Medical achieving a 37% improvement in net income in 2001 versus 1997 on only 11% higher sales -- an outstanding performance.

But as impressive as that is, the vast majority of the 124% increase in earnings per share has come from the other factor -- smart share repurchases. In both 1999 and 2000, Utah Medical completed self-tender offers, in which it offered to repurchase shares from its stockholders at a premium to the then-quoted stock price. In each case, shares tendered exceeded the company's announced limit. Utah Medical bought back over 1 million shares in each case, at prices of $8 in 1999 and $8.20 in 2000. I guess the departing shareholders are wishing they'd kept their stock, what with the shares sitting at over $18 today.

A primer on share buybacks
Before we look at what Utah Medical has accomplished through intelligent share buybacks, let's quickly review how share buybacks add value.

First, a properly executed share buyback will increase earnings per share, assuming earnings stay constant, because there will be fewer shares outstanding after the repurchase. Using a simple example, Company X has 100 shares outstanding, each priced at $10. So, its market cap is $1,000. Last year, it earned $100 in profits, or $1 per share. Let's assume it decided to use that $100 to buy back shares and repurchases 10 shares at $10 each. The buyback reduces the shares outstanding to 90 shares. This year, it once again earns $100 in profits, but there are now only 90 shares outstanding. Earnings per share increase to $1.11, an 11% improvement from the year before. Thus, by judicious use of share buybacks, Company X is able to produce earnings-per-share growth of 11% without profit growth.

When buybacks make sense
Berkshire Hathaway Chairman Warren Buffett has written extensively on the proper use of share buybacks in his annual shareholder letters, demonstrating his fondness for companies that engage in share buybacks when shares are significantly undervalued. The following is taken from his 1984 letter (I have edited it slightly because of space considerations):

The companies in which we have our largest investments have all engaged in significant stock repurchases at times when wide discrepancies existed between price and value. As shareholders, we find this encouraging and rewarding for two important reasons. The obvious point involves basic arithmetic: major repurchases at prices well below per-share intrinsic business value immediately increase, in a highly significant way, that value. When companies purchase their own stock, they often find it easy to get $2 of present value for $1.

The other benefit of repurchases is less subject to precise measurement but can be fully as important over time. By making repurchases when a company's market value is well below its business value, management clearly demonstrates that it is given to actions that enhance the wealth of shareholders, rather than to actions that expand management's domain but that do nothing for (or even harm) shareholders. Seeing this, shareholders and potential shareholders increase their estimates of future returns from the business. This upward revision, in turn, produces market prices more in line with intrinsic business value.

Back to Utah Medical
Let's now turn from theory to practice. Utah Medical has treated its shareholders to a textbook example of how good capital allocation adds to per-share intrinsic value. This first table shows revenues, net income, and free cash flow for Utah Medical for the years 1997 through 2001 (all figures in thousands). Note that there has been virtually no growth in sales, but some growth in net income. Free cash flow has been slightly declining for the past four years.

	2001	**2000**	**1999**	**1998**	**1997**
Sales	$26,954	27,193	29,444	27,677	24,272
Net income	$ 5,934	5,373	5,468	4,858	4,322
FCF	$ 7,336	7,464	8,415	8,677	3,339

Now look at this table, starting with shares outstanding. Utah Medical has reduced average shares outstanding from slightly below 8.5 million to 5.2 million in just five years. This has allowed the company to more than double earnings per share and more than triple free cash flow per share over the five years.

	2001	2000	1999	1998	1997
Shares out.	5,210	5,978	7,197	8,273	8,495
EPS	$1.14	$0.90	$0.76	$0.59	$0.51
FCF/share	$1.41	$1.25	$1.17	$1.05	$0.39

Adding it all up

As best as I can figure it, Utah Medical has repurchased some 7.3 million shares since 1992 at a cost of about $65.3 million. That's an average of about $8.95 per share. Today, the price is $18 and change. I think it's fair to say that Utah Medical has gotten well over $1 in value for every $1 spent in share buybacks, value which has accrued to its shareholders.

So far in 2002, Utah Medical is having another exceptional year. Sales, profits, and cash flow are all improved in the first nine months of the year versus one year ago. In October, it announced another tender offer to repurchase up to 750,000 shares at $17.05, which was then a premium to the market price. This time, only 503,000 shares were tendered, which will still reduce shares outstanding by about 10%. I guess Utah Medical stockholders are starting to catch on to this game -- and the market is beginning to recognize the value, as well.

Guest columnist Zeke Ashton has been a long-time contributor to The Motley Fool and is the managing partner of Centaur Capital Partners LP, a money management firm based in Dallas, Texas. At the time of publication, Zeke had a long position in Utah Medical. Please send your feedback to zashton@centaurcapital.com.

Thanks for the Lessons, Yahoo!

Sure, it's painful to lose your shirt on a holding, but the good news is that you probably won't make the same mistakes twice. Zeke Ashton hardly cheered when Yahoo! revenues dropped unexpectedly, but he explains why the lessons he learned in the process will pay off in the end.

By Zeke Ashton
July 22, 2002

I suspect that most investors have stocks they can point to and say, "I really learned my lesson on that one!" Usually, the lesson was painful and involved the loss of large sums of money. The silver lining is that the greater the pain, the better and longer the lesson is retained.

In my case, one stock has probably taught me more lessons than the others: **Yahoo!** (Nasdaq: YHOO). We normally talk about small caps in this column, but the lessons I learned from Yahoo! apply to companies of any size. While I lost a lot of money on Yahoo!, I'm convinced that the lessons learned will stick with me for the rest of my investing life.

The most common investing trap
Robert Olstein, one of my favorite reads in the mutual fund world, has a favorite saying that overpaying for good companies usually produces the same results as buying bad companies. No stock has ever hammered that home like Yahoo! I still believe Yahoo! is a quality company, and I'm still amazed at how fast the thing grew to be an international powerhouse, but there's no level of quality to save you when you pay 15 times revenues for a company running into slowing growth.

At the time, I was still under the delusion that, because I was a long-term shareholder, the risk of overpaying wasn't as applicable to me as it was to somebody with a shorter time horizon. Well, let me tell you: Overpaying for a stock, any stock, is going to hurt your returns, no matter how long you hold on to it. If you think a stock is overvalued, no matter how high quality the company, don't buy it. I'm convinced now that overpaying for good companies is the most common investing trap.

Growth cannot be extrapolated
In 1997, Yahoo! did $84.1 million in revenue. In 1998, that number was $245.1 million, growing to $591.8 million in 1999 and $1.1 billion in 2000. This sounds like an SAT question, but what number comes next in the series? If you are a stock analyst, you'll have to fight every possible mental bias to not project revenues somewhere higher than $1.1 billion for the next year. This is going to sound ridiculously simple, but I believe that investors run into some cognitive dissonance when it comes to extrapolating forward growth rates. Again, I looked at the trend and found it hard to believe that the revenues for 2001 wouldn't be higher than in 2000. That's the way numbers work, right?

My revenue expectations were way too high for Yahoo!, long after it became apparent that the fundamentals were deteriorating, and I attribute this denial to my desire that the world be a neat, orderly place where revenues grow to the sky, just like in all those Wall Street research reports. Yahoo! has taught me that no matter how impressive or consistent past revenue growth has been, you have to be aware of the possibility that it can fall right off a cliff. I should have considered at least the possibility that revenue could drop from $1.1 billion to $717 million, but I didn't until it was too late.

Unhealthy customers equal unhealthy business
This one is right out of Peter Lynch, and I should've seen it coming. I knew by the spring of 2000 that dot-coms were starting to hurt. Unfortunately, at the time I saw this as a positive, thinking that Yahoo! would take more and more of the online advertising pie.

I remember reading an article by Jim Cramer of TheStreet.com, where he was fretting over how smaller Internet sites were being squeezed by Yahoo! and **America Online** (NYSE: AOL). Of course, Cramer was writing this as an owner of TheStreet.com. From my position at The Motley Fool, I could see how dominant these two portals were becoming and how many eyeballs we got by our affiliation with Yahoo! Unfortunately, I didn't think about the fact that Yahoo!'s competitors were, more importantly, Yahoo!'s customers. And if they could no longer afford the stiff advertising and exclusive sponsorship slots Yahoo! was peddling, that would not be good for Yahoo! Sure, Yahoo! competitors were hurting, but, more importantly, its customers were hurting, too.

Don't lose your objectivity
In looking back on my mistake with Yahoo!, I realize that part of the problem was that I suffered from inflated confidence, thinking I had an insider's edge. We used to talk to Yahoo! management every quarter, and they sounded so confident and optimistic about their business. I discovered that any legitimate insider edge I had was totally offset by my tendency to overweigh that information. It's way easier to be objective when you are outside looking in, and, at some point, I lost my objectivity when it came to Yahoo!

No margin of safety
While the above lessons are important, the overriding lesson I learned from Yahoo! is that when you invest without a margin of safety, you get hurt. There was simply nothing holding Yahoo! up if anything negative were to develop. The company absolutely had to have sales growth, rising profit margins, and growing cash flow in order to justify its stock price. Warren Buffett has often said that when Benjamin Graham distilled the art of investing into the three words, "margin of safety," well over 50 years ago, he got it exactly right. I agree with him. Look for a margin of safety in the price to protect you from errors, large or small, in your estimation of intrinsic value. The larger the margin of safety you demand in the stock price, the better your investing results are likely to be.

While I certainly regret my decision to buy Yahoo! stock at the price I paid, I do value the many lessons I learned from the experience. For that, I am thankful.

Zeke Ashton did not have a position in Yahoo! or any of the stocks mentioned in this article at the time of publication. The Fool has a disclosure policy.

How to Miss a Perfect Sell

Small-company investors should be prepared to review their investments each quarter for new developments and to watch for signs of trouble. While investors should buy with the intention of holding as long as the business is performing well and is fairly priced, investors can't afford to ignore warning signs. When the telltale signs appear, be ready to sell.

By Zeke Ashton
May 29, 2001

As I promised in last week's column, today I'll share with you one of my less-than-finer moments in investing. I hope you'll find, as I do, that postmortem examinations of investing decisions often lead to new insights that are useful in making future decisions. As I noted last week, investors in small companies must be prepared to review company performance on at least a quarterly basis, and while we generally buy with an intention of holding as long as the business is performing well and is reasonably priced, we need to be ready to sell if the situation dictates selling.

On to my first episode in small-cap investing: the story of how the perfect sell presented itself to me and how I ignored it. The stock market, patient though it sometimes can be, is not merciful forever. Eventually, it took back the money that it had let me think was mine. And it was entirely my own fault.

The perfect sell started with the perfect buy. **Plantronics** (NYSE: PLT), a fine little company that makes lightweight communication headsets, first appeared on my radar in August of 1998, at $18 per share (all historical share prices are adjusted for splits.)

Plantronics was and is a company with a history of strong performance. It had been growing consistently for many years at the 20-25% growth rate that we like to see in small growth stocks. Gross profit margins were well above 50% and had been expanding. Net profit margins had risen from the low teens to almost 20% over the previous several years. The company had lots of cash and no debt. Importantly, operating cash flow and free cash flow were both consistent with and sometimes better than reported net income. The table below shows how the reported net income compared with operating and free cash flow (which is defined as operating cash flow minus capital expenditures) for the four fiscal years of 1997 through 2000 (fiscal years ending in March; all numbers in millions of dollars):

	'97	**'98**	**'99**	**'00**
Net income	$29.7	39.2	54.2	64.5
Operating cash flow	$34.6	39.2	86.9	81.1
Free cash flow	$26.4	33.3	83.1	65.9

Finally, the company had a large insider ownership, with more than 50% of the shares insider-owned, and the company had been a consistent re-purchaser of its own shares. In short, everything looked good. I watched the company for a while before making my first purchase in February of 1999 at $23 a share. At the time, I noticed that most of my colleagues had begun using headphones in order to carry on business conversations while simultaneously using their computers.

The perfect buy came towards the end of September 1999, when Plantronics announced that it wouldn't meet analyst projections for the quarter, and the stock sold off to the mid-teens. After carefully analyzing the situation, I came to the conclusion that the problems were likely temporary, and that the stock, now selling at about 13 times earnings, was a bargain. I doubled down at $16 a share.

The next month, the company announced that earnings for the September quarter were up only 13.5%, but that it was accelerating its share buyback program. The balance sheet looked good, with inventories and accounts receivable under control, and still lots of cash. The December quarter brought another double-digit increase in earnings along with strong improvement on the balance sheet. By the March quarter of 2000, Plantronics was hitting on all cylinders again. Sales were up 26% and earnings up 33% over the year before. By that time, the stock price -- at $20 -- had begun to improve.

It got better. On June 29, the company announced a three-for-one stock split, followed by strong earnings on July 18. The price raced up to over $100 before the split, and sold for $42 on the day of the earnings release (or $126 pre-split.) At that point, I had more than doubled my money. The stock continued to blaze through August and September at around $50, helped by the buzz of Bluetooth. On September 15, amid rumors that Plantronics wasn't going to make its quarterly estimates, the company's press release deemed the September quarter to be "on track". Sure enough, Plantronics announced outstanding earnings on October 17 -- or that's what it looked like on the surface, anyway. Sales were up 44% and EPS grew 39% from the previous year. The stock was now selling at $38 a share. In retrospect, the date of October 17 marks the first day of what would be about a 100-day window of opportunity that Mr. Market was giving me to take my winnings off the table. But I paid Mr. Market no mind.

While the income statement was all roses and chocolates, the October 17 earnings release harbored an axe murderer hiding in the balance sheet. Take a look at the increase in inventories and receivables compared to sales: (All dollar numbers in millions.)

	June 30	**Sep 30**	**%change**
Sales	$100.3	$103.9	3.5 %
Accounts receivable	$40.1	$48.4	21.0 %
Inventory	$56.8	$63.6	11.9 %

As you can see, sales went up slightly, while both receivables and inventories grew big-time. This meant the company’s profits weren’t going directly to the bank, but were being used to fund increasing inventory and customer receivables. Stubbornly preferring to bask in the glory of the income statement, I decided to hold on.

On November 14, with the stock trading at $40 per share, Plantronics released its quarterly 10-Q filing. It would have been a five-minute exercise to print out the cash flow statement and take a little gander. I surely would have noticed that while the reported net income for the quarter was $20.7 million, cash flow from operations was only $6.5 million. And, even worse, of that $6.5 million, $5.8 million came from tax benefits from employee stock options. In other words, only $0.7 million of the operating cash flow was attributable to the business.

At this point, I had benefited from the double dip of 1) increasing earnings and 2) an increasing multiple. The stock had almost tripled from my average purchase price. Clearly, Plantronics would have to keep executing perfectly to justify the stock price. The company had reached not only fair valuation but a significant over-valuation. Whereas the Price/Earnings ratio was about 14 when I last purchased the stock, and the historical multiple had been in the high teens, the stock was now changing hands at above 35 times earnings -- a very rich valuation. This alone would have been reason enough to consider selling off at least some of the position. The combination of an overvalued stock and the ticking bomb that was evident from the balance sheet and cash flow statements should have had me running for the exits. Mr. Market continued to give me every opportunity to do just that.

On January 16, Plantronics announced quarterly earnings for the December quarter, and once again reported record sales and income. The Flow Ratio was still at 2.13. The stock price stayed above $50, 250% above my cost, for most of January and February. A Plantronics investor would have had another three weeks to react. On February 12, the bad news came: The company issued an earnings warning for the upcoming quarter. Still, the stock price slowly drifted from $30 on down to the low 20s, where it remained until the next earnings warning on March 19, which knocked the stock for another loop down into the teens.

In retrospect, the market gave me the perfect sell, and waved it in front of my face for almost four months. From October 17 until February 11, I could have sold my shares for anywhere from $38.75 to $54.50 each, which would have meant my investment would have doubled or tripled with an average holding period of a little over 18 months.

Unfortunately, I didn't sell, despite the presence of three classic warning signs:

1) excessive valuation of the business
2) inventories and receivables increasing much faster than sales
3) sudden drop off in operating cash flow

That's it for today's episode from my small-cap investing X-files. I hope you'll come back for more next week.

Acquisitions Gone Bad

For investors interested in companies showing strong growth by following an aggressive acquisition strategy, it's important to remember that what you give in a trade is as important as what you get. Koala Corp. is an example of a company that forfeited too much and gained too little.

By Zeke Ashton
June 5, 2001

Welcome back to the investing X-files. In last week's episode, I showed you how an astute investor would have sold shares of **Plantronics** (NYSE: PLT) based on three classic warning signs. Today, I'd like to share another small cap (mis)adventure with you.

The year was 1999. The company was **Koala Corporation** (Nasdaq: KARE). Koala Corporation makes those cute Koala Bear Kare baby changing tables that you see in restrooms at restaurants, malls, and other public areas.

While it never made the Foolish 8 list, Koala certainly had all the attributes of a small-cap growth stock. The company had a big year in 1997, with sales growth of 52% and gross profit margins just shy of 60%. It also had no debt, and cash from operations exceeded net income by a large amount for the full year 1997.

Koala was founded in 1987 with a better idea for a diaper changing station, and business took off. By the early '90s, the company had added new products such as child protector seats and high chairs. In an effort to diversify the revenue stream and generate some new growth, it eventually added children's activity products -- acquiring Activities Unlimited in 1996 -- designed for use in commercial waiting areas, as well as modular indoor play equipment for fast-food restaurants and shopping malls. Still, at the end of 1997, the baby changing stations accounted for the majority of the company's revenue. Koala's management obviously felt the need to do something radical to grow the business.

Management decided on an acquisition strategy: It would grow by buying businesses that fit its "family-friendly" theme. In 1997-98, Koala acquired two modular play equipment makers: Delta Play and Park Structures. By the end of 1998, the baby changing station represented less than half of Koala's sales and the 10-K articulated that the company had established a "formal acquisition program... as a means of adding complementary businesses and product lines."

The company still had a tiny market capitalization of about $50 million when I purchased shares at $19 each -- or about 15 times 1998 earnings -- in January of 1999. Here was a company growing sales at 52% and earnings at 28% per year -- how could I go wrong paying only 15 times earnings?

In hindsight, it's clear that the company's changing table business, simple though it was, had some fantastic economic characteristics. Profits were high and cash flow was excellent. In contrast, the modular play equipment business had much lower profits and was much more capital intensive. Even before the impact of the Park

Structures acquisition, Koala was tying up almost twice as many assets in the modular play business as in the convenience and activity products business -- for less than one third the profits.

Koala's convenience/activity products business was generating 30% operating margins and a return on assets of around 25%. The modular play business, on the other hand, generated operating margins of 14%, and returns on assets of less than 5%. In addition, as the baby changing stations gradually became a smaller part of the business, Koala's profit margins dropped from 64% in 1996 to 54.8% in 1999.

In 1999, Koala acquired two more businesses: Superior Foam & Polymers, a maker of children's foam activity products for amusement and water parks, and Smart Products, a manufacturer of child safety and parental convenience offerings. By the end of 1999, sales of the baby changing station accounted for less than one quarter of the company's total sales.

By 1999, all those acquisitions were really juicing sales. Revenues jumped 94%, to $37.1 million, and net income grew 64.1% from the previous year. In October, the company did a 2-1 stock split. *Forbes* magazine included Koala in its annual 200 best small companies list for the fifth consecutive year. The shares soared. Unfortunately, diluted EPS grew only 30%, and cash flow had begun to underperform net income. More importantly, the company's cash balance was only $173,000 at the end of 1999, and a short-term credit line was tapped for a $13.9 million loan.

I sold in April of 2000 after noticing that cash had dropped to almost nothing, and short-term debt had increased to $31 million. Despite impressive revenue growth of 57.3% and net income growth of 33%, diluted EPS increased only 26.6%. There was a happy ending of sorts for me, as I was rewarded for a poor investing decision with a 33% gain in about a year. The market cap was then around $85 million.

Things went rapidly downhill from there. Koala made two more acquisitions in 2000 and sales continued to grow rapidly, coming in at $59.7 million in 2000, up 60% from the year before. But earnings per share actually declined by 25% and the company -- with virtually no cash -- had amassed almost $40 million in debt.

As of yesterday's close, Koala shares had lost 72% of their value in the last year, and had entered penny-stock country. The market cap is down to $27 million. I'm sure that there are still many Koala investors simply shaking their heads and wondering what happened.

In a nutshell, what happened was the natural result of Koala's management continuously giving away portions of a good business (the changing stations and related businesses) in return for businesses of vastly inferior quality. Warren Buffett, in writing about acquisitions, always cautions that in a trade, what you give is just as important as what you get.

Let's run through Koala's acquisition scorecard and see what it forfeited and what it gained:

- In June 1997, Koala paid $5.3 million (about 13.9% of its value) in cash and stock for Delta Play.
- In December 1998, Koala paid a total of $19 million in cash and stock for Park Structures, a company with $10.6 million in 1998 sales and income of $2.8 million. Koala's business was then valued at $48.5 million, so it gave away value equal to 39% of the company to acquire Park Structures. In part to raise money for the acquisition, Koala did a secondary offering that resulted in share dilution of about 15%.
- The March 1999 Superior Foam acquisition cost about $6.2 million in cash and stock -- 10.7% of Koala's value.
- In September 1999, Koala bought Smart Products for $1.3 million in cash, or about 1.5% of Koala's valuation.
- In March 2000, Koala acquired SCS Interactive for about $23.6 million in cash and stock, or 26.8% of Koala's market cap.
- In August 2000, Koala acquired Fibar for a total cost of about $6.4 million, or 7.2% of Koala's total valuation.

In total, Koala gave away value of somewhere near $68.8 million. In return, it received a bunch of businesses that, in aggregate, produced about $37 million in sales and $3.5 million in operating income in 2000. The pre-tax return on assets of those businesses was likely in the area of 6%.

Koala investors had a lot of time to see this coming. If they had been carefully watching the business, they would have seen the warning signs of shrinking profit margins, sales growing much faster than earnings, and debt mounting rapidly on the balance sheet.

Despite the company's problems, Zeke Ashton still has a soft spot in his heart for that cute little Koala Bear Kare logo. Zeke does not own shares of Koala, but he does hold stock in Berkshire Hathaway. The Fool is investors writing for investors.

Straight Talk on Penny Stocks

By Zeke Ashton
November 19, 2001

If you've been a reader of The Motley Fool for any amount of time, you are probably familiar with our stance on "penny stocks" -- just say no. I hasten to add that it is with good reason that we urge investors to stay away from the pennies -- and I encourage you to read the articles in the "related links" section of this page for more about the dangers of penny stocks.

What is a penny stock?
But what exactly are penny stocks? As has been loosely defined by various writers here at The Motley Fool, they are companies with share prices of below $5 and market caps below $200 million.

While I agree that when combined, avoiding stocks with the two criteria above will dramatically lower your chances of getting sucked into a penny stock scam, personally, some of my best ideas would have qualified as a "penny stocks" -- i.e., the stock was trading at less than $5 and had a market cap of less than $200 million when I purchased my shares.

While I strongly believe that beginning investors or those without the time to do in-depth research are much better off sticking to bigger fish, I just as strongly believe that for advanced investors, with the time and the inclination, finding the undervalued gems with market caps of between $50 to $250 million offers the best chance to beat the market -- and some of them will happen to trade for less than $5 a stub. I think that, if you know what to look for (and what to look out for) going in, an advanced investor can do a lot to separate the gems from the scams in this area of the market. But before I tell you what I look for, you're going to get some disclaimers (you didn't think I'd just let you go on to the good stuff without scaring the pants off of you first, did ya?)

Who should target small stocks?
It is my true conviction that those with less than one year's experience investing in individual stocks should not even think about investing in small cap stocks, particularly if you haven't found your rhythm with the mid- and large-cap universe yet. Also, until you know your way around a balance sheet, income statement, and cash flow statement like you know the route from your house to the nearest convenience store, don't even think about it.

Finally, you need to be suitably prepared to take everything you hear and read with a grain of salt, be ready to challenge every assumption, and in short, examine every possible scenario that could cause your company to fail in order to ensure that you are getting a real business for your money. Also, you need to have the time and the desire to keep digging for more information, even after you've bought the stock, so that you know more about it than your average Fool small-cap writer.

Even armed with the disclaimers above, it's best to concentrate your efforts where it will bear the most fruit -- and that means knowing where not to go.

Where not to go
First of all, I don't bother with stocks that aren't traded on one of the major U.S. exchanges. That means no bulletin board (better known as over-the-counter, or OTC) stocks for me. Essentially, most bulletin board stocks are those that for whatever reason don't qualify (or can't afford) a listing on one of the major exchanges. Besides, many online brokers don't even offer bulletin board stocks. So just don't bother.

Second, if the company doesn't have revenues, I look no further. And if the revenues aren't at a minimal level, say, $10 million annually or so, it isn't worth my time. I also make sure that the company has been generating revenues for several years -- I don't want any flash-in-the-pan companies in my portfolio. I typically am exceptionally careful in the sub-$50 million market cap area -- and I generally don't go in there unless the situation is almost perfect.

Third, I never, ever waste my time looking at those small-cap companies that are hyped in the various e-mails I get from websites and promoters that are dedicated to penny stock investing. Just about all of these promotions are paid advertisements in which the company gives the penny stock tip-sheet operator some sort of payment, either in shares or in cash, in order to hype the stock. I just delete those messages.

Finally, I don't bother looking at companies that compete in industries that I don't like or understand well. I know a couple of industries pretty well, and I know of several industries where the economic characteristics are outstanding -- and I stick to those.

As a final disclaimer, I never, ever invest in any small company without having first read its annual 10-K and most recent 10-Q filing. I never fail to find some piece of material information (either good or bad) that changes the way I think about the investment as a result of reading these two documents.

What I look for: cash, cash, and more cash
Essentially, when evaluating small companies for investment, the ability to generate cash is king. I look for companies that have demonstrated the ability to consistently generate cash, and are actually growing their free cash flow over time. I aim to buy these companies at a very low multiple on that cash flow -- ideally under six times. This low price compensates me for the risk I am taking by purchasing a tiny, illiquid stock -- it's the old "margin of safety" that I am looking for. I never try to pay fair value for these stocks -- if I don't think I am getting the company for 20 or 30 cents on the dollar, it's not worth the risk. The other thing I look for is cash on the balance sheet. If I find a stock trading for $3 a share, and that company has $2.75 a share in cash on the books and is also generating cash from the business, well... it's tough to lose a lot of money on those types of stocks.

As a final risk-control technique, I limit any tiny stock to no more than 5% of my portfolio, and usually I keep the percentage to 2.5%. That way, even if I'm wrong, I haven't invested more than I can afford to lose on any one stock.

Zeke Ashton urges extreme caution even for advanced investors who are considering looking at tiny companies, and is not responsible for you losing your shirt to some penny-stock-pumping scam artist if you do. The Motley Fool has a full disclosure policy.

Buy This Penny Stock!

By Zeke Ashton
December 17, 2001

In a recent article, "Straight Talk on Penny Stocks," I warned readers about those penny stocks featured by small-cap email promoters. Unfortunately, if you spend any time on the Web investigating stocks, you are going to end up on the mailing list of any number of these promotion outfits. Typically I just delete them from my in-box, but I saved one this week that may be of instructional value for small-cap investors. The email was sent to me from some entity calling itself Hot Picks.

VOLT INC (NASDAQ: VOLT)

We are very proud that we can share this information with you so that you can make a profit out of it. It is highly advisable to take a position in VOLT Inc. as soon as possible, today before the market closes, or tomorrow.

Note that the email recommends immediate action, urging readers to buy today before the market closes. It should go without saying that you should never buy a stock without having read the most recent 10-K and 10-Q filings with the SEC, and certainly not to buy until you are very comfortable with both the company and the stock price.

As a provider of alternative energy and back-up power systems, VOLT's assets jumped over 2,000% this year to $5.8 Million along with solid net income versus a loss in the previous year. With these type of numbers and news of contractual developments, we anticipate huge volume, rapid analyst coverage, and broker participation.

The company, according to the diligent folks at Hot Picks, is in alternative energy, which is one of those sexy industries. Interestingly enough, Volt Inc. had recently changed its name from Deerbrook Publishing Group Inc., and acquired a wind farm facility in California that, according an SEC filing, is "currently not operating because the company intends to repower the facility with new wind turbines."

The email described the net income as "solid." Well, the filing shows an operating loss of $35,130 for the three months ended June 30, and a loss of $57,605 for the nine months ending the same date. The company shows non-operating income of $262,600 from an extraordinary item called "forgiveness of debt," on the strength of which the company reported diluted earnings per share of $0.00 for the quarter and $0.02 for the nine-month period. While it's technically net income, I wouldn't describe this as "solid."

We hear a stock spit is about to happen. This is one of the most Bullish events that a company can reward their shareholders with.

This is just the peach. First of all, stocks split, not spit (though perhaps there is a market for expectorating equities). As Fools, you know that stock splits have absolutely no effect on the value of the company whatsoever. Note the language, though. There is no guarantee that a stock "spit" will even happen, only that "we hear" that it is about to happen. This becomes even more unbelievable when you check the SEC filings, which reported that on April 23, 2001, the company did a 1-for-100 *reverse* split. If a stock split is indeed the most bullish thing that can happen, what does a 1-for-100 reverse split say? (Also, my editors want me to point out to you budding writers that "Bullish" should never be capitalized mid-sentence.)

The stock has built a solid base at its current level and will start moving up immediately. We think the stock can easily reach $10.00 in less than a month.

The writer just throws in some technical-sounding mumbo jumbo, and then pulls a price target out of his or her nether regions, along with a ridiculously short time frame for that stock price to materialize. This is just a beauty.

VOLT INC. experience and reputation in the renewable energy business bring a constant stream of new opportunities. VOLT intends to be a major consolidator of PROFITABLE renewable power companies, and has additional opportunities under consideration. Listing on The American Stock Exchange is on pending application.

This just keeps getting better and better. The email now argues for the company's experience and reputation as a source of new opportunities. Remember, this company used to be in publishing, and has only been in the energy business since March 30, 2001. I'm sure the company intends to be PROFITABLE, but capitalizing the word is no assurance that it will be.

Hey, wait a minute! Didn't the opening line say that this company trades on the Nasdaq? Well, as far as I can tell, the company isn't listed on a major exchange, and is only traded on the over-the-counter markets. Although I know a couple of advanced investors who will admit to buying an OTC stock once or twice, I wouldn't touch any of them.

The email then goes into a fairly lengthy description of the wind facility, and notes that the company will be engaged in batteries, backup power systems, and thin-film photovoltaic cell technology. I won't make any comments on this section, seeing as the information isn't contained in the SEC filings that I could find.

Disclaimer: We have been paid a sum of $1500.00 as payment for this mailing service. We hold no stocks and have no personal interest in this company.

Folks, here's the bottom line. This stock-promoting company gets $1,500 for sending out this junk, and they don't care what happens to those poor souls who actually are persuaded to buy this stock. The promotion is so poorly written and so full of half-truths masquerading as stock analysis that it's actually entertaining. It's hard to believe that these emails actually succeed in parting people from their hard-earned dollars. If more investors would follow the simple rule of doing some research before blowing money on penny stocks, then we at The Motley Fool wouldn't feel compelled to spend so much time warning our readers about the dangers. I suppose that there must be people who take these emails seriously, or the companies wouldn't waste their time sending them out. Don't you be one of them!

Zeke Ashton, suffice to say, does not own shares of Volt Inc. The Motley Fool is [investors writing for investors](#).

FOOL ON THE HILL

Siriusly Toxic

By Zeke Ashton
July 25, 2002

If you read the Rule Breaker column here at the Fool, you probably know that back in January the Breaker Portfolio managers made a smart investment decision -- to sell short **Sirius Satellite Radio** (Nasdaq: SIRI). Readers of the *Motley Fool Select* were treated to a full overview of the satellite radio industry in the January 2002 issue, in which *Select* questioned whether there would be enough of a market for satellite radio to support both Sirius Satellite and its (better) competitor, **XM Satellite Radio** (Nasdaq: XMSR). At the time, Sirius Satellite was selling for $6.90 per share.

Let's review. Sirius is the number two player in the nascent market for satellite radio, behind XM Radio. Sirius has managed to put three orbiting satellites into space and has a network of terrestrial repeaters. Its state-of-the-art studios in New York City broadcast 100 commercial-free channels of digital-quality radio, mostly to motorists, for $12.95 per month. The company launched its service in four test markets in February and announced the availability of its services on a nationwide basis on July 1, 2002. Sirius has agreements with major stereo manufacturers for its Sirius-ready radios, and big auto makers such as **Ford** (NYSE: F), **DaimlerChrysler** (NYSE: DCX), and BMW are set to install the radios in new car models.

Ignoring the Wall Street hype
After my own review of the company's financials, I shorted Sirius myself. But by that time it was March, and the stock was around $5. Today, it's trading around $2 and change.

Why did this particular short work out so well? Sure, part of it is because the market has taken a beating this year -- the Nasdaq's down more than 35% for the year. But even more than that, I'm convinced it was because the Wall Street hype machine has continued to support Sirius with sell-side research reports that paint far too positive a picture of this company's prospects.

Using www.multex.com, I reviewed the Wall Street research reports on Sirius dating back to August of last year. Proving that I'm not the only one who can come up with a pun on Sirius, Ladenburg Thalman initiated coverage of Sirius with a report noting the company's "Sirius potential" and offering a $42 target price for the stock in August of 2001. Deutsche Bank Alex Brown has consistently maintained a "target price" for the stock well in excess of the market price.

Select quoted a Deutsche Bank Alex Brown projection for 8.4 million satellite radio subscribers by 2005. It should be noted that at least Deutsche Bank doesn't continue to have a "buy" or "strong buy" rating on the stock -- it has a "market perform," as of March 27, though it did maintain a target price of $9.

As of Feb. 20, Robertson Stephens rated Sirius a "buy" with a $7 price target when the stock was at $4.89. But it's Lehman Brothers analyst William Kidd who has been most supportive of this stock. In fact, he still rates Sirius a "strong buy," though he has reduced his price target from $15 on June 24 to $9 this past week. Why is Lehman Brothers so high on the stock? Surely not because Lehman owns $150 million in Sirius debt, which came with a ton of warrants to purchase Sirius stock?

An ordinary investor willing to ignore the sell-side fluff would've come to the conclusion, within an hour, that this company is likely to hit zero. In fact, let me say here and now that I rate this stock "toxic," and hereby establish a 12-month price target of $0.09 and two Cheerios box tops. Why? Let's look at the numbers:

The financial statements tell all
I cracked open the Sirius 10-K for 2001 back in late March. Here's what I found:

- Since the company's inception in May of 1990 through the end of 2001, Sirius has spent $939 million in capital expenditures and has experienced aggregate net losses of $505 million.

- The company lost $241 million in 2001, which included $58.4 million in engineering design and development costs, general and administrative costs of $95.9 million, and interest expense of $89.7 million. Cash from operations was a negative $148.8 million, and capital expenditures were approximately $81.3 million. As of December 2001, Sirius had total debt of $672 million and shareholders equity of $323 million. The company's cost of capital is frighteningly high, with $242 million worth of 15% discount notes due in 2007, and $176 million in 14.5% notes due 2009. Additionally, $150 million of that debt is in the form of a term loan with Lehman Brothers, which contains various covenants that, if not met, could result in a demand by Lehman for accelerated repayment of the loan (a demand that would likely also trigger accelerated repayment by the other Sirius debt holders).

Then I looked at the 10-Q filing for the first quarter of 2002.

- In the first quarter of 2002, Sirius burned through another $117 million in cash from operations, plus $11 million in capital expenditures. Since the company didn't launch the service in test markets until February, subscriber revenues were only $4,000 for the quarter. Meanwhile, competitor XM has now signed up 136,000 subscribers as of June 30 (though that company is burning cash at an alarming rate as well). Sirius ended the first quarter with approximately $400 million in cash.

Here's the bottom line on Sirius: The company will run out of money by the first quarter of 2003, at the latest. It will need $300 million or so to get through 2003, then at least several hundred million after that to reach profitability.

In 1999, it could have happened. Not now. No matter what Wall Street says, this stock is going nowhere but down.

At the time of publication, Zeke Ashton was short Sirius Satellite for the reasons detailed above. Or maybe it's because of the 10 commercials for XM Satellite Radio he hears every day driving from his house to 7-11. The Motley Fool has a disclosure policy.

Bradley Pharmaceuticals Breaks Out

By Zeke Ashton
March 25, 2002

Most biotech and specialty pharmaceutical companies have to spend millions of dollars and often a decade or more to discover, develop, test, and, eventually, to market new drugs and medical treatments to patients and doctors. It's a long, expensive, and ultimately very risky process, and it's what makes investing in development-stage drug companies such a gamble. Of course, once on the market, drugs are a very high-profit business, but few people realize how brutal the odds are against most startup drug companies making it that far. But what if a company could somehow just skip the development and clinical testing stage, and get right to the business of marketing approved drugs -- now that would be an attractive business, right?

One such company is **King Pharmaceuticals** (NYSE: KG). King has accomplished some outstanding growth by acquiring neglected pharmaceutical products from the shelves of the big drug companies at bargain prices, and then marketing the heck out of them. With a $10 billion market cap, King is certainly no longer an undiscovered small cap, but there is a company following the same road map to growth: **Bradley Pharmaceuticals** (Nasdaq: BPRX).

Like King, Bradley specializes in acquiring products from major drug companies that are too small or unprofitable to justify the efforts of the big players, and then to market them effectively to increase sales and profits. Since the company's founding in 1985, Bradley has acquired 16 products from Big Pharma. These products treat symptoms that won't be making the major medical headlines -- acne, foot fungus, warts, and dandruff may not make big drug company executives tremble with greed, but they helped Bradley Pharmaceuticals stock increase in value by more than 1,000% in 2001 alone.

Bradley acquires these ugly-duckling products from other drug companies and builds promotions around them, using clever slogans, creative marketing techniques, and a ton of hustle to get the attention of dermatologists and other specialists who prescribe them. These are usually slightly older products, and they are therefore on the lower end of the prescription price spectrum. This means that doctors are less hesitant to prescribe them, and patients don't mind giving them a try. Importantly, though, the company does have patents protecting their major products.

By far the best feature of the company's business model, however, is that the hefty research and development expenses that characterize most pharmaceutical companies aren't present on Bradley's income statement -- in fact, there isn't even a line item for R&D on the company's financial statements! Also of critical importance in evaluating a company like Bradley is that the biggest risk of most small-cap drug and biotech stocks isn't present -- namely, the failure of the company to gain FDA approval for its products. Since Bradley and the other drug acquisition specialists usually purchase only approved products, this risk is essentially nonexistent.

Of course, since these companies don't possess a core competency in drug discovery or development, they had better be darn good at the bread-and-butter of the business, which is marketing and distributing their products to doctors, healthcare providers, and in many cases, consumers. In the case of Bradley Pharmaceuticals, the company markets niche medical treatments to doctors through its two subsidiaries, Doak Dermatologics and Kenwood Therapeutics. Doak sells mostly skin care products, while Kenwood targets products for respiratory and digestive ailments. In 2001, Doak accounted for approximately 60% of total revenues, while Kenwood accounted for the other 40%.

Bradley's biggest seller is Doak's Carmol line of urea-based skin moisturizing lotions and creams for the treatment of dry skin, as well as shampoo for the treatment of dry scalp and dandruff. Sales of Carmol products have grown from right around the million dollar mark to about $11.7 million in 2001, making up nearly 45% of total sales. Bradley acquired Carmol from Swiss drug giant Hoffmann-LaRoche back in 1994. Another Bradley success story has been Kenwood's Pamine prescription product for digestive discomfort caused by hypermotility (increased muscular activity in the GI tract). With Bradley's strong sales efforts, Pamine sales have increased from less than $400,000 in 1998 to almost $5 million in 2001.

These two products are evidence of the success of Bradley's "acquire, enhance, and grow" mantra -- the company looks to acquire what for another company is a non-strategic product, and then enhance the product through improvements in the formula and more attractive packaging, and then grow it by adding line extensions and getting the word out via the company's dedicated sales force, presence at medical conventions, and spending marketing dollars in other ways to get the product in front of prescribing doctors.

Sales have been growing strongly, from $12.6 million in 1996 to $25.7 million in 2001. The most recent year's sales increased 38%, and the company turned in a net profit of $3.6 million, or $0.37 per share. Management also recently upped its guidance for 2002 to $34.1-$35.9 million in sales and earnings per share in the range of $0.55-$0.58, or 33% growth in sales and almost 50% growth in net income. Bradley's stock rocketed ever higher throughout 2001 and into 2002, hitting an all-time high in February of $24 per share only to drop back on disappointment that the fourth-quarter results and management's guidance, as strong as they were, weren't even better. This is a problem with buying small, fast-growing companies at nosebleed P/E ratios -- inevitably, there are virtually impossible expectations priced into the stock. The best course is often to wait until the momentum traders and growth mavens jump ship, which usually comes at the first failure of the company to meet their inflated expectations.

Now that Bradley's stock has dropped back to under $12 a share, it's starting to get interesting for investors looking for growth at a reasonable price. The company still trades at about 33 times trailing earnings, and even with the aggressive estimates guidance provided by company CEO Daniel Glassman of $0.55 to $0.58 per share in 2002, the company trades at a forward P/E of 22. Free cash flow has been better than reported earnings, and the company generated $7.9 million in FCF during the 12 months ending in September of 2001 (the cash flow statement for the fourth quarter is not yet available). If sustainable, this would put the company's valuation at somewhere around 13 times its free cash flow. If Bradley can continue to acquire, enhance, and grow its top and bottom line, that's not at an unreasonable price.