Take advantage when good companies come to market
Mark Sellers

When Google completed its initial public offering in August 2004, the stock seemed overpriced. Even after reducing its IPO price from $108 to $85, the company’s trailing price/earnings ratio was well over 200. Journalists, analysts and market pundits exclaimed that Google was the most overpriced IPO in years, and warned investors to avoid it.

Shortly after the IPO, analysts were confused about how to model the company’s earnings. The average analyst estimate for Google’s first quarter as a public company was 56 cents a share, but the range of estimates was all over the map. Clearly, there was no “consensus” earnings number. Most analysts were cautious.
When Google then reported earnings in October 2004, its earnings per share were 70 cents a share, and the stock jumped 15 per cent in one day. Analysts then rushed to increase their estimates for the following quarter, but were again too cautious. The next quarter, Google beat the average analyst estimate by 15 cents, earning 92 cents a share compared with estimates of 77. The quarter after that, Google earned $1.29 compared with the average estimate of 92 cents.

As it turned out, Google’s stock was incredibly cheap at its IPO price of $85. Over the following year, the company’s actual (not estimated) earnings turned out to be $4.27 per share. This meant that it was priced at just 19.9 times its forward earnings on the date of its IPO, though no one knew that at the time.

We can learn something valuable from this historical analysis: great companies are often treated by the market as if they are merely average companies when they first become public. Over the first four to six quarters as a public company, expectations rise as analysts come to appreciate the company’s competitive position. At the same time, analyst estimates become more clustered around a consensus, which gives investors more certainty about the company’s earnings outlook.

The interaction of these two factors causes a “double-whammy” effect: not only do earnings expectations rise, lowering the forward p/e ratio, but the risk premium priced into the stock falls. In other words, both the earnings outlook and the p/e ratio go up. These two factors work like a slingshot, causing the stock price to rise dramatically. Google, for instance, saw its stock rise from $85 to $280 in its first year of trading as earnings estimates rose and the p/e ratio expanded.

There are other examples of this phenomenon. The Chicago Mercantile Exchange went public in December 2002 at a price of $42 a share, which was about 18 times trailing earnings per share. That seemed a fair price to many pundits, who said the stock was fully valued at that amount. But the company continually beat estimates because of its operating leverage and ability to fend off would-be competitors. The stock price responded by rising more than 700 per cent over the next three years as earnings expectations continually rose and the p/e ratio expanded dramatically.

Another good example of this “increasing expectations” phenomenon is Morningstar, which went public in May 2005 at $18. Today the stock is $66, a 270 per cent increase.

There are two fundamental factors all these companies share. First, they have an “economic moat”, or natural defence against competitors, allowing them to generate high returns on capital. Second, they have lots of operating leverage (as opposed to financial leverage); in other words, a 10 per cent increase in revenue translates into far more than a 10 per cent increase in bottom-line profits. Operating leverage is almost always underestimated by analysts when they are not very familiar with a company.

When a company with these two traits begins to trade publicly, analysts are too cautious at first. They do not know the company that well, so their estimates are all over the place. Investors can play this to their advantage by buying and holding great companies when they go public, ignoring what pundits or analysts say and betting that analyst estimates will rise and become more clustered, causing the p/e ratio to rise at the same time as earnings expectations.

Excess investment returns come from buying an asset when the market's expectations are too low, and selling when expectations are too high. Nowhere are expectations off so much as when a great company first trades publicly. In August 2006, I highlighted two stocks here that I felt were at the beginning of this "increasing expectations" cycle: Mastercard and Chipotle Mexican Grill. Since then, Mastercard is up 314 per cent and Chipotle is up 92 per cent.

A future IPO that I'm excited about is Visa, which plans to go public this year and is certainly a wide-moat company (even more so than Mastercard) and has oodles of operating leverage. It remains to be seen whether analysts will underestimate its potential or not. I will be sure to comment on this in future columns, when the IPO date is announced.

Fonte: Financial Times, 23 Feb. 2008, Life & Arts, p. 4.