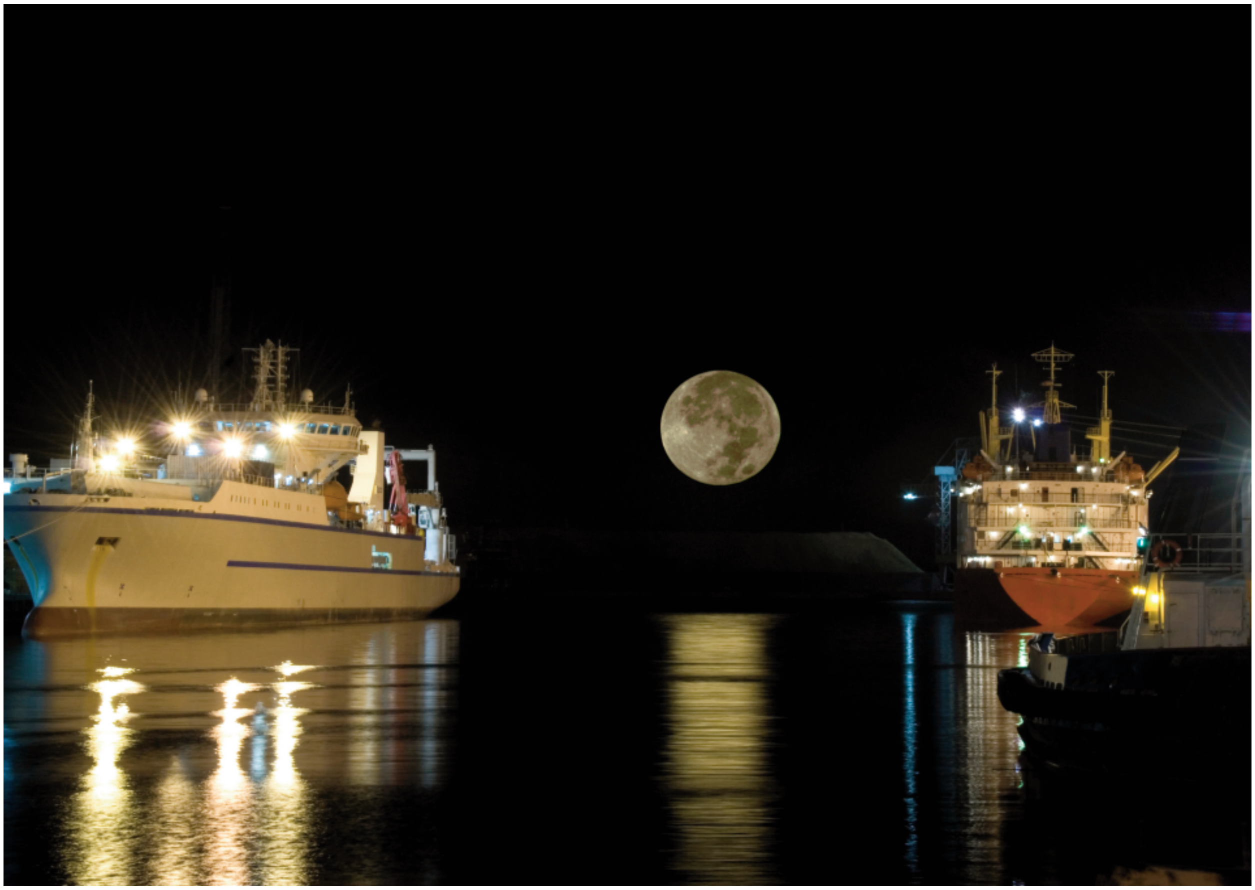
Disciplined Growth Investors



Two Ships Passing in the Night

Insight from the perspective of our Chief Investment Officer.

By
Fred Martin, CFA

Note: This article was originally published in 2003.

DISCIPLINED GROWTH INVESTORS

The Way Wealth Is Built

Two Ships Passing in the Night

Insight from the perspective of Fred Martin, our Chief Investment Officer.

Note: Originally published in 2003, this article highlights key differences between old economy and new economy companies. In particular, note "Macroeconomic Implications," highlighted in the final section on page four.

Steaming through the ocean at 16 knots in a single ship formation takes on a life of its own. Often the sea is calm. The ship feels as though it is swishing through the water. The sky is relatively free of pollution and filled to the brim with stars. Life is good and peaceful. There is just the ship, the sea, and the sky. Occasionally the spell is broken. The ship's radar will pick up a blip. The blip will then become a set of navigation lights on the horizon. Another ship has entered our mobile cocoon, bound for some destination other than ours.

Night encounters are mysterious. Often it is not possible to discern much beyond the other ship's navigation lights. Sometimes one can see the dark shape of the other hull and superstructure. On foggy nights there is no visual contact. There is rarely contact via radio. We are two ships in the same patch of ocean experiencing the same sea and stars, yet we can only speculate on what's happening inside the other ship. Large ocean-going freighters typically steam on autopilot, so we cannot even know whether the crew on the other ship is healthy!

Investing often seems like steaming at sea during the night. We investors rarely have the luxury of full knowledge upon which to make decisions. We become accustomed to dealing with incomplete information. This developed skill, so vitally necessary to succeed as a public market investor, carries with it a major risk. Far too often we ignore the obvious information in front of us. Today the stock market is telling us an important story, a story of two companies headed in opposite directions. Yet in our habits we investors are choosing to ignore this important development. We are allowing this story to become two ships passing in the night.

The Way

At DGI we do not want to let this story slip by in the darkness. There is plenty of publicly available data to see where these two companies are headed. We do not have to settle for the limited visibility offered at night; we can shine the full light of day on these two companies. For the moment we are going to leave these companies nameless; we are going to tell the financial story of these companies in a way we hope you will find decisive. The stock market currently awards the two companies approximately equal market values, approximately $20 billion each. One has a great chance for long-term success; the other is in a state of decline.

Company A was founded in 1908. For long periods of time, it was among the most admired companies in the world. Today it has a leading market share in its industry. It sales activity is high, totaling nearly $187 billion in 2002. The industry is very competitive; the company earned $1.6 billion in after-tax profits in 2002, or 0.9% of revenues. Because the company's products do not have sufficient differentiation in their respective markets, gross profit margins were low, at 17.9% of revenues.

The company has many employees, about 341,000. Sales per employee are high, about $547,000 per employee in 2002. Gross margin profits per employee were low at $98,000. The business is capital-intensive. At the end of 2002, the company had invested $72.7 billion in fixed assets. Total capital invested (equity plus debt plus equity and/or debt equivalents) was $346.5 billion. Return on average fixed assets in 2002 was 2.5%; return on average total capital invested was 0.7%. For all of 2002, the company had negative free cash flow ($19.7 billion). Company A is in a mature industry. Total revenue growth from 1997 to 2002 was 5% per year. Its workforce is also mature; the company has large, unfunded retirement and other post-retirement obligations. According to its 2002 10k report, the company was underfunded by $76.8 billion with regard to its employee retirement obligations. The company's balance sheet is highly leveraged. At the end of 2002 the company had $201.9 billion of debt and $6.8 billion of equity.

Company B was founded in 1995. Today it is widely ridiculed as a "flash in the pan."

Today the company has a leading market share in its industry. The industry is young; revenues for the company in 2002 totaled $953 million. The company earned $107 million in 2002, 11.2% of revenues. Gross profit margins were 82.9% of revenues.

The company has only a few employees, 3,600. Revenues per employee were about $265,000 in 2002. Gross margin profits per employee were about $220,000 in 2002. The business requires little capital. At the end of 2002, the company had invested $371 million in fixed assets. Total capital invested was $2.2 billion. Return on average fixed assets in 2002 was 42.5%; return on total capital was 5.1%. For all of 2002 the company had free cash flow of $251 million.

Company B is in a new industry. Revenues grew at 70% per year from 1997 to 2002. Company B's workforce is also new. The company has no retirement obligations. The company's balance sheet is overcapitalized. At the end of 2002, the company had cash and marketable securities totaling $1.5 billion and no debt. The company also had total equity of $2.2 billion and tangible equity of $1.75 billion.

Company A vs. Company B

Select Financial Data For The Year Ended December 2002

	Company A	**Company B**
Market Value (9/8/03)	$23.8 billion	$21.7 billion
Growth Rates:		
Annualized revenue growth 1997 to 2002	5%	70%
Projected long-term growth rate	0%	20%
Select Income Statement and Cash Flow Data:		
Revenues (bil)	$186.8	$1.0
Net income (bil)	$1.7	$0.1
Gross margin	17.9%	82.9%
Net margin	0.9%	11.2%
Free cash flow (bil)	($18.90)	$0.25
Productivity and Returns:		
Employees	341,000	3,600
Revenue per employee	$547,692	$264,750
GM$ per employee	$98,003	$219,500
Return on fixed assets (avg)	2.5%	42.5%
Return on capital (avg)	0.7%	5.1%
Select Balance Sheet Data:		
Cash and marketable securities (bil)	$38.3	$1.5
Investment in fixed assets (bil)	$72.8	$0.4
Debt (bil)	$201.9	$0.0
Pension and post-retirement obligations (bil)	$60.9	$0.0
Stockholders' equity (bil)	$6.8	$2.3
Tangible equity (bil)	($10.8)	$1.8

As we hope you can see from the above data, company A is a capital-intensive, low return operation in a mature industry. In this case the company's reported earnings may not reflect the company's ability to pay dividends; it appears that most, if not all, of the company's future cash flow is promised to employees and debt holders. Company B is a scalable, high-margin operation in a new industry with high growth prospects. The business needs little capital to grow and the company has no past obligations so future cash flow generation should flow to shareholders.

If you could only buy one stock for the next ten years and your choices were confined to company A or B, which would you rather own? General Motors (company A) or Yahoo (company B).

Macroeconomic Implications

The economic implications of the story of these two companies are profound. General Motors still retains an important place in American commerce. The sheer size of its annual revenue stream ($187 Billion) and number of employees (341,000) means the company cannot be ignored. General Motors looks like a lumbering dinosaur when compared to Yahoo. Yahoo requires almost no capital and has virtually no employees (3,600).

The superior characteristics of Yahoo's business and the past obligations of General Motors means that investment dollars are highly likely to prefer Yahoo over General Motors. The collateral effects of this stunning difference in businesses will create social strains within the U.S. economy. It appears that Yahoo and many of its new economy peers will continue to employ a fraction of the number of people employed at General Motors and other mature, capital-intensive industrial companies. This may mean that uncomfortably high U.S. unemployment becomes a semi-permanent fixture in the economy. Yahoo is also likely to use only a fraction of the capital required by General Motors. This may relegate the debt markets to a less important role in the U.S. economy.

This fundamental and enduring difference also creates a dilemma for U.S. economic policymakers. On the one hand, companies like Yahoo require at least neutral economic policies to continue to grow and thrive. On the other hand, the hard-fought and legitimate rights of the past and present GM employees and creditors cannot be abridged without great turmoil. The ability of present and future U.S. business and political leaders to manage this conflict may have a significant effect on future U.S. economic success. In closing, we wish to note that we have featured Yahoo as representative of the new economy stocks. As with any one company, it is possible that the management of Yahoo will make poor decisions and botch the huge opportunity facing the business. To this, we say we would rather invest our clients' money on 10 Yahoo-like situations than 10 GM-like situations.

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About Disciplined Growth Investors

Disciplined Growth Investors is a Minneapolis-based investment management firm specializing in prudently exploiting investment opportunities in publicly held small cap and mid cap growth companies. Founded in 1997, the firm remains employee owned and completely independent.

About the Author

Fred Martin is Disciplined Growth Investors' founder and Chief Investment Officer. Fred has been managing portfolios since 1976 and is the primary architect of the investment philosophy employed by the firm.