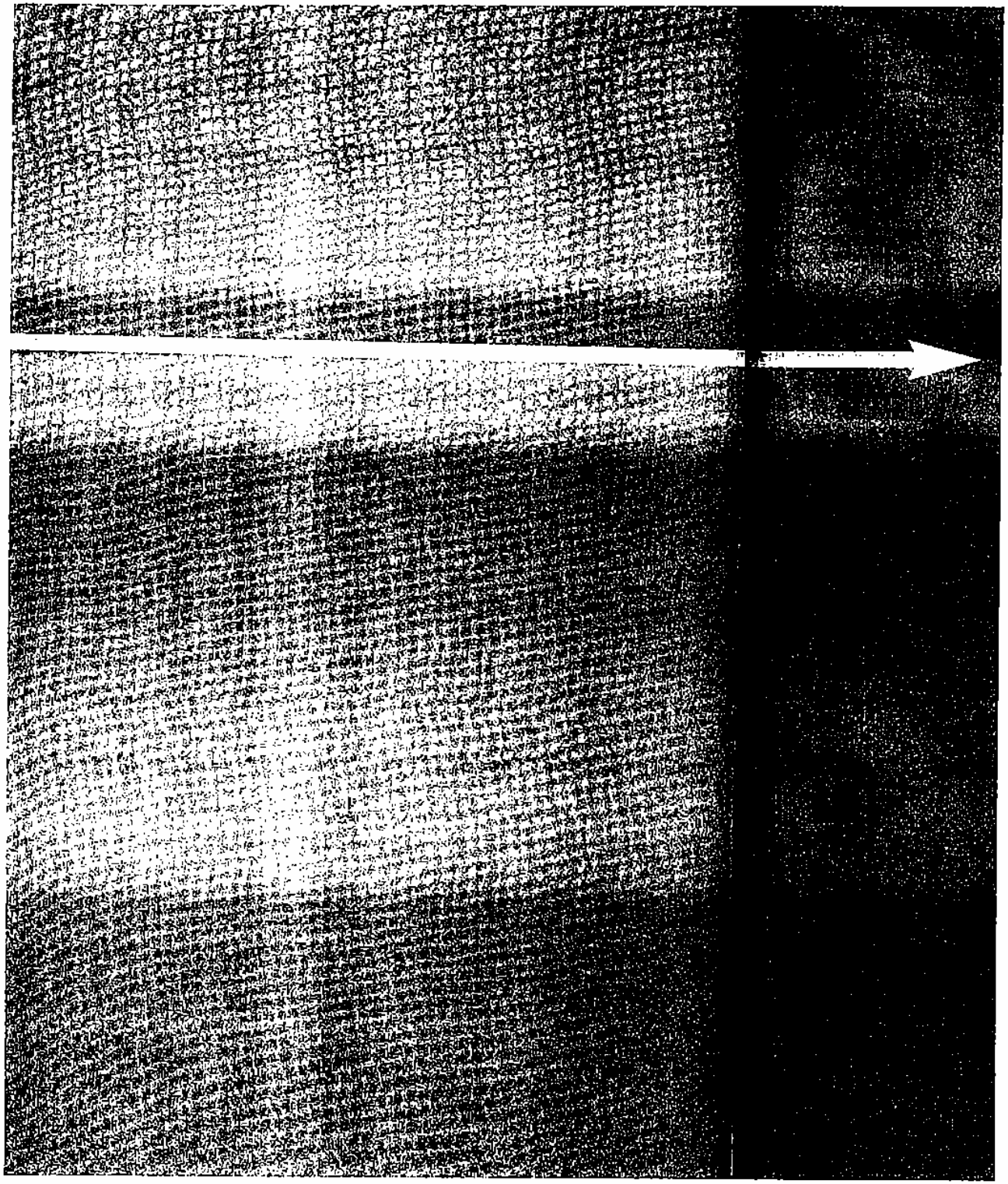


FINDING THE NEXT STARBUCKS

How to Identify

and Invest

in the Hot Stocks

of Tomorrow

MICHAEL MOE

Portfolio

CONTENTS

INTRODUCTION

GROWING UP, I was obsessed with sports—both playing and watching. I knew every obscure fact and statistic for "my teams"—the Vikings, the Twins, and especially the University of Minnesota Golden Gophers.

As a kid, I was around business a lot because my dad was a successful corporate attorney who constantly had clients coming over to our house to work on deals at our kitchen table and calling at all hours of the night. Additionally, both my grandfathers, whom I adored, were accomplished senior business executives and active investors. But business and investing were of little interest to me—give me the sports page.

In life you have these Aha! moments that are extremely impactful, maybe like the first time you met your spouse. You remember the time, place, and date as if it was yesterday, even if it was twenty years ago. An Aha! moment happened for me at the University of Minnesota, where I majored in political science and economics, thinking I would be a lawyer like my dad, but my real "major" was as a very backup quarterback for the football team.

When I was a senior, a friend of my dad's took me to lunch and asked me if I ever thought of working on Wall Street. At the time, I thought the Federal Reserve was an Indian reservation. He gave me examples of how very small investments in companies like Control Data,

Medtronic, and 3M turned into very large sums of money based on the success of those companies.

Seeing I was interested, he explained how the magic of compound interest works over time and the Rule of 72. I couldn't believe how amazing it was. I was hooked and found a new passion. Out with *Sports Illustrated,* in with the *Wall Street Journal.*

I wrote this book to share what I have learned over the past 20 years about how to identify and invest in the small companies that can become big companies—what I call the stars of tomorrow. The hunt for these companies has the greatest potential for reward, but can also be very dangerous for the ill-prepared.

In reality, finding the best stocks is really finding the best companies—over time a stock's performance will be aligned with how the company does. Great companies and investors are both systematic and strategic to achieve their obejectives. The framework I provide in this book with our growth-investing 10 commandments, the four Ps for every great growth company (people, product, potential, and predictability), and sources to use to spot these companies early is a guide to finding tomorrow's ten baggers.

I am honored that one of my investment heroes, Peter Lynch, reviewed *Finding the Next Starbucks* and gave me some practical input to making it clearer and better. An analogy he used to describe the purpose of the book is that of a ski instructor. With a couple of lessons, you can't expect to be an expert, but you will learn some important fundamentals and also some strategy for not getting hurt. This book is meant to be a guide that will help you with both.

You don't have to be the next Warren Buffett or Peter Lynch to find the next Starbucks, Google, or Amgen, but you do need the right fundamentals, which I hope you'll find here.

1

Star Search—Finding the Supernovas

"Personally, I hope to find the next Siegfried and Roy."

—Simon Cowell, *American Idol*

I WAS FORTUNATE to be one of the first research analysts to identify Starbucks Coffee as a huge opportunity following its IPO in 1992, when its market cap (share price multiplied by number of shares outstanding) was $220 million. Today, its market cap is $23 billion.

I was also one of the first research analysts to follow and recommend Apollo Group after it went public in December 1994, with a $110 million market cap. Apollo was the top-performing stock out of all U.S. publicly traded companies from 1994 to 2004. A dollar invested in APOL at its initial public offering (IPO) is worth $83 today.

My firm was the first to recommend the purchase of Google the day it went public at $85 a share. When the shares hit $200, I was on CNBC saying Google was "cheap" and the most important growth company in the world. CNBC *Squawk Box* host Mark Haines made an offhand remark that only somebody in San Francisco could be that nuts. As of December 31, 2005, it was $415.

Lucky? Maybe a little. Art or science? Both. Hard work? Absolutely. Let me tell you a story.

It was a Thursday afternoon after a long week on the road visiting companies. I was in Seattle with one meeting to go before I flew home. My friends told me about this coffee company—named after a *Moby-Dick* character—that had a cult following. I almost canceled my meeting

on the way to the airport because I just wanted to get home and the company sounded ridiculous.

Maybe people in Seattle would embrace a coffee house as a great business, but I couldn't imagine this concept traveling beyond the Puget Sound. I didn't even drink coffee! But, Starbucks headquarters was just off Interstate 5 on the way to the airport and I figured, "Why not, I'll make it quick."

The minute I walked into the reception area, I knew something was going on there. The receptionist made me feel like we'd been friends for 100 years. The level of energy in the air was electric.

When I sat down with the CEO, Howard Schultz, he crystallized how Starbucks was going to become the most important coffee company in the world. He talked about the importance of his employees and how he was creating a partnership with them. He was passionate about the quality of the product and the customer experience. He painted a picture of how Starbucks was going to develop one of the most respected brands in the world. After our first meeting, I was convinced. I started to drink coffee!

An investor who looked at opportunities based on price to earnings (stock price divided by the company's earnings), price to book (stock price divided by book value of the company's net assets), or price to comparables (valuation relative to other restaurant companies) would have wondered what Howard had in his coffee. I left that believing that I had just met the next Ray Kroc—the man who turned McDonald's into a billion-dollar hamburger business.

What gave me that impression? Read on.

→ STARS OF TOMORROW, TODAY

"Don't bunt. Aim out of the park. Aim for the company of immortals."

—David Ogilvy

One dollar invested in Microsoft when it went public in 1986 is worth $374 today. One dollar invested in Cisco Systems when it went public in 1990 is worth $274. One dollar invested in Home Depot at its IPO in 1981 is worth $1,153, and a dollar invested in Yahoo! at its IPO in 1996 is worth $72.

VALUE OF $1 INVESTED AT IPO

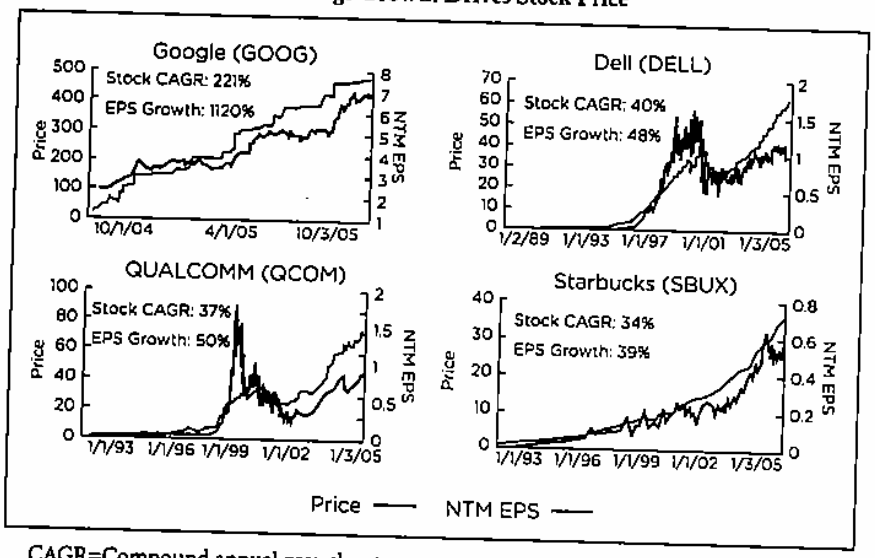
COMPANY	IPO	MARKET CAP AT IPO	MARKET CAP TODAY	VALUE OF $1 TODAY
Wal-Mart (WMT)	1970	$25 million	$195 billion	$5,809
Home Depot (HD)	1981	$34 million	$86 billion	$1,153
Microsoft (MSFT)	1986	$519 million	$278 billion	$374
Dell (DELL)	1988	$212 million	$71 billion	$338
Southwest (LUV)	1971	$11 million	$13 billion	$299
Cisco (CSCO)	1990	$226 million	$105 billion	$274
Oracle (ORCL)	1986	$228 million	$63 billion	$264
Amgen (AMGN)	1983	$463 million	$97 billion	$210
Genentech (DNA)	1980	$263 million	$98 billion	$133
QUALCOMM (QCOM)	1991	$314 million	$71 billion	$86
Apollo Group (APOL)	1994	$118 million	$11 billion	$83
Yahoo! (YHOO)	1996	$334 million	$55 billion	$72
eBay (EBAY)	1998	$715 million	$59 billion	$58
Starbucks (SBUX)	1992	$216 million	$23 billion	$56
Schwab (SCHW)	1987	$419 million	$19 billion	$41
Guidant (GDT)	1994	$247 million	$21 billion	$18

Source: FactSet, ThinkEquity Partners.

The stocks that generate the most spectacular returns are small companies that become big companies. My objective is to identify and invest in what I call the stars of tomorrow—the fastest-growing, most innovative companies in the world.

In the long run, a company's share price will be nearly 100% correlated with its earnings growth. Earnings growth drives stock price. Accordingly, over time, the companies that have the highest returns will be the ones that have the highest earnings growth rates. But, as economist John Maynard Keynes wrote, "In the long run, we are all dead." Hence, we need to analyze short-term pitfalls as well.

Earnings Growth Drives Stock Price



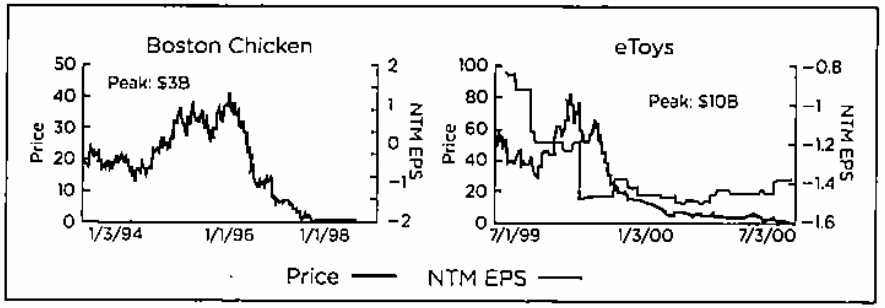
CAGR=Compound annual growth rate
EPS=Earnings per share
NTM=Next 12 months
Source: FactSet, ThinkEquity Partners.

The reason why Google, Starbucks, QUALCOMM, and Dell have had spectacular stock performance is that they have had spectacular earnings growth. Unfortunately, in growth investing, often what seems like the next Starbucks turns out to be the next Boston Chicken. Our objective is to provide a process to identify the stars of tomorrow and avoid the roman candles.

The highway of emerging growth companies is littered with the remains of once high-flying stocks. The reality is that when you are going 80 miles per hour along the highway and hit a speed bump, it causes a much greater problem than if you encountered the same bump at 15 miles per hour.

Boston Chicken was once thought to be a huge growth story, but hypergrowth combined with aggressive financing and a flawed business model resulted in a spectacular crash when Boston Chicken's market value went from $3 billion to zero. I know; I used to follow it. A Silicon Valley truism is that you can learn more from your losses than from your winners. I've learned a lot.

Hall of Shame: High Flyers to Zero



Source: FactSet, ThinkEquity Partners.

→ WHY GROWTH?

"The race is not always to the swift, nor the battle to the strong, but that's the way to bet." —DAMON RUNYON

To get things started, we need to have a common understanding of what a growth company is (and isn't). At its most fundamental level a growth company is a business that is growing its sales and earnings at a much higher rate than the average company. I think revenue growth, unit growth, and earnings growth are a start, but not the finish.

Some would say, "Since gross domestic product (GDP) is growing at 3 or 4% per year, a company that is growing faster than that is a growth company." I think that's rubbish!

Others look at the long-term earnings per share (EPS) growth of the U.S. stock market of 7% and say that if a company is growing faster than that, it's a growth company. While we are getting closer, we're not there yet.

I had a very sophisticated investment consulting firm tell me a growth company is "a company with a higher price to earnings ratio (P/E) than the market"—the logic being that growing companies would have higher P/E multiples. While this was interesting, it was ABSURD! It's like saying that the definition of a home-run hitter is a batter who strikes out the most. The point being, while home-run hitters often strike out a lot, and growth companies often have higher P/Es than the market average, to identify the home-run hitters you should count not the strikeouts, but the home runs!

So, what is the right hurdle rate of revenue and earnings growth to be in the Growth Club?

Obviously faster is better, but the minimum growth rate for admission is also a function of a company's size. *The smaller a company is, the faster it needs to be growing to be of interest.* Nobody is going to make spectacular gains by investing in a small company that is always going to be small. On the flip side, a large-cap company that is growing its revenues and earnings significantly above the market may be attractive as a growth company due to its likely predictability and liquidity.

Accordingly, my framework for classifying a business as a growth company takes the company's market cap into account. For a company with a market cap below $250 million, revenues need to be growing at a rate of at least 25% and earnings at a rate of at least 30%. For a company with a market cap between $250 million and $1 billion, the minimum revenue growth is 20%, and the minimum EPS growth is 25%. For a company with a market cap between $1 billion and $5 billion, the minimum revenue growth is 15%, and the minimum earnings growth is 20%. At a market cap above $5 billion, the minimum revenue growth is 10%, and the minimum EPS growth is 15%.

GROWTH CLUB QUALIFICATIONS

MARKET CAP	REVENUE GROWTH	EARNINGS GROWTH
<$250 million	25%	30%
$250 million–$1 billion	20%	25%
$1 billion–$5 billion	15%	20%
>$5 billion	10%	15%

The story goes that when infamous thief Willie Sutton was asked why he robbed banks, he replied, "Because that's where the money is." Similarly, the reason I focus on growth companies is because that is where the greatest potential investment returns are. In the short term, a variety of factors influence stock prices—geopolitical events, fund flows, interest rates, oil prices, and so on. In the long term, one thing influences stock prices—earnings growth!

As I will continue to say, over time there is nearly a 100% correlation between a company's earnings growth and its stock performance. Or as Peter Lynch once said, "People may bet on the hourly wiggles of the market, but it's the earnings that waggle the wiggles long term."

→ GROWTH AND RISK

"Worldly wisdom teaches that it is better for a reputation to fail conventionally than to succeed unconventionally."

—JOHN MAYNARD KEYNES

One of the golden truths of high finance is the relationship between risk and reward: the greater the potential reward, the higher the *perception* of potential risk. This truth, when applied to just about any activity—whether it's sports, education and career choice, gambling, or investing—provides for many possible combinations of risk and potential reward. Before conceding this truth then, it is important to understand what is at risk.

At one extreme of the risk–reward spectrum is the combination of paying a premium for quality in exchange for greater confidence in a potentially winning outcome. The P/E multiple on QUALCOMM, a blue-chip growth company, is approximately 50% higher than the overall market's, but the likelihood of its having superior earnings growth justifies that multiple. At the other extreme is the goal of maximizing potential gain by buying cheap, with the hope of hitting it big. There are numerous examples of buying inexpensive fallen angels that find new wings for turnarounds and actually turn. This strategy obviously has the appearance of carrying with it a high degree of risk, not only from the potential for permanent loss, but also from the *appearance* of foolishness if it fails.

Given that people are by nature risk-averse, the avoid-looking-foolish principle compels many investors to pay a premium in order to hide behind the averages of their peers if the chosen strategy falls short of succeeding.

Unfortunately, history shows that investors fall into this "quality trap" all too frequently. With well more than half of all portfolio managers underperforming the market each year, the most common source of the quality trap is extrapolating past success into the future. Ultimately, this leads to paying a hefty premium for those phantom successes.

Somehow, it is accepted as conventional wisdom that it's more conservative to buy Wal-Mart or General Electric at any price than to buy a lesser-known emerging growth company at a low price. However, if we look at investing from a different perspective, this conventional wisdom falls short of making sense.

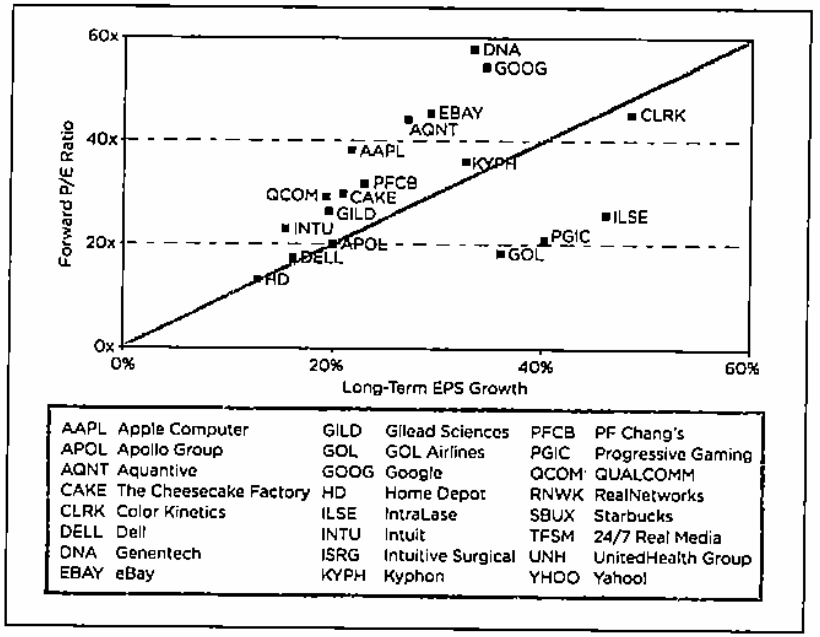
Consider, for example, the following two companies: first, a large, well-established, 50-year-old company trading at $40, with $2 per share in earnings, that is expected to grow future earnings at the rate of 8% per year; and second, a small, emerging growth company, trading at $50, with $1 in EPS, that is expected to grow earnings at 50% per year.

If we look at P/E multiples for what they are—the number of years before we realize in today's earnings what we paid for in share price—then the large, established company looks more attractive at 20 times earnings, versus the growth company's 50 times (in other words, 30 fewer years until we are repaid in earnings what we paid for the stock).

However, when the rate of earnings growth is accounted for, the results change dramatically. At the large company's annual growth of 8%, we would be repaid in earnings in just over 12 years, while at the emerging company's 50% growth rate, we would be repaid in just over seven years. By year 12, we could receive $387 in earnings versus the $50 we paid for the stock. (See the charts on pages 10 and 11.)

Even if we assume that the emerging company's growth slows by 10% each year, so that in year 10 growth has slowed to "just" 16%, we would have been repaid in 9½ years, or 2½ years sooner than the conservative investor. Of course, as our top-performer study highlights in chapter 3, we would also expect to be compensated handsomely for our

P/E to Growth for Growth Stocks



AAPL	Apple Computer	GILD	Gilead Sciences	PFCB	PF Chang's
APOL	Apollo Group	GOL	GOL Airlines	PGIC	Progressive Gaming
AQNT	Aquantive	GOOG	Google	QCOM	QUALCOMM
CAKE	The Cheesecake Factory	HD	Home Depot	RNWK	RealNetworks
CLRK	Color Kinetics	ILSE	IntraLase	SBUX	Starbucks
DELL	Dell	INTU	Intuit	TFSM	24/7 Real Media
DNA	Genentech	ISRG	Intuitive Surgical	UNH	UnitedHealth Group
EBAY	eBay	KYPH	Kyphon	YHOO	Yahoo!

efforts, with sizable appreciation in share price consistent with growth in earnings.

Ultimately, in sports, gambling, investing, and life, there is little value in knowing what happened yesterday. The largest rewards come from anticipating what will occur in the future. As Warren Buffett once said, "If history books were the key to riches, the Forbes 400 would consist of librarians."

Fundamental in our pursuit of attractive investment opportunities is my philosophy of risk and reward. I view risk as measuring the potential for permanent capital loss, not short-term quotational loss, and assess the probability of that against what we think the value of a business will be in the future.

EARNINGS ARE EVERYTHING—THE POWER OF GROWTH			
Annual EPS			
YEAR	BLUE CHIP: 8% EPS GROWTH	GROWTH COMPANY: 50% EPS GROWTH	GROWTH COMPANY: DECELERATING EPS GROWTH
0	$2.00	$1.00	$1.00
1	$2.16	$1.50	$1.50
2	$2.33	$2.25	$2.18
3	$2.52	$3.38	$3.06
4	$2.72	$5.06	$4.17
5	$2.94	$7.59	$5.54
6	$3.17	$11.39	$7.17
7	$3.43	$17.09	$9.08
8	$3.70	$25.63	$11.25
9	$4.00	$38.44	$13.67
10	$4.32	$57.67	$16.32
11	$4.66	$86.50	$19.16
12	$5.04	$129.75	$22.17

CUMULATIVE EARNINGS			
YEAR	BLUE CHIP: 8% EPS GROWTH	GROWTH COMPANY: 50% EPS GROWTH	GROWTH COMPANY: DECELERATING EPS GROWTH
0	$2.00	$1.00	$1.00
1	$4.16	$2.50	$2.50
2	$6.49	$4.75	$4.68
3	$9.01	$8.13	$7.74
4	$11.73	$13.19	$11.91
5	$14.67	$20.78	$17.45
6	$17.85	$32.17	$24.62
7	$21.27	$49.26	$33.70
8	$24.98	$74.89	$44.95
9	$28.97	$113.33	$58.62
10	$33.29	$171.00	$74.94
11	$37.95	$257.49	$94.10
12	$42.99	$387.24	$116.27

It is with this perspective that I fly right in the face of conventional wisdom, which suggests that the bigger the return, the more risk one has to assume. From my point of view, large returns will occur when we find an opportunity where the upside is substantial, yet the price we pay for it is not. My goal is to find a stock whose price is below what I think the appraised value should be, not what the quotational value is as indicated by the current stock price. I also want to find the stock in the "right neighborhood," an industry where there is tremendous market growth potential. This heaven-on-earth company is not an easy one to find, but that is my mission.

→ THE GROWTH OPPORTUNITY— FINDING THE SWEET SPOT

"Great stocks are extremely hard to find. If they weren't, then everyone would own them."

—PHILIP A. FISHER

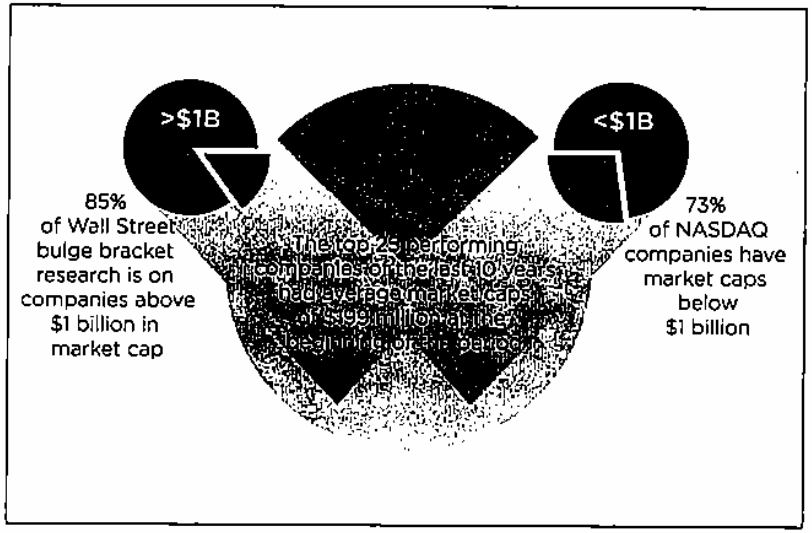
In searching for the fastest-growing companies with the greatest potential, the best pond to be fishing in is the small-cap pond. Not only does the small-cap pond have the most fast-swimming fish, it's typically the least expensive relative to growth opportunities.

For purposes of this book, I will define size relative to market capitalization in this way:

Nanocap stocks	Below $50 million
Microcap stocks	$50-$250 million
Small-cap stocks	$250 million-$1 billion
Midcap stocks	$1 billion-$5 billion
Large-cap stocks	Over $5 billion

Ironically, while the opportunities for outsized returns for investors lie in identifying early-stage growth companies, large investment banks are driven by the economics of trading volume and therefore generally ignore the stars of tomorrow today. In fact, analyst coverage for small companies (nano-, micro-, and small caps) is proportional to a company's size. For example, while 75% of NASDAQ companies have a market cap below $1 billion, 85% of research from the seven largest firms on Wall Street is on companies with market caps above $1 billion. Moreover, the big winners over time almost always start with a market value below $1 billion—and often under $200 million—which is microcap territory.

Wall Street Research Focuses on Big Companies— Tomorrow's Winners Are Small-Cap Today



The reason I point this out—and, for that matter, the reason I'm writing this book—is that if you are looking to invest in tomorrow's winners, it's unlikely you will find them by reading Wall Street research. Mainly, Wall Street is focused on reporting on companies everybody already knows about. Consequently, to identify and invest in tomorrow's stars, you are unlikely to be battling Wall Street's finest—they aren't there.

As proof of the inefficient analysis of smaller companies, of the 767 publicly traded nanocap companies in the United States, only 126 (just 16%) have analyst coverage. For microcaps, the percentage covered by analysts rises to 58%, which still leaves nearly 650 microcaps uncovered.

Combined, the total number of nano- and microcap companies without analyst coverage is nearly 1,300, or 20% of all equities. Even for those that do have coverage, often only a single analyst provides research.

$10,000 INVESTED IN 1973		
	VALUE IN 2005	ANNUAL RETURN
Small-Cap Stocks	$1,066,057	16.3%
Midcap Stocks	$756,864	15.0%
Large-Cap Stocks	$127,963	8.6%
Inflation	$44,060	$4.9%

Focusing on small companies has proven rewarding, as $10,000 invested in small-cap stocks 33 years ago (1973) would have appreciated to $1,066,057 by the end of 2005, for a 16.3% compound annual return. Small-cap returns significantly bested returns on large caps ($127,963, or 8.6%) and NASDAQ ($239,214, or 10.8%) over the same period.

Accordingly, my intense focus is on rapid and sustainable growth, and I believe that size forges an anchor to sustaining rapid growth in sales and earnings. In my view, if I can identify a young, unknown company with a lot of growth potential, then I stand to benefit not only from the long-term earnings potential, but also from the herd nature of investors as the opportunity becomes more widely recognized.

We have conducted a number of studies over various periods of time to determine characteristics of top-performing stocks. The punch line is always the same. Of the 25 best-performing companies over 5 and 10 years' time, the average market capitalization at the beginning of each period is always very small—between $100 million and $200 million (microcaps). Now, many of these companies are well recognized as the stars of today's equity market, with much larger market capitalizations (some well into large-cap territory) and, of course, widely followed by analysts.

With the right framework, I believe the heightened perception of greater risk with growth stocks leads to greater opportunities for growth investors. As analyst coverage of underfollowed companies increases, and the information gap narrows, the potential return is driven not only by the underlying potential being reflected in share prices, but also by the reduced risk aversion from the broader group of investors.

You may think, "Great, unloved for sure, but most are small and forgotten for a reason." And perhaps you think I'm biased. After all, just as you don't ask a barber if you need a haircut, don't ask a small-cap growth guy where you should invest.

While this may be true, the fact is that just as trees don't start as trees, they start as acorns; big companies don't start as big companies, they start as small companies. Behind every one of today's bellwethers and blue chips was an entrepreneur who had the foresight to identify a market opportunity and build a company around a vision, product, and customers.

It is easy to forget that even large-cap stalwarts such as UnitedHealth Group and Nike had market caps of just $29 million and $418 million, respectively, when they went public in 1980. In both instances, the companies were founded by an entrepreneur who saw an opportunity to do something better than it had been done before.

What characteristics do I look for in a small company that can become a big company? I call them the four Ps: *people, product, potential,* and *predictability.* The four Ps are key ingredients for the secret sauce of investing in the stars of tomorrow, and I will discuss them in more detail in chapter 6. In the meantime, the facts support my affection. Small companies with great growth potential are the brightest stars of tomorrow. The goal of investing should be to get the highest return for acceptable risk.

WHERE DO BIG COMPANIES COME FROM?

COMPANY	YEAR OF IPO	MARKET CAP (MILLIONS)		STOCK CAGR	EPS GROWTH
		IPO	TODAY		
UnitedHealth Group	1984	$29	$79,002	33%	33%
Apple	1980	$810	$59,662	12%	18%
ADP	1961	$10	$26,737	15%	15%
Gilead Sciences	1992	$208	$24,173	27%	30%
Nike	1980	$418	$22,660	15%	20%
Boston Scientific	1992	$1,692	$20,274	13%	15%
XTO Energy	1993	$192	$15,964	35%	38%
Electronic Arts	1989	$59	$15,834	34%	30%
Biogen	1991	$109	$15,030	21%	21%
Paychex	1983	$61	$14,732	27%	23%
Coach	2000	$884	$12,775	70%	50%
Express Scripts	1992	$82	$12,296	44%	27%
VeriSign	1998	$437	$5,633	20%	23%
Dollar Tree Stores	1995	$294	$2,571	22%	27%

Source: FactSet, ThinkEquity Partners.

2

The Power of Growth—The Magic of Compound Interest

"Compound interest is the eighth wonder of the world."

—ALBERT EINSTEIN

SINCE MY PHILOSOPHY is that earnings growth is what drives stock price over time, it seems that the simple solution would be to find companies with high earnings growth, take a deep breath, and then hang on for the ride. While that's true, investing in high-growth enterprises is even better than that due to the way compound interest works. Understanding the magic of compound interest and the power of earnings is critical to appreciating why growth investing has such huge potential rewards.

Compound interest, high earnings growth rates, and time create a potent combination that leads to spectacular returns. Even slight differences in short-term returns can produce dramatic results over a meaningful time period when aided by compounding.

To understand the magic of compound interest, let me tell you another story. In 1626, Dutchman Peter Minuit purchased the entire island of Manhattan for $24 worth of trinkets from the Wappinger Indians. In other words, for what it would cost to order a bagel and café latte at a midtown hotel today, Monsieur Minuit owned the *entire* Big Apple.

While there are many outside of Gotham who would look at neither as a bargain, my point is to demonstrate the power of compound interest. Albert Einstein called compound interest the eighth wonder of the world, and with the help of the ninth wonder of the world, the HP 12C, we can calculate whether Peter Minuit got a good deal.