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Formula for Identifying and Evaluating the Stars of Tomorrow (the Process)

"Here's something to think about: How come you never see a headline like 'Psychic Wins Lottery'?"

—Jay Leno

One of the most bizarre realities of Wall Street is the generally random process security analysts use to evaluate investment opportunities. I was an analyst at Lehman Brothers when it had the number-one-ranked research department on Wall Street. I was director of global growth research at Merrill Lynch when it was ranked number one. I was director of growth research and strategy at Montgomery Securities when that firm did better research than the other two top-ranked firms. And at all three places, the instructions were essentially the same: "Here's a laptop. This is your industry. Go write research and recommend companies."

Was there a Merrill Lynch way? A Lehman Brothers way? Or was there a process to identify, analyze, and recommend stocks? Absolutely not. Basically the "process" for doing security analysis was to hire bright, ambitious people and tell them to do their thing. Sometimes it works. And often it doesn't. It's not a mystery that research analysts are held in such low regard. The way Merrill Lynch and Lehman Brothers have established themselves as world-class firms has nothing to do with their approach to identifying the stars of tomorrow.

But it's not their fault because they haven't been given a process. If Starbucks hired kids off the street and told them, "Go make a latte," very few people would have ever heard of Starbucks.

One of the characteristics of great companies is that they are *systematic and strategic* in how they operate their business. Similarly, if you want to be a great investor, you need to be systematic and strategic in how you analyze companies.

We have created a "recipe book" on how to identify and invest in the fastest-growing companies in the world. It starts with our Think 10 Commandments and then proceeds to our megatrend analysis, our evaluation of a company's four Ps, and a disciplined valuation approach. How is this integrated in my process to identify the stars of tomorrow today?

→ THE THINKEQUITY PROCESS FOR IDENTIFYING AND INVESTING IN THE STARS OF TOMORROW

The ThinkEquity Partners' 10 Commandments are embedded in ThinkEquity's investment process. It's through these simple principles that investors will create the foundation to enhance their investment returns. Obviously, an investor's objective is to make money, but without a method, there is madness!

First, *be right on the fundamentals.* Earnings growth drives stock price. There is essentially a 100% correlation between how a company does and how its stock performs over time. Focus on the fastest-growing companies.

Second, *be proactive, not reactive.* Looking ahead and anticipating where the world is heading is how we catch winners early on. Try to predict what will be in tomorrow's newspapers, as opposed to reacting to what is in today's.

Third, *be rigorous, but don't have rigor mortis.* Looking at the balance sheet to make sure a company has enough cash to support your "blink" decision is important, but it is possible to overanalyze opportunities. The best investments are often easy and intuitive.

Fourth, *when wrong, admit it.* The best investors and analysts are wrong a lot. The worst thing to do is rationalize a mistake. Be intellectually honest. Make decisions based on current facts, not what you had thought to begin with.

Fifth is *the cockroach theory.* You seldom find just one cockroach in a kitchen. Likewise, if you find a problem at a growth company, there are always more behind it. It's rarely a one-quarter issue—the first loss is the best loss.

Sixth, *investment ideas are about information and insight.* Information is valuable if it is proprietary. Insight is valuable if we know what that information means.

Seventh, *the four Ps (people, product, potential, and predictability) are key for any successful growth company.* The first P, people, is the most important.

Eighth, *use five independent sources for each stock you invest in.* If possible, have a regular dialogue with the company management, but remember they will always see the glass as half full.

Ninth, *find three main reasons for a stock to move up or down.* In addition, identify near-term catalysts for price movements. Maintaining a thesis for why you own a stock is key.

Tenth, and finally, *be passionate about investing, but dispassionate about the investment.* The stock doesn't have feelings or know you own it.

The 10 Commandments create a consistent framework to cement my philosophy and are integrated in all that we do. We then start with a top-down view of each growth sector to determine how megatrends and industry drivers are influencing the potential of an industry. From that top-down approach, we create investment themes, which are where we focus our research and resources.

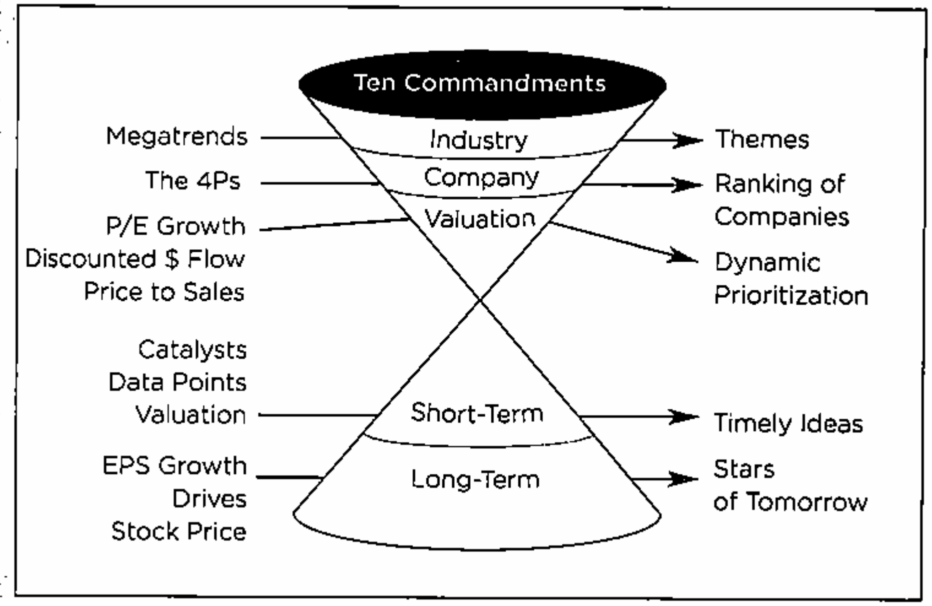
Next, we strive to know and list all the companies within the investment themes we've identified. From big to small, public to private, fast growing to slow growing, we will rank the companies based on the four Ps. We may not have a model on every company, but we will have an opinion on who the best and worst companies are, based on the four P framework.

After we rate the companies within our investment themes, we have a disciplined valuation approach based on earnings growth and price to earnings to determine near-term attractiveness. The reality is that at any given time, there are great companies selling at bad valuations that create near-term risk, as well as bad companies selling at compelling valuations that create near-term opportunities. A disciplined valuation

approach focused on future earnings gives us a framework to make informed decisions and manage risk.

The other part of our research process is to have one eye on the short term and one eye on the long term. There is no question that the greatest benefit will be derived from being right in the long term, but we need to be alive to enjoy the success.

Think Recipe for Finding Megawinners



The eye focused on the short term needs to understand catalysts, data points, and valuation. Understanding what will move a stock in the next two minutes, two hours, two days, two weeks, and so on, is highly relevant. The eye focused on the long term assesses earnings growth. As I'll say again and again, earnings growth is what drives stock prices and is nearly 100% correlated with long-term performance.

→ MEGATRENDS—THE DRIVERS OF LONG-TERM GROWTH

"My interest is in the future because I am going to spend the rest of my life there."

—C. F. KETTERING

The largest market-growth opportunities are those created on the frontiers of the economy, where change at the edge leads to wide-scale change within the economy. A core element of my strategy in successfully identifying emerging growth opportunities is trying to understand the megatrends that drive change, productivity, and ultimately growth throughout the economy.

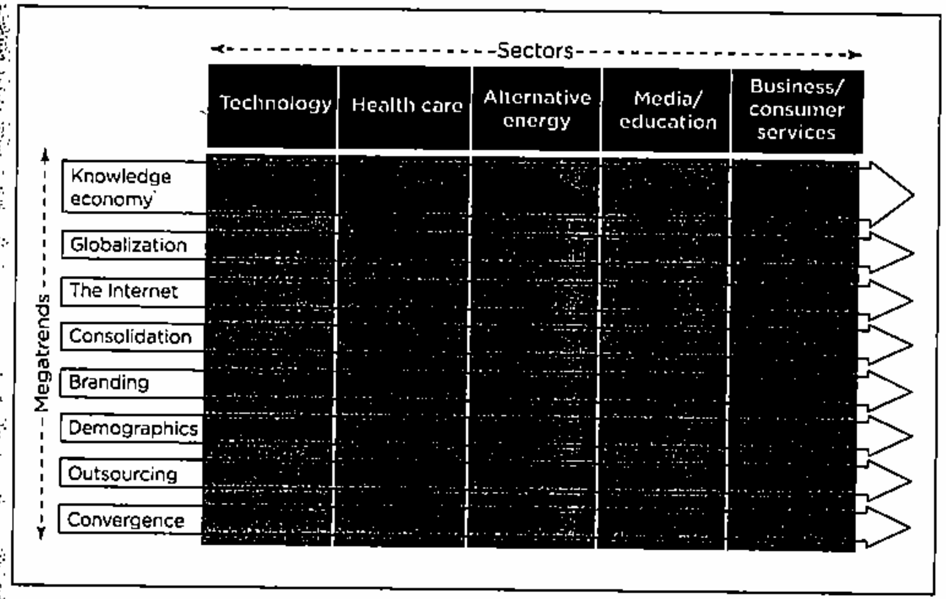
I see megatrends as the fundamental catalysts for growing markets through their influence on consumer behavior and business processes, and because they serve as building blocks for the introduction of new products and services. Additionally, by influencing price and quality improvements, megatrends unlock latent demand and reinvigorate growth in mature markets, while freeing resources to finance the growth of new market opportunities.

Megatrends effectively create a tailwind at the back of emerging industries. The tailwinds accelerate the opportunity and provide the fundamentals to grow at a high rate for a long time. Great growth opportunities are often found where megatrends intersect the growth sectors of the economy: technology, health care, alternative energy, media and education, and business and consumer services.

Some of the current megatrends affecting consumers, businesses, and entire economies for that matter are knowledge economy, globalization, the Internet, demographics, convergence, consolidation, brands, and outsourcing.

In the long run I believe these dynamic forces will drive sales and profits of entire industries, some directly and others indirectly, while companies focused on becoming industry leaders will capture the largest share of these rapidly growing markets and ultimately create tremendous shareholder value.

Megatrends Create Tailwinds



→ THE FOUR Ps

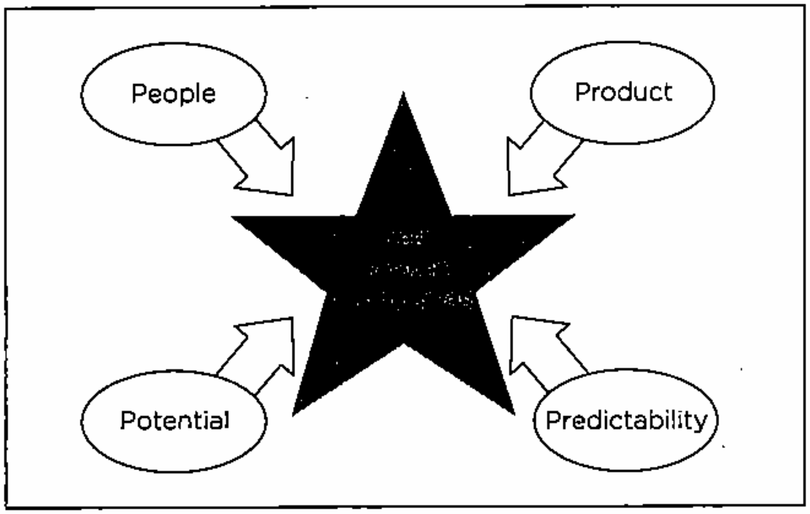
"The only time I really ever lost money was when I broke my own rules."

—JESSE LIVERMORE

Identifying the catalysts behind rapid market growth is an important element of successful growth investing, though finding companies that are able to translate these opportunities into bottom-line results remains my ultimate objective. Companies that are best positioned to accomplish this feat are those that have the most dynamic earnings prospects and that incorporate the four Ps into their business.

I believe the critical components of success for a growth company are the *people* and its growth culture. With young growth companies, this is particularly important, given that a young company won't likely have a measurable track record, but the management and key personnel of the company will.

Next, I look for companies that are leaders in their market, with a proprietary *product* or *service* that can lead to disproportionate gain relative to the competition. Having a claim to fame is essential.



With respect to *potential,* I look for large addressable markets or nascent growth opportunities with open-ended growth, where small, rapidly growing businesses have the opportunity to become big companies. Megatrends play a critical role in assessing how large a market can become and how quickly.

Finally, I assess the visibility of a company's growth—its *predictability.* Does the company have recurring revenue or a formula that produces predictable returns? The best growth companies have high predictability and gain operating leverage as they continue to achieve economies of scale.

Ultimately, I hope to identify companies capable of capitalizing on nascent market growth, rather than relying upon a favorable market tailwind. Those are the companies that will capture larger market shares and be rewarded with premium valuations.

Investors who are early to identify the potent combination of a dynamic market with open-ended growth, and companies executing their

business plan to achieve a disproportionate share of the market, will ultimately receive the benefits of the growth premium.

Finding companies with characteristics such as these is as difficult as spotting rare and swiftly moving elephants. The good news is that when we find one, we should know it!

THINK POINTS

- → Great businesses and great investors are systematic and strategic in how they operate.
- → The Think 10 Commandments are an overarching framework to help investors.
- → The recipe for finding and investing in tomorrow's megawinners is to evaluate the megatrends in each growth industry to determine investment themes.
- → Within each industry/theme we rank each company by the four P formula.
- → Use several valuation methods such as P/E to growth and price to sales to determine appropriate value and timeliness.
- → From the top-down process, I determine short-term risks and opportunities by analyzing catalysts, data points, and valuation.
- → Last, but most important, look to invest in the company you believe will have the highest earnings growth for the longest period of time.

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Megatrends

"I don't set trends. I just find out what they are and exploit them."

—DICK CLARK, *AMERICAN BANDSTAND*

IN ESSENCE, MEGATRENDS ARE POWERFUL technological, economic, and social forces that develop from a groundswell (early adoption), move into the mainstream (mass market), and disrupt the status quo (mature market), driving change, productivity, and ultimately growth opportunities for companies, industries, and entire economies.

Megatrends play a key role in how social, economic, technological, and political changes take hold, and as we look backward through history, their effects are easily seen. In real time, however, megatrends tend to go underappreciated. The nature of megatrends is that they are relatively slow to develop, driven by bottom-up, "local" events that slowly gain in critical mass until they come to define large-scale and pervasive change.

In his 1982 book *Megatrends,* John Naisbitt identified several trends that were in various stages of restructuring an industrial economy that was regionally concentrated and national in focus, with corporate America best characterized by industrial giants and extensive management hierarchies. Technological improvements were often feared, particularly by workers and unions. Politically, power remained concentrated, polarized by business, labor, and social issues, and focused on short-term solutions.

In the midst of this restructuring, which the consensus had yet to appreciate and fewer still wanted to embrace, Naisbitt anticipated what

most feared: the continued decline of manufacturing and the rise of the information economy.

The trends he identified more than 20 years ago have steadily progressed, with many information technology companies as recognizable and mature today as industrial bellwethers were then. Aside from identifying the trends themselves, one of Naisbitt's key insights was that the most powerful of the trends occurred independently, across geographies and throughout communities, only later becoming a large collective trend.

What Naisbitt was able cull from these seemingly disparate trends were common factors, or megatrends, that were in effect catalyzing the restructuring of the past, present, and probable future.

Megatrends continue to play just as important a role today as they have over the past 10, 20, and 50 years. What is changing are the smaller but related trends resulting from today's more visible megatrends. For example, while globalization is clearly not a new trend, in combination with greater geopolitical openness, economic development, and more robust information and communications technologies, the pace of globalization, trade, and outsourcing has rapidly accelerated.

Likewise, with the explosion in the number of products and services to address a growing number of global markets, the value of brands is growing exponentially, as companies find it a necessity to differentiate their products and defend their markets with the value embedded within their brands.

Information technologies have been around long enough for IT companies to now be mature, although the application of IT continues to rapidly broaden beyond traditional business investments and consumer electronics, spurring growth in new areas of biotechnology and nanotechnology as well as consumer and business services.

Identifying new trends is always difficult. As the venture capital community notes, by the time something becomes a trend, it is too late for many investors to reap benefits. That said, only by continuing to look for the forces that shape the realms of businesses and consumers can we hope to understand and capitalize on emerging growth markets in today's global economy.

Within these megatrends are themes that become increasingly pervasive through economies, though they generally remain unrecognized