
Searching for growth in a slow-growth world

BY JEFF WUORIO, FIDELITY INTERACTIVE CONTENT SERVICES — 06/15/10

Slow economic growth doesn't mean you can't find growth stocks. Some firms will shine brighter than the rest.

Finding winning growth stocks is a challenge in any sort of economy. Finding them in an economy where few sectors seem to be growing much at all is an even greater challenge — but by no means an impossible one.

Tight credit, high debt burdens and the upcoming end to the federal government's monetary and stimulus programs will likely mean modest economic growth through the fall. That, experts say, makes it critical for investors to employ strict criteria when seeking out growth stocks. Here are six things to keep in mind:

Solid revenue growth. Start by looking for companies that are growing faster than their industry average. Curtis Gross, director of Investment Research at Financial Advantage Inc. in Columbia, Md., recommends revenue growth rates that are 1.2 to 1.3 times the average industry growth rate. This information, along with other statistics cited in this article, is usually available on company websites as well as in their quarterly and annual reports, also available at the Securities and Exchange Commission (www.sec.gov).

Fidelity.com's "stock snapshot" feature is another handy source; other financial services websites also contain similar information.

For further perspective, look at the growth rate for the past five years and the Wall Street consensus forecast for growth over the next 12 months. (This can be found for free at Fidelity.com's stock research tool under "key statistics.") The message is clear: Any company that's bettering its competition in terms of revenue growth amid sluggish economic conditions has a distinct advantage — as Gross points out, higher revenue growth almost invariably leads to higher earnings.

Low debt and lots of cash. Companies face the same borrowing restrictions as individuals: If you're not a good credit risk, any money you borrow is going to come at a higher price. If credit tightens throughout the economy as a whole, companies could find it difficult to borrow the money needed to underwrite growth. That means the next step is to see if the company you're considering has a net cash balance or a low debt-to-capital ratio.

The first term refers to cash on hand; the latter, says Gross, measures the portion of a company's finances that's funded by debt. "The lower the amount of debt, the more flexibility a company has to borrow for future growth at significantly lower interest rates than its competitors," he notes.

The average debt-to-capital ratio for the S&P 500 (.SPX) is roughly 30%, so anything below that is a decided plus. Gross adds that any cash on hand is also positive — enough, ideally, so the company could be debt free in five years if it chooses.

Growth through acquisition. In a sluggish economy, growth may not come only from increases in sales. Another barometer is a company that is snapping up weaker competitors, especially at reasonable prices.

"In a weak economic environment there are always companies willing to sell," says Gross. "Since by the definition



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of a weak economy there are very few buyers that can afford to buy, those that can have a big advantage in what they buy and how much they pay. They buy what they want and pay what they want." To make certain the price is reasonable, look for recent acquisitions of like-sized companies in the same industry to help gauge if an appropriate price was paid.

The best way to do this, says Drummond Osborn of Osborn Wealth Management in LaPort, Ind., is to roll up your sleeves and do a little digging on the SEC's website. There you'll find details on prior merger and acquisition activity on any public company in its 8K filing, as well as Forms 10-K and 10-Q.

High operating margins. Operating margins measure how much of revenue is left over after the costs of running the business are subtracted and so are a solid indicator of profitability.

Gross says he generally looks for operating margins that are 25% higher than those of competitors and an operating margin advantage that has held steady over time. "That shows a long-term competitive advantage. We also look for companies whose margins are expected to improve with the introduction of new products or a shift in the product mix."

Strength in overseas markets. As the United States and much of Europe struggle to regain solid economic growth, another key component in finding profitable growth companies is a firm footing in overseas markets. Again, however, it's critical to be selective since many foreign countries such as Japan are struggling as mightily as the U.S.

And, as financial analysts note, targeting overseas growth involves educated guesses.

"When we talk about 'predictable' growth, we don't mean steady growth. Those are two different concepts," says Gross. "Predictable growth for us means we have an 80% certainty that growth rates in India or Brazil will be significantly higher than developed countries over the next five years. We are not predicting that growth rates will be 20% for the next five years. We look at growth rates for companies and countries on a relative basis."

Reasonable stock prices. Even though finding growth companies in a good position to buck the economy may be challenging, you certainly don't want to overpay for the stock. One solid barometer is the so-called PEG ratio, which combines the more commonly referred to ratio of price-to-earnings and divides it by the firm's growth rate.

The price-to-earnings ratio, or P/E, is a measure of how much investors are willing to pay for future earnings. The higher the P/E, the more they're willing to pay. This helps compare the firm's growth to its current value.

For instance, a company whose profits are growing at 20% a year may create a lot of buzz that pushes the stock price up, causing it to be not as attractively priced as a firm growing earnings at a 10% clip.

What to look for? John Frankola of Vista Investment Management in Pittsburgh points out that the overall market PEG average is 1.36 — anything less than that, and lower than competitors' PEGs, suggests an attractive stock price.