Intelligent Investing

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Ground Xero

There is a difference between price and value. The fast growing Xero provides a great case study of this in recent years. Back in early 2014 Xero stock hit stratospheric levels above $45.00 per share having erupted from below $7.00 over a period of only 12 months. There was much excitement at the company's prospects and in mid-March 2014 Xero had a market capitalisation of NZ$5.70 billion. So what did the business look like then?

Xero had been good at raising funds given its exciting longer term prospects and the company had cash on hand of $210m at March 2014 (having raised $180m in October 2013). Revenue in the year ended March 2014 was $70.1m from 284,000 paying customers. A favourite company measure, annualised committed monthly revenue ("ACMR") had reached $93m at year end. For the year to March 2014 the company reported a net loss of $35.5m. Clearly much depended on the company's ability to deliver strong growth and meet very elevated expectations. At the time there was plenty of growth, excitement, even hype, but not all were happy. Local fund managers bemoaned the high weighting Xero had in the NZX50 index as they had a well-founded view the company's valuation was "in the cloud" while on the ground the managers were underperforming the benchmark NZX50 index. Fast forward a couple of years.

Xero today is trading near $18.00 per share and the company's market capitalisation is $2.44 billion, only 43% of its' March 2014 peak equity valuation. In that time though the company has delivered a lot of growth. Customers numbers have grown from 284,000 to 717,000 and at March 2016 ACMR had reached $258m ($93m in March 2014). Gross margin has improved strongly from 66% in March 2014 to 73% in March 2015 and 78% in March 2016. Operating cash outflows are slowing as the company approaches the point when it makes a maiden profit. Analysts estimate Xero may be profitable in 2019 or 2020, around three years from now. By March 2017 the company has set a target of exceeding 1,000,000 customers and as the network continues to grow strongly the cost base is being well controlled. The point at which Xero shares may represent reasonable value is closer now than it was in March 2014, and may have already arrived. The company is in a stronger, more advanced, position that it was in early 2014. Much of the potential is coming to fruition even if the company does remain a higher risk investment. With a maiden profit in prospect in three to four years' time investors prepared to hold the stock for at least 5 years may do well from here. Those that bought into the hype in 2014 will have to wait far longer for a return on investment.

What the recent history of Xero's share price demonstrates is the clear difference between price and value. A stock will at all times be either undervalued, fairly valued, or overvalued by the market and you can only know which it is if you value the company. Valuing a loss-making growth story like Xero is much more difficult than valuing a more established business but that does not mean an investor should forget that it is value that drives price over time, not the other way around. Or as Warren Buffett succinctly put it:

"Price is what you pay, value is what you get".

The companies mentioned above are examples of the types of quality companies in the sectors discussed. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends listed above.

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