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# Go Beyond the Financial Statements: Break a Company Down Revenue Line by Revenue Line

**by GEOFF GANNON**

One of the biggest issues I come across when talking with people about specific stocks is that while we can have a good discussion of bottom-line numbers like earnings – the discussion of items higher in the income statement is not so good. Andrew and I did a podcast about this recently. It's the one where we discussed gross profits. But, it's not just an issue of gross profits. It's also an issue of what are the customer economics like, what are the store economics like, what are the "unit" economics like. A lot of times, this information is given out by the company – if at all – in ways that don't guarantee an easy comparison between two companies. The bottom line figure is probably comparable (though not always – note, for example, that different companies in the same industry sometimes depreciate at different rates and so on). However, the way companies discuss their projections for store level EBITDA of a "model" store or customer level economics are going to be different. Does this make them less useful? It makes them more susceptible to fudging. You have to rely more on whether management is being candid, realistic, etc. Is management promotional? Are they always too optimistic? Are they always too pessimistic? Do the numbers they give you as projections of how their business model should work line up nicely with reported results? If not, why not?

These numbers are often more important for the long-term investor than the current earnings results. Current earnings – and whether they miss or beat analyst estimates and market expectations – are very important in determining short-term results in the stock. But, they are less important in determining long-run results. This is because just knowing the bottom line result is less helpful in projecting the future of the business than in having more detailed trend information.

The same stuff I've been saying about the "bottom line" also applies to the "top line". For example, **OTCMarkets (OTCM)** reported results recently. Both bottom line and top line numbers were right in line with what I might expect. But, the mix of what areas of the business were up a lot and what areas of the business were flat or down was different than I'd expect. So, it could've looked like a typical quarter if you look only at: revenue, gross profit, operating profit, etc. But, it looked atypical if you focused in on what specific product lines were up by what percentage amounts over last year. They had a very bad showing – no growth, actually a bit of shrinkage (which is unusual for this company) – in the actual number of companies that pay for "corporate services" (sort of like being listed on OTCM – although, technically, OTCM is not an actual stock exchange). Meanwhile, revenue that is driven by trading activity grew way more than you'd normally expect. Now, none of this should've come as a huge surprise to me given the level of speculative activity in U.S. common stocks – including small and more speculative stocks like might make up more of the volume that benefits OTCM – during the quarter. But, here we have a combination of more and less cyclical elements. If you had a very cyclical element like something driven by number of trades done in the quarter up 20% while you had a less cyclical element – like number of stocks paying for "listing-like" services – down 2%, that's telling you different things than if those revenue items were reversed in terms of growth. Imagine a quarter where the more stable, "listing-like" corporate services were up 20%. Well, that would be much more of a long-term positive for the business than something that is driven by how active or inactive trading is during a given quarter.

This is also true of price changes. Sometimes, companies give you this information directly. More commonly, you have to find this information through backing out changes in volume. So, the company might say that revenue in a certain segment was up 30% while unit growth was 20%. If there are different products sold in this segment, then you don't know exactly how much all the different prices were raised. But, you can guess that the company pushed prices up something like 10% over last year. The importance of such a big price increase differs a lot depending on the type of business. If Starbucks increases its prices by 6% year-over-year, that price increase is very likely to stick. If a commodity type product sees a price increase of even 16%, this can be a lot less meaningful. It's not likely to last. The company just sells at the market price. And the market price is volatile.

In some industries, major price increases accompanied by declining unit volume can actually be a bit of a concern. I saw this recently with one insurer. It had been increasing revenue a bit over time in a line of business it actually said it was shrinking over time – and had been for years – in terms of number of policies. It was the company's goal to reduce the number of policies over time. And yet revenue wasn't going down. When you looked a little deeper into this, you could see that the company was probably increasing its rates for the same coverage by 15-20% a year for several years in a row – and still, they were probably ending up with more policies than they really wanted. Eventually, this company announced it was totally abandoning that line of business, because of severe adverse claims development in that line of business. The fact it was constantly raising rates in a line of business it kept saying it was trying to rely less and less on can be a hint – for an insurance company – that it had mispriced these policies in the long ago past and didn't feel it could raise rates 100% all at once, and didn't have the determination to abandon this business earlier. That's a rare example where dramatic price increases might not even be a sign of anything good.

Insurers often give you information on both the revenue in a part of their business and the number of policies. Again, this isn't giving you exact information on rate increases. But, in broad strokes – it's giving you a lot of useful info. If revenue is rising 10% a year in most years and policies are rising 12% a year in most years – it's clear they aren't really increasing or decreasing rates much at all. So, the amount of risk they are taking in a given line of business is increasing rapidly through actually having a lot more customers at much the same pricing. This is very useful information to know. And it's the reason why you want to read 10-Ks, 10-Qs, investor presentations, and even other regulatory filings. You can get a better feel for the actual kind of growth the company is experiencing.

What is the best kind of growth? Some ability to constantly raise prices on existing customers is usually good. Some ability to increase the value of each order from a customer in terms of not just pricing but also physical volume is usually good. And then growing the number of customers who are similar to existing customers is also good. Getting entirely new kinds of customers can be very good for the long-term, but it’s the kind of thing you need to analyze. Are these customers going to be – over their entire lifetime – much better, much worse, etc. than existing customers? This can show you how a company is likely to change for better or worse. It’s a leading indicator of what things like returns on equity will be in the future.

Bottom line numbers are easiest to analyze for a couple different types of companies. One, very diversified companies. If companies have a lot of very small customers paying them in a lot of different ways – it’s unlikely things will change dramatically in enough segments to throw off the earnings trend you’ve seen. But, be careful with this. This is why it’s difficult to analyze the “quality of earnings” of companies like General Electric (GE). What is often happening is some very bad stuff in one segment and some very good stuff in another segment. But, this doesn’t get much discussion from the company, because the net effect of it doesn’t take the earnings trend for the whole company very far off what was expected. It doesn’t draw analyst or investor attention. So, there isn’t enough discussion of what is going well and what is going badly.

The other kind of company where focusing on just the top line and the bottom line is the exact opposite of a diversified company – it’s a very focused company. The reason why it’s easy to analyze these companies using just top line and bottom line is that the economics of the whole company are very similar to the economics of any one product, one customer type, etc. So, it’s the opposite situation from a diversified company. As soon as big successes or big failures happen in a given line of business – because that line of business is nearly 100% of the company – investors are instantly alerted to it. If a company relies on a small number of products, customers, geographies, etc. –

you’ll see some evidence of changes in any of the economics of those products and places in the top and bottom line for the entire company.

Companies in transition that have say 3-4 major segments are the hardest to analyze using top and bottom line information. It can be very deceptive. The best example I can give of this happening is what Babcock & Wilcox (read my old report in the Focused Compounding Stocks A-Z section for details) looked like before its spin-off. The company had a very successful and very consistently growing nuclear business focused on the U.S. Navy, it had a much more cyclical and slower growing (and sometimes much less successful) business focused largely on coal power plants, and then it had what was basically a very big money-losing start-up betting on experimental technology all housed in a single company. When you screened this stock, it didn’t show up as super cheap as a stock or super successful as a business. It looked very mixed overall. It was mixed. But, just “overall”. Not individually. Individually you had some very good parts and some very bad parts. Eventually, they were separated out.

Much the same was true in the write-ups I did on **Libsyn (LSYN)** for the Focused Compounding website (again, you can find these in the stocks A-Z section of the website). There, you have essentially one business segment that has been a very consistent grower. That business is the podcast hosting revenue that comes from fees charged to podcasts in the form of sort of flat monthly fees and more variable (but still very predictable) bandwidth fees. Libsyn breaks its business down into two segments. Pair is a website hosting company (which obviously grows MUCH slower than podcast hosting). Libsyn is the podcast host. But, you actually have to break things down one level further. Libsyn gets a revenue share on advertising inserted into the podcasts it hosts. This ad-supported model is very different – and much more cyclical – than the flat fee and bandwidth sales taken directly from podcast hosts. So, looking at numbers like the active number of shows on the platform, the number of episodes, the total monthly audience size of all their podcasts etc. can give you a better idea of the long-term trend in the company’s intrinsic value than you’d get from including big up and down years from the ad business. If you separate out the lines of business producing the actual free cash flow – you get a much better idea of the business’s momentum (whether positive or negative) than you would from just looking at the statement of cash flows for the whole company. That's why you need to not just use QuickFS.net. Start with QuickFS.net. But, then read the 10-Ks and 10-Qs and the investor presentations and the earnings call transcripts and put them all together to analyze the company business line by business line.