Market Update
Spring/Summer 2022

SCORNED TODAY AND LOVED TOMORROW?

Finding Value in Early-Stage Growers

A colleague of mine once proclaimed that you "can't make money just by using a calculator." Rather, one needs a correct and differentiated view to outperform the market, and that view can not come from simple arithmetic; simply declaring a stock "cheap" or "attractive" by looking at its price-to-earnings multiple (P/E) or some other shorthand valuation metric is unlikely to lead to outperformance over time.

Brad Neuman, CFA

SENIOR VICE PRESIDENT
DIRECTOR OF MARKET STRATEGY

Using Fundamental Analysis

Attractive stocks – those that go on to produce strong returns for shareholders – come in all forms; they can be early in their maturity, or they can be late in their life cycle. At Alger we invest in Positive Dynamic Change, which can mean investing in a company that is early in its life cycle and experiencing rapidly growing demand, which we call High Unit Volume Growth, or it can mean investing in a company undergoing a growth renaissance, which we call Positive Life Cycle Change.

Of course, we prefer to invest in companies that are profitable, and most of the companies that we own produce earnings and free cash flow, which is cash generated from operations after capital expenditures. However, some High Unit Volume Growth companies, particularly those with smaller market capitalizations, have not yet achieved scale to generate profitability.

Our fundamental, bottom-up research process enables our analysts to model company fundamentals several years into the future and it is these future projections that help us determine if a stock is attractive or not. Sometimes our estimate of future growth is so robust that a company can be undervalued in our opinion even if it is profitless at the time of purchase. These companies would not screen well on shorthand valuation metrics such as P/E or maybe even when using valuation metrics based on EBITDA (or earnings before interest, taxes, depreciation and amortization), but that does not mean the companies are not immensely valuable.

Profitless Value

If investors had a crystal ball and knew what price a stock would be in the future, they could "correctly" price it today given a discounted cash flow valuation method. Simply, an investor estimates the future cash flows of a company and determines what rate of return they want to earn. The cash flows are then discounted at that rate and a present value is determined. For example, if someone offered you $100 one year from now and you wanted to earn 10% on your investment, you would pay $91 today.

Using this concept, history shows how two well-known companies, Amazon and Tesla, should have had much higher stock prices prior to becoming profitable. Amazon wasn't sustainably profitable until 2004 (and was not profitable in 2012 or 2014).

Investors are not as focused on trying to understand how disruptive products or services may alter industries and capture market share over the coming years. Rather, the market is focused on current cash flows and is more heavily discounting future growth.

At the end of 2003, the stock traded at about $53 per share, representing a $21 billion market capitalization. Its enterprise value, which is determined by market capitalization, debt and cash on its balance sheet, was 4x its sales (this is its enterprise value to sales ratio). Investors were clearly ascribing value to the unprofitable company.

But if investors knew that Amazon's share price would be $2,486 in April 2022 and they wanted to earn a 12% return on their investment, the stock should have been trading at $311 per share, or nearly six times the observed price at the end of 2003. This would have implied a roughly 21x sales multiple despite no earnings. That is an example of a terrific investment opportunity in a profitless company.

More recently, Tesla had years of red ink before making a profit in 2020. At the end of 2019, the stock price was $84 with a market capitalization of $76 billion and its enterprise value was 3x its sales.

However, had investors correctly priced the stock for a 12% annual return through April 2022, the market capitalization would have been a whopping $600 billion or 24x sales, despite Tesla being profitless!

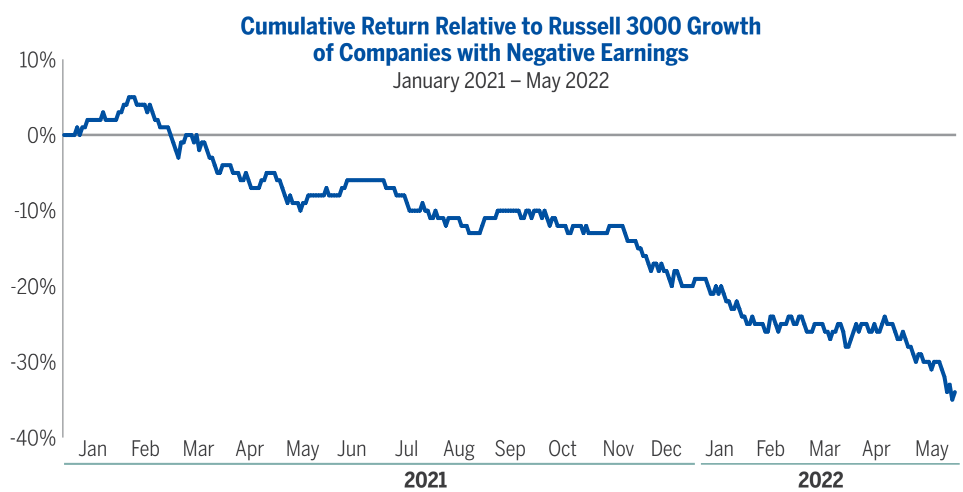
Many other companies have been worthy of large market capitalizations even though they were not profitable as well. In fact, we believe that some of the best investment opportunities, particularly within small caps, are companies that have yet to become profitable.

Profits and Performance

Due in part to rising interest rates and higher risk premiums, many investors have recently shunned rapidly growing but profitless companies. In fact, profitless growth companies have dramatically underperformed the Russell 3000 Growth Index by over 30% since the beginning of last year (see Figure 1).

To us, this means investors are not as focused on trying to understand how disruptive products or services may alter industries and capture market share

Figure 1: **Negative Earnings Factor Underperformance**



Source: Piper Sandler & Co. Factor performance relative to the Russell 3000 Growth, which is sector neutral and is calculated by comparing the performance of stocks with negative net income in the trailing 12-months to those with positive net income in the same time period. Calculated daily.

over the coming years. Rather, the market is focused on current cash flows and is more heavily discounting future growth.

The hard, but necessary, work of long-term projections is not easily communicated in media soundbites.

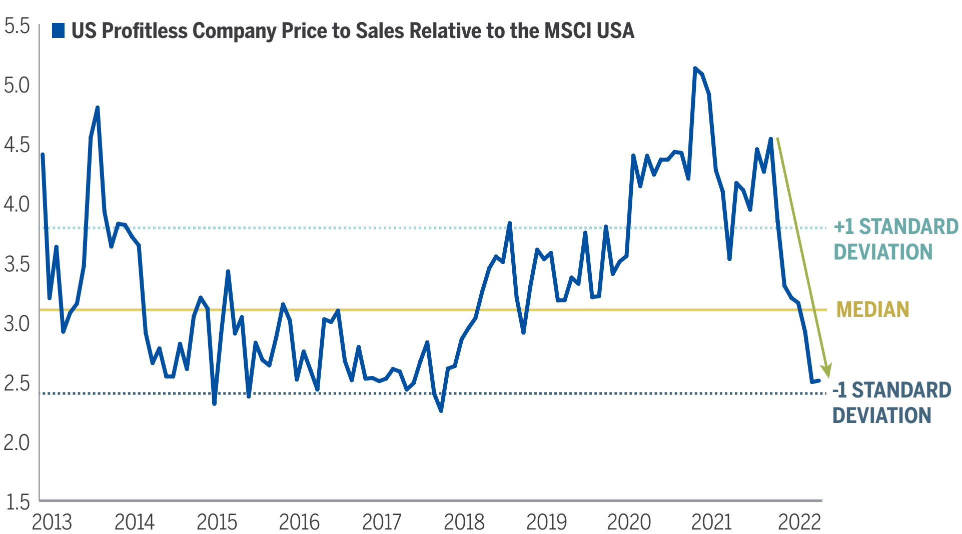
Current Opportunities

The markets' distaste for early-stage companies is particularly apparent in small cap growth stocks, which we believe have the greatest proportion of their present value tied to cash flows far into the future. Indeed, by some metrics these stocks are the cheapest they have been in decades, with the S&P 600 Growth Index trading at close to its lowest level in history relative to the broad S&P 500 Index based on price-to-earnings valuations. Non-profitable stocks, specifically, are close to their lowest price-to-sales multiple relative to the broader stock market in many years (see Figure 2). With investors focused on the near term at the expense of long-term growth, some disruptive companies that are early in their life cycle may be compelling opportunities.

Ultimately, valuing companies is part art and part science. The hard, but necessary, work of long-term projections is not easily communicated in media soundbites. At Alger, we focus our research on how companies and industries may evolve. To do so, we speak with competitors, suppliers, customers, and management of the companies in which we may invest. This work drives our long-term forecasts and sometimes uncovers opportunities in stocks that have yet to scale enough to be profitable. These companies are often gaining market share rapidly but are still investing to drive growth. In our view, to avoid them systemically would risk missing out on some compelling growth stocks. As the market has done just that over the past year, the opportunity set of undervalued smaller growth stocks is expanding, in our view.

Brad Neuman, CFA
Senior Vice President, Director of Market Strategy

Figure 2: **Relative Valuations of Profitless Companies**



Source: J.P. Morgan. Data is as of May 2022.

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Amazon and Tesla represented 4.4% and 2% of Alger assets under management as of 3/31/2022, while Piper Sandler & Co. and J.P. Morgan each represented 0.0% of assets.

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The price-to-book ratio is the ratio of a company's market price to its book value.

Price-to-earnings is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Free cash flow is the cash a company generates after taking into consideration cash outflows that support its operations and maintain its capital assets.

EBITDA (earnings before interest, taxes, depreciation, and amortization) is a commonly used accounting measure of a company's overall financial performance.

Piper Sandler & Co. is an advisory firm that provide macroeconomic research and other information for investors.

The Russell 3000® Growth Index combines the large-cap Russell 1000® Growth, the small-cap Russell 2000® Growth and the Russell Microcap® Growth Index. It includes companies that are considered more growth oriented relative to the overall market as defined by Russell's leading style methodology. The Russell 3000 Growth Index is constructed to provide a comprehensive, unbiased, and stable barometer of the growth opportunities within the broad market.

The S&P 500 tracks the performance of 500 large companies listed on stock exchanges in the U.S.

The S&P SmallCap 600 Growth Index measures growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum. Constituents are drawn from the S&P 600.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

Index performance does not include deductions for fees and taxes. Investors can not invest directly in an index.

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