IFB225: Understanding the Different Business Models and Recurring Revenue, Plus A Brief Look at the Retail Furniture Sector

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I love this podcast because it crushes your dreams and getting rich quick. They actually got me into reading stats for anything you're tuned in to the Investing for Beginners podcast led by Andrew Sather and Dave Ahern with a step-by-step premium investing guide for beginners. Your path to financial freedom starts now.

Alright, folks, welcome to Investing for Beginners podcast. Tonight we have a great show for you; we're going to answer some great listener questions; we have four of them that we're going to answer. A couple of them are a little bit more rapid-fire than usual. And then we'll do our usual give and take that Andrew and I like to do. So without any further ado, I'm gonna go ahead and read the first question. So I have Hi there. Thanks for the ebook. I've just listened to your podcast show, where he talks about your favorite books on investing for beginners. There was one book I wasn't quite able to figure out the name of it. Maybe you could help me find the title and the author, please. I think the author is called Bonish Pabrai. And the title of the book has an investor in it.

Do you know the name of the book, please? And did I get the name of the author? Right, please? Best wishes today. So I hope I pronounced your name correctly. And yes, the answer to the question is Mohnish Pabrai. He's an Indian investor. And the name of the book is The Dhando Investor. It's one of my favorite intro books to learn how to invest very, very well written, easy to read has some really interesting concepts in it. And he does a great job of kind of outlining how to think about value investing, valuing companies looking for companies, and just kind of the whole idea behind investing. So I've been a big fan of this book. Basically, since I began, it was one of the first or second books in investing that I read. And like I said, it's really easy to read; it's not overly technical. And there is some math in it. But he does a good job of kind of laying it out and making it not so overwhelming and scary.

Andrew

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I do like he starts the book out talking about how there was a group of people who took advantage of hotels being really, really cheap. And the way he described it was just very approachable, kind of like you were saying.

So even if you have no experience with investing, I think you'll find it to be. I think they say by value investing, either the concepts will click or they won't. But if they do, click here; you'll find the book like that to be very helpful.

Dave

1:59

Yep, exactly. The main focus of the book is trying to find companies that are selling less than they're worth and buying them and holding on to them. And that's a great way to make money. So hopefully, that helps you find the book; you can find it on Amazon; I saw it in the library. So there are lots of great resources also available on Audible. So there are lots of great resources to find; find the book if you're out there looking for it. So hopefully, that helps.

All right, let's move on to the next question. Hey, Dave, thanks for all you and Andrew. Do I really enjoy your podcasts and the resources you put together? With respect to your time, I'll keep this short and simple to one specific company, Ethan Allen furniture; incorporating all the metrics you put emphasis on and reviewing the previous year's financials; it seemed this would be a great company to buy into. They do not have to rely on overseas materials. They've increased earnings and profit each year and paid a dividend, just to name a few. You are reviewing some other options out there. With regards to the current stock price, Ethan Allen appears to be a great buy. I'm curious about your thoughts, of course, specifically how they may or may not be appealing to you. So Andrew, what are your thoughts on Ethan Allen,

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Andrew

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I guess I'll preface by saying I haven't done the deep dive into this company. I'll just kind of give some initial thoughts based on looking at the company. So I did do somewhat of a deep dive with another kind of related company in the whole furniture household product space company called temper Sealy. They are ticker TPX. And so something that I found interesting when I was reading through their annual report, this is something that they put, you know, if you have the patience to dig through all of the big words and all the pages of text in an annual report, you can find little nuggets like this, but they said according to is PA, which must have been one of the industry associations that analyzes these industries, they said the industry has grown by approximately 4% annually over the last 20 years.

So that's kind of like the first, I think, a good concept to get your brain around the mean; there are lots of good concepts. But that's a good one where if you can kind of figure out what the growth prospects of an industry is, particularly if a company is close to maturing in that industry, that could be a good way to set your expectations on how you think the industry is going to grow. So that would be kind of one of the first insights I had. And when I looked at the revenue trends for Ethan Allen, it's hard to tell whether they are keeping up with that pace or not. So that would be something that I think is a good place to start. I know a lot of growth investors kind of start with the top line, this revenue growth concept.

But it really does make sense because you can only squeeze profits so much at a certain point. If you want to grow, you have to grow the top line, which means growing your sales. So to know that okay, this industry grows around 4% helped set my expectations for how I think the growth rate of the company would be; that's kind of my first thought.

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Dave

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Yeah, that's a good thought. And it's a good place to look. I know that when I was looking at Ethan Allen, the He's going back to the top line, the first thing that kind of popped out to me was that, although the revenues are doing better over the last two years, they're still below 2016 levels. And so that, to me, was something that was a bit of a concern. And the reason why that would be a bit of a concern is, again, this is not a space that I follow. So this is all anecdotal. But Restoration Hardware, which is roughly in the same kind of industry, did quite well during the pandemic. And several other furniture companies like pottery barn and such, I think, did very well through the pandemic as well because people were using their stimmy checks to buy furniture.

And I remember the Motley Fool podcast talking about this over and over again, how astonished that they were, that people were buying so much furniture, and they just it seemed unusual to them. And so when I compare that to what you see the financial results for a company like Ethan Allen, it we do two, why did they not benefit from the same scale or same benefits that some of these other companies seem to be benefiting from during the same period? And so that would ask me that would lead me to ask the question of, are they not positioned? Well, are there is their marketing, maybe not as up to snuff as some of the other companies, maybe their niche is a little bit different than the other ones?

Again, I don't know as much about the space as I should. But it will; those will all be questions that I would want to answer before I kind of move on to whether or not Ethan Allen would be a good investment or not. For me, the company is a little too small. It's around 600 million in market cap. So it's a pretty small company. And so that just makes me a little more nervous too. But I think those are all questions that they're fairly easy to answer, just by doing a little research with other comparing other companies and kind of seeing how they're positioned another, I guess, unused. And I think a great technique if it's available to you is just to go to a store. If there's anything out around you, go to the store and walk into the store, walk around, notice what customers are buying, notice the clientele that is there, notice how employees aren't behaving, and or just sit outside watch how many people go in versus how many people come out with something.

Now, sometimes maybe buying a bed and walking out of bed may not be realistic, but some of those things can give you a guess a sense of how the company is doing. And then you could likewise do the same thing with Restoration Hardware, for example, if that's a competitor of Ethan Allen. So those are just, I guess, some quick ideas of some things that kind of popped in my head when I was kind of looking at the company,

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Andrew

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I really liked the idea of thinking about the competition, because it is so important. I think it's easy to get really excited about the company. And there are particular numbers, but you always need to take it in the context of who is their competition. So that's probably my next step. If I'm looking at something that I'm diving deep into, who else is in the space, like Restoration Hardware, like potentially temper Sealy with their mattresses? Where are they competing with other companies? And how do they stack up? Who has more sales? Who has fewer sales? How are their sales going is one company growing their sales faster than somebody else? Those are all other things to kind of look at.

And I think it helps you get a good picture of, like what Dave was saying; there's going to be companies that can execute better than others, especially if you have a great tailwind like a bunch of people moving and getting new homes or upgrading their homes, that that's obviously been the trend lately. So those are some other things to think about. And go into that size question to you know, are they with sales, I see their latest sales are around 685 million and their market caps around the same. So in my mind, that's a little small for my tastes as well. How does that compare with other companies in that industry?

Maybe it's actually not that small; maybe all the companies are that size, in which case, they could not have the issues a small company might have when it comes to competing against their peers. But I think going to the numbers helps you answer a lot of those questions. I like that that was a focus in this question. And they are looking at profit and profits, good to look at year over year. But you also want to think about the longer term. Is there going to be enough sales growth to continue to let the company continue growing profits because you can't cut costs to zero? There's always a max to how much you can cut costs. That's why sales growth you need to have that too.

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Dave

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Yeah, I totally agree with that. And if you're looking for, I guess a couple of quick ways to find potential competitors. For a company like Ethan Allen, there are several options for you. So number one is the proxy statement which is available for free@sec.gov. Or you can go to investors the investor relations for Ethan Allen, and that website will give you a proxy or a def14. A proxy is an easier way to think of it. But that, in essence, is a document then that talks about all the different things that pertain to shareholders voting rights, insiders, and how much different companies pay their CEOs and management. There's also, most of the time, there's a section in there that will contain who they consider their competition because they base their pay and their remuneration for the officers based on what other competitors are doing as well.

And they'll also compare the different metrics that they're looking to try to beat that they think will help their business. Another way to look is a place like ticker.com, which is a website that I use. And they have a listing here with all their competitors; Ethan Allen's competitors are Home Depot, Lowe's company, Ross, Best Buy, William Sonoma Restoration Hardware, Bed Bath and Beyond, and Sleep Number Corp. So those are just a few listings of some of the companies that Ethan Allen could be competing against. And looking at those companies and seeing like, what kinds of sales gross they're having, what kind of margins they have, see what kinds of returns on the capital they have, and then compare those to Ethan Allen's, and you can kind of get a sense of how that company fits in their niche. And all those things will help you decide whether you want to continue down the path of finding out whether this company could be a great investment for you or not. And everybody has a different comfort level of what they're comfortable investing in.

And if Ethan Allen is a company that knows really well, and let's say you work in an industry, you may have more insights into it than I do. And so that would give you better judgment on some of the things that I'm talking about. And it certainly would help a lot if you worked in an industry or if you have different ideas about how some of those things work. And again, it all comes back to positioning, how the company competes against the other companies, and how long the company has been around versus its competitors; there are a lot of things to consider. But for me, it's easy to just make a list, in essence, so take a list of some of the things that Andrew and I are suggesting, and then just start making notes of things that you discover. And by doing that, you may discover that maybe Ethan Allen isn't the play, but maybe one of these other companies is. And so that's another great way to search for companies.

When you're doing research on one particular company, maybe you find something that's not appealing, but you find other things about other companies that are appealing. And it just kind of goes from there. So it's not just static; you know, I'm only focusing on this. It's it can be, I guess, a more broad range idea to find other investment ideas.

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Andrew

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Yeah, that's all great advice. Those are good resources for TIKR.com. That's T IC K r.com. Right.

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Dave

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It's actually ti kr.com. To care. Okay, yeah, ti K r.com. Cool. Yep. All right. So let's tackle the next part of Brock's question. So this is a good one, too. And one final question, please. How much credit do you put into finviz when it comes to financial statements compared to looking up their 10k? Report through Andrews recommended Avenue. Thank you, sir.

All right. So what are your thoughts on Brock's final part of that question?

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Andrew

13:04

Yeah, finviz is always just a starting point. So for people not familiar, finviz.com is a place you can go to quickly sort between pretty much every stock that's publicly traded, at least in the United States; some of them are abroad; I think they have 8000 stocks on there now. So you can search, it's great, because you can search by size by country, do they pay a dividend, you can get really, really granular with it. And it allows you to narrow down and make these lists of companies that fit the criteria you're looking for. And so it's a great starting point, too; I like to sometimes just put the company's ticker on the top of finviz. And you get kind of like a snapshot of okay; this is their dividend yield. This is their price to earnings ratio; this is their debt to equity, all that really cool stuff. But that's just the starting point. From there, I think you do have to go deeper, and you have to start looking at their 10k, also known as an annual report. And that's where you start to get nuggets about how the company feels about the industry. It's like going back to the temper Sealy thing.

They report that the growth rate for that industry has been historical, and they also a lot of companies will talk about their competitors right there in the 10k. So I know a 10k is really, really, it is like very intimidating, especially if you've never done it. But Dave has actually done a great blog post on it. So if you go on our website, you just type in the annual report; his posts up there should go near the top. And he did a whole blog post showing you the different sections, how you can find them, and how to read them. And so that really helps you kind of focus and the stuff that maybe you don't need to focus on so much and the Stuff You Should laser focus on. You don't need to read a 10k like you would a novel.

It's more like, you know, like you're doing forensic work on it. And you just got to make sure you know where to put the magnifying glass and what parts to really pay attention to

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Dave

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exactly the cool thing about finviz, like Andrew was saying, is it gives you these great snapshots. And especially when you're trying to narrow down the search of companies that you're looking for, it allows you to refine that search. So that it reduces the number of companies that you have to look at, if you just look at them, like the initial ticker, or not the initial ticker, the initial pages like 11,090 800, or something or some crazy number of companies to look at, it's, you know, it's global. So you can even search it via whether you want to look at companies here in the US, or you want to look a Canada, or you want to look at them in Asia, you can kind of its really broad range. So it's nice in that respect.

And like Andrew said, you know, having that clicking on a particular company, let's say Home Depot, and you see, all the metrics that they portray can really give you a nice snapshot to give you like, I guess a little more defining of the metrics that you want to use to search for particular companies. If you want to get, I guess, broader looks at the financials of the companies, then you kind of have to you have two choices; you can look at the 10k, which I definitely recommend. The only drawback to that is most of those companies only show a three-year snapshot of the income statement, for example, whereas a company like our buddy Stratosphere Investing, they have ten years of financials, so you can look at everything for ten years of a balance sheet, income statement, free cash flow, everything, so that's awesome. There's also a quickFS; there's a ticker that I mentioned, you know, there's guru focus, although they're a little briefer, some of these companies now are offering ten years up to 10 years of financials.

So it can kind of give you a broad overview of maybe how the company has performed during a longer period of time. And a perfect example of that is how a company did pre COVID COVID. And now, air quote, post-COVID, hopefully, knock on wood. And so you know, all those things can help give you a good overview. But again, those are just overviews of buying a company based on what you see on Stratosphere Investing, or quick FS is not what we would recommend; we recommend you do look at the financial reports read a 10k weren't how the company operates. That's what the 10k For me, that's the most beneficial part of the 10k is the financials or the financials, and I can find them in a lot of places now. But the biggest thing that I get away take away from it is what does the company do? And how does the company talk, and then also any risks that may be involved in investing in a company that I can't think of just as a general rule, and then there are other little nuggets in there as well. But I always think of reading a 10k like eating a pizza.

And Andrew, I know, likes this idea. But it's like you don't eat a pizza all at once; as much as we really want to, you have to eat it piece by piece. And the 10k needs to be kind of the same idea. And if you don't have two hours to sit down and work through Home Depot's 10k Or even Ellen's 10k, then take a little bit and work on just how the business operates. And then take a little slice and work on the risks and just kind of work your way through it. And that will help give you a better overview. And you will be astonished by how much you understand the company. By the time you get to the end, you'll get a really good sense of whether these are people you want to give your money to or not.

You know, though all the other details will come as you work on it more. But you'll just get an overall sense of whether this is a business you want to be invested in or not. A

Andrew

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Yeah,

it's like you said, it's astounding how much you can learn just from reading it for a lot of these companies. Highly recommend.

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Dave

18:37

Yeah, really? It really is. Yep. All right. So let's move on to the last question. So this is from Wayne, says Hi there. I've always been a fan of your articles. And these have been integral in my personal investing journey. I'm a health care worker who's taken a keen interest in value investing. Recently, I've come across a company called in mode with incredible margins, high growth rates, and negligible debt, but they sell a one-time product and radiofrequency machines for dermatologists and plastic surgeons.

What are your thoughts on a company that grows fast but with its recurring revenue making up only 10% of its entire sales? Thank you very much. So Andrew, what are your What are your initial thoughts on Wayne's questionnaire?

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Andrew

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By the way, before I dive into this, I love how everybody's coming up with these cool ideas. And they're kind of doing their own research and finding these little gems and are making a lot of fun to try to take these and give some teaching lessons out of it. I also don't know this industry much. Fortunately, we don't have time to deep dive into every single industry we get alerted to, but to think about the question of am I worried about a company that does not have much recurring revenue? I would say it very much depends on what kind of industry we're talking about. So I'll give an example.

I have a company I really like in the homebuilding space. And if you think about that industry, what the home builders do is they buy the land, and they develop on it, they build a house on it, and then they sell it to somebody. And then it's like, wipe your hands clean and move on to the next customer. It's not. So there's not much recurring revenue in that sense. But it's not something that worries me, because I understand that the demand for homes is really high, it's been very high historically, for a very long time. And new customers are not very hard to find, especially these days. So it's not a thing that would concern me that they don't get much recurring revenue. On the flip side, you have a company like Microsoft, which I've been long for; it was the first stock I ever bought, and I recently bought more of it; they have a ton of recurring revenue, which is very, very nice because it's almost like every year, their revenues are the floor, they had more customers.

And that's like where the new floor and then you have more customers where the new floor, you raise prices around the new floor. So it makes their revenues very reliable. And that's why you do see the higher attend to get a higher price in the stock market higher valuation compared to its earnings. So, obviously, I like both situations. And that's why I say it really depends on the business model. Because if I were to see Microsoft when they had their recurring revenue start to decline, that would be something to look at potentially be a bad signal. Whereas you know, with a home builder, we don't care about recurring. So that's why I say, you really have to know, okay, what are these machines? How does that fit in with our customers? You know, how is this serving their customers? Why are they buying these machines? How often do they buy them?

These are all things that, again, if you read the 10k, you should get a lot of insight into some of these ideas. And then also having that industry experience from being a worker there, that's, I'm sure gonna help immensely. Two,

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Dave

21:49

Yeah, those are all great insights. And I think the idea of recurring revenue is obviously a great idea. And but the fact of the matter is, is not every business model will allow that. And depending on what it is, you think about, you know, Home Builders is a great example, cars, you know, think about cars, our favorite company, Tesla has gone to the moon, based on the idea that it's not a recurring model, it's you buy a car, and you don't buy another car for I'm not sure what the average rate is, I guess, five or six years, just for giggles. I don't know if that's actually true or not, but you think about, you know, but nobody worries about whether they're going to find, you know, the demand for other people to step in and buy a new car. And whether it's Tesla or whether it's Honda or whether it's Ford. And so that business model, it's kind of the same idea, there's a never-ending flow of people that are going to want to buy a car, or you could call that a tam, total addressable market. There's a very big tam for the auto industry or for electric vehicles. In particular, right now, the same thing with homes and look at the demand for homes right now.

And all the companies that are associated with building homes are to worry about whether there's going to be other people lining up to buy one after they sell the one they have in front of them. So it really goes back to like Andrew was saying, understanding the industry that they're in and going to be a recurring demand for that product down the road. If it's you buy this one time, and it only lasts for 30 years, and there are 150 people available that would want to buy it, well, then yeah, that's going to be something of a concern. But if it's something that has to be replaced on a somewhat regular basis, or upgraded, because of technology improving, there are all kinds of things that you need to take into consideration when you think about that. And reoccurring revenue is not always the panacea that it's made out to be by market analysts there. Sometimes there are higher costs associated with recurring revenues. And that may be a shock to people.

But sometimes, the cost to acquire a customer is quite expensive. And if you have high churn, in other words, if somebody signs up for Netflix, they're only in service for six weeks, then they turn off, they unsubscribe because they wanted to watch squid game, and it's over. And now they don't really have any interest, then Netflix has to go back and spend more marketing money to acquire that customer to come back on the platform. And so that's why when we talk about companies that have recurring revenue, sometimes the cost to acquire those customers can be very expensive, and it can really eat into the margins. And sometimes you'll notice that companies that have more one-time charge kinds of opportunities may have better margins than companies that are reoccurring revenues because of those costs that are required to acquire the customer.

So it's not always a panacea that every company is going to have recurring revenue because some just aren't. And they may, or it may be a smaller portion of their business. So it goes back to figuring out what it is that they sell with or can they sell it to and how much can they sell it for, and how long can that continue to go on? And like Andrew said, if you have inside knowledge of that industry, then you're lightyears ahead of me looking at a company like Inmode right now because you're in it, you know what's going on, you know how they operate. And you may even be using their product. And if you are, then it just gives you even more insight. So I think that's a great question to ask. But it really comes back to, I think, understanding the business model and what separates it from its competitors.

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Andrew

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If you want an example of a recurring model that hasn't worked out so well lately, just look at the cable industry. I mean, we've all, we all know how that monthly cable bill has been so annoying. And finally, people just got sick of it. And those companies have been struggling really, really badly. And so it does come down to, that's the industry, you if you understand the industry, if you're a cable customer, you understand the industry, and you understand the alternatives. And it's been a very tough period for those companies because they haven't been able to keep customers on that recurring model; there's been a ton of churn.

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Dave

25:59

And what Andrew was saying at the beginning is to understand the business model, understand what it is that they're trying to do and how much growth that could be possible from that business model. Yep. All right. So with that, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for taking the time to send us those fantastic questions. That's all great stuff. We really appreciate that. And like Andrew was saying, you guys or guys are asking some really interesting questions and are doing some really interesting dives into some areas that we have not explored before, which is a lot of fun for us. So without any further ado, I guess I'll go ahead and sign us off; you guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week, and we'll talk to you all next week.

We hope you enjoyed this content. Seven steps to understanding the stock market shows you precisely how to break down the numbers in an engaging and readable way with real-life examples. Get access today@stockmarketpdf.com until next time have a prosperous day. The information contained just for general information and educational purposes. Only it is not intended as a substitute for legal, commercial, and or financial advice from a licensed professional review, our full disclaimer@einvestingforbeginners.com.