IFB232: How to Calculate Price to Sales Ratio, Plus Interpreting the Ratio

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D

Dave

0:00

Alright, folks, welcome to investing for beginners podcast. Tonight we have Episode 233; we are going to answer three great listener questions that we got recently. And so, without any further ado, I will go ahead and read our first question. And then Andrew and I will do our little usual given take for you.

So we have. Hey, guys, I will be taking on some extra summertime work. And I'm wondering what the best place to put that is. I've already got about three times my monthly expenses in savings and putting money automatically in my 401k. I have a credit card, a car loan, and student loans. I opened my first brokerage account and invested in my first index fund. Should I try to get to the max Roth IRA amount for the year to invest or work on paying off loans? I already have planned to take part in each of my regular daytime paychecks and put it into the Roth. I'm just not sure what to do with some of the extra income for a couple of months.

Thank you. I appreciate all your help and advice for your podcast and postings, medicine. So Andrew, what are your thoughts on medicines? A

Andrew

1:00

Great question. Well, first off, congrats sound like you're killing it. These are great problems to have. And sounds like you're working hard and really working to improve yourself. So that's fantastic. You know, a lot of people have different opinions on what to do with how you prioritize extra money. And to at a certain point, I almost wonder if it's too counterproductive to try to get too cute with some of that stuff, you know, for a summer job, if it was me, and I was back to my young, rebellious self, I would definitely want to enjoy some of that, you know, but obviously, you have some that you want to put away and do responsibly with too. I know people will say, Well, you got to pay off all your debt. And I get that, and there is value in working towards paying off debt. But if it's really, I don't see somebody paying off a student loan from a summer job unless you got to like the best student loan deal we've ever seen.

So, you know, I'm always a big proponent of having that investing habit in place, meaning are you paying yourself first. So whatever that dollar amount means to you, are you committing to doing that every month? When I recommend for people who have started their careers in their kind of work in their everyday life is to start at $150 a month. And just use that as a vesting habit so that you're in the market, and you have that habit in place, which you can keep for a long period of time. It's really the consistency. And it's really about your behavior more so than it is about the numbers, in my opinion.

And just based on my own experience and the way I kind of live my life pretty emotionally, too sometimes, especially when I was younger. So I would do what is best for your behavior, whatever that will be. And I think that's more important than the numbers. Especially because we're talking about something that's three months in length and not like your next five-year plan kind of a thing.D

Dave

3:01

Yeah, that's great advice. And I would agree that having a plan and following that plan is a great idea, and Andrews's idea about setting behaviors, especially if you're on the younger side, can start to set those for a long period of time. It's a great foundation to build from; that's fantastic advice. And that's something that I wish my younger self had heard for sure because it would have put me in a better position. These are some things that I learned later on in life. So I would definitely heed the some of the things that Andrew was saying; if you want to look at the numbers, part of it, something that always has kind of stuck in my head was when I was working in the bank world, I had a mortgage banker, talk to me one time because he had heard a customer talking to me about kind of the same kind of idea, I have money, I don't know whether I should invest it or if I should pay off some debt.

And something that he recommended to me after hearing this conversation was something that he was taught by a private banker was that look at what kind of return you can get versus the interest that you're paying on your debt. So mortgages generally tend to be lower interest rates. So it's a little bit easier to make a decision in that circumstance. Because you can earn without a lot of effort, you can earn decent returns in a market buying indexes and ETFs, you know, on a consistent basis. But the flip side of that is that if you're trying to pay off a credit card at 20%, then trying to beat that hurdle in the market is it's a lot bigger of a challenge. The professionals struggle to do that.

And so somebody that would just be starting out, it would be a challenge. And so his advice would be too, if you had extra money and you wanted to put a good use, and a short term would be to maybe look at it paying down your credit card debt because that would be ideal in theory would be at the higher interest rate of the three that you're talking about. If you're talking about a mortgage, then you're looking at depending on what your rate is to 4%, you could make more money by putting that extra money in the market because you can earn a greater return than would offset paying off the student or the mortgage faster, for example. So those are just, I guess, some generalities of some ideas that some people have suggested to me. And that's something that I kind of liked to keep in mind as well.

And if you are looking at paying down debt, just as a general rule, I think it's better to look at the ones that have higher interest rates. So let's say you have two credit cards, and one is 20%. The other ones, 15%, pay off the 20% faster than the 15% because that's going to save you more money in the long run.

But it sounds like Madison has a good plan and is got a great head on its shoulders, and has really started moving in the right direction. And I would definitely suggest listening to what Andrew said. And I think, you know, if you're younger, have some fun. I mean, life is short. And you should have some fun. And you know, if you got a little extra money, take a trip or go someplace or do something fun with your friends or a significant other, or family and enjoy yourself because sometimes focusing only on the money can we do to not enjoying yourself, and we're all here to enjoy ourselves as much as we can anyway.

A

Andrew

6:21

Yep, move on to the next question, then I've got nothing else really to add. So this one is from Nate; he says, I'm wondering what you guys think about the defense sector investing both with long hold and what's going on. Currently, I'm a subscriber to the Sather Research eLetter, which has previously bought some of that, and I'm holding some others like Lockheed and Raytheon. We saw basically everything in that sector jump in price the day after the latest hostility started. Is that a good sell? Or are these companies just more valuable? Is there anything special we as investors need to consider when looking at a defense company? Thanks, Nate.

D

Dave

7:00

Well, that's a very interesting question. And the defense sector is something that I've briefly looked at. I know Andrew has much better insights into the defense sector than I do. But I think overall; I would say that the defense sector is it's a strong industry; it tends to be undervalued as a general rule. And it's something that it's not going away. And I do remember that the contracts that these companies were generating were pretty big and pretty substantial. And we're going to only continue to increase.

And as even though the country politically, maybe encouraging us to downsize some of what's going on is maybe not having as many soldiers or foot soldiers. But technology is improving. And that's something that we're definitely seeing what's going on in the unfortunate situation in Ukraine, is that the ability for the foot soldier to inflict a lot more damage based on the technology that they're using is far greater than it was 510 15 years ago. And so it looks like it tends to even out things on the battlefield.

So all that to say, the money that's going to be spent on defense, I think, is only going to increase. And the other thing that sometimes doesn't, at least something that I noticed, was that a lot of these defense contractors are also involved in the space industry. And so satellites, for example, as we increase more of the technology, we're going to need more satellites and better satellites. And that's going to just continue to evolve. And then there's the whole issue of this air, quote, the space race between SpaceX and Blue Origin and all the other players, these companies are directly involved in a lot of that stuff as well, trying to go to the moon, trying to go to Mars, and some of the other projects that they're working on. So there's definitely a lot of moving parts and a lot of things going on in the defense industry, kind of beyond just the airplanes in the battleships, for example. So I would be more curious to hear Andrew's thoughts on the defense industry

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Andrew

9:02

Are sound like you read my E leather issue about us? I surely did. So yeah, we bought Northrop Grumman back in February 2021. And I'm still holding. And the reason why I'm still holding is that I believe it's still undervalued, potentially, or potentially fairly valued. And one of the things I would highly recommend if you're kind of skeptical about investments in defense is if you look at the long-term government spending trends on defense, you'll see it's cyclical, which is very similar to a lot of other things we see in the economy, things cycle up and down. And so, defense spending is the same way. And so what's interesting is historical, over decades, it's been around 4% A year growth for defense spending.

For the last ten years, it's been less than 1% a year in growth. So you have to ask yourself, is the human race just that much better? More and more peaceful and more socially and behaviorally advanced that we don't need defense spending anymore, or is this one of those down cycles that could cycle back up. So, you know, obviously, you can't just always simplify it to say if an industry is growing, then the stocks in that industry are good investments. But these are very well-run companies, particularly the one that we own; they buy back a lot of stock; they're not trying to go aggressive, crazy, and trying to take over the world or anything like that. So they're providing good returns for investors. And until that changes, I don't see it as a sell because there's reason to believe that the growth could be even greater than it has been, and even where it had been like if that defense spending had stayed the same, it was still a great value at that time.

So that's why you try to look for these kinds of margin of safety companies were based on where they're at, you know, it's a good value to buy the stock. But things could improve, and it could become an even greater value. And you really want to hold through those periods to be able to let those things play out. Because a lot of these things are really long-term, and so that was something I learned early on this, like, you can be right. But you could be so wrong if you sell too soon. Because, yeah, you may have made 50% on the stock, but Wall Street doesn't know how much you made. And it really hurts to be right on an idea and wrong when you thought 50% was a great return. When you kind of earned 200% or more, that hurts.

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Dave

11:34

Yeah, that would hurt for sure. So I guess a couple of questions I kind of have about the defense industry just as a kind of a general rule, the kind of the way that they generate revenue is from these contracts that they're given. And those come from the appropriations from Congress, correct?

A

Andrew

11:52

Yeah. All right. Defense.D

Dave

11:55

Yeah. Yeah. And there, they're generally kind of longer-term contracts, if I'm correct.

A

Andrew

12:00

So you can look at one; I guess it would be an accounting term, but that's something in the company's financials called a backlog. And so, not a lot of businesses necessarily deal with the backlog. But for something that makes contracts like defense, they do a backlog so you can look. And you can kind of see how much revenue a defense company is going to make in the next several years based on what their backlog is.

Because even if they have a contract, they don't get to record those revenues until they actually perform the services. Right. So yeah, the backlogs right now are huge. And they're growing, and there's plenty of work to be done. Right. So so, it is a very defensive kind of defensive in the sense of like, you kind of know what's going to happen, because it almost gets projected in the backlogs.

D

Dave

12:51

Yeah, it totally does. So the thing that I took away from looking at the companies was that they aren't going to be the fastest growers in the world by any stretch of the imagination, but you also have the predictability of the revenues over a longer period of time because of that backlog. And that's one of the things that makes them, I guess, a safer play, if you will. And it made me feel like if I was going to invest in these companies, that these would be stable companies as far as the performance of the business, you know, stock prices and stock price, and that's going to do what it's going to do.

But the performance of the company, you know, eventually into like in the long run, it's going to impact the return you make. I think another thing to point out is they are very strong capital returners in the fact that they pay strong dividends and they pay they do a lot of buybacks as well, correct? Yes. Yeah. The other thing that I thought was kind of interesting, too, was that even though one of the companies, they all kind of they're competing, but they also are working side by side. So think of the F 35.

They have someone company like Raytheon makes a part for the plane. And Lockheed makes a part for the plane. And Northrop Grumman makes it part of the plane. So it's not just one company that's making a lot of these weapons, is that correct?

A

Andrew

14:10

Yeah. So for the F 35, lucky kids playing the Northrop's collaborating with them on the right, in a big way. And that's kind of something that's interesting, too, about these companies is the government needs a healthy marketplace to be able to have fair bids on these contracts, right? So it's highly, highly, highly unlikely that one company comes in and swallows all the rest, right, that's I don't see how that's ever going to fly.

And so you don't have to be number one per se. You just have to be strong and kind of staying in your lane, kind of that idea that I've talked about several times over the past several months. So yeah, it is very interesting because they will have to worry about Amazon coming in and like going cutthroat on their business because there's not gonna be a defense company that can stay number one forever, like, it's just not in anybody's best interests.

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Dave

15:07

Yeah, yeah, for sure. So there is one industry that it appears that Amazon's not going to try to disrupt.

A

Andrew

15:12

Exactly. One, one. Never say never, though, right?D

Dave

15:19

Yeah, true. Yeah, very true. I never say never. Well, I mean, Jeff Bezos did leave the company. So he could do Blue Origin. So I guess he could say he did. He decided he didn't want to take that on as Amazon anyway. Right. All right. Well, we move on to the last question here. Hi, thanks for the very helpful info on the site; I am struggling with how to assign a premium for a company growing at a faster rate than another but having the same margins and, for argument's sake, similar risk characteristics. So take Carvana's (CV), and a whose price to sales is 0.46.

With a growth of 55% versus Affirm (AFRM), whose price to sales is 5.4. With a growth of 60%. How would you assess the two from a pricing vantage point? And this is from Neal? This is an interesting question. Would you like to chat a little bit about numbers? Or would you like me to talk about a firm in particular, A

Andrew

16:16

First of all, I would love to grab some popcorn and hear you talk about the firm because I know you feel very strongly about them real quick. Before we dive into that, I'll just quickly talk about the price to sales. So that's just looking at the price of the stock compared to how much sales it generates per share. So if I'm just going to make these numbers up, if a firm is like a $3 billion company, and they make $1 billion in sales, that would be a price to sales of three because the markets are pricing them at 3 billion, they generate 1 billion in sales. That's what the price of sales does. So you can make apples-to-apples comparisons between different companies, regardless of how big or small they are, by using the price to sales.

So in the case of this question, Carvana at point four six prices to sales, and the firm at 5.4 prices to sales implies that the market is valuing Affirm much, much higher based on its sales than they are valuing Carvana. Now, yep. How do you feel about it? There are so many ways you could probably go with this. But how do you feel? Yes, question.

D

Dave

17:25

All right. So it's a really interesting question. And for those of you unfamiliar with a price to sales, it's an easy metric to calculate. And Andrew gave a great overview of kind of how to calculate it; it tends to be used a lot with companies that are unprofitable. And when we're talking about unprofitable, it means that the company is not generating earnings, either on an operating basis or net income basis.

So when you think about the income statement, as you work down the income statement, the top lines are the revenue or the sales, and that's what everybody knows. But as you start getting into the costs, and the expenses, and the taxes, and all the different things that a company has to undertake to generate those sales, then that all starts to detract from the sales in new companies, which both of these companies are very new to the market, in general, are newer companies do or companies tend to not make money kind of coming out of the gate. Not always the case, but just as a general rule. And so, a lot of people will use metrics like the price to sales to help them value a company or, as Andrew was pointing out, use relative numbers to look at which one is more expensive than the other according to what the market thinks. So a firm is for those of you I'm going to speak more on Affirm; I'm not as familiar with Carvana.

So I can't speak to that; specifically, Affirm is a company that offers a product called Buy now pay later, which is a newer, updated version of layaway. So older folks like myself know what layaway is; that's something that they used to have in the 70s and 80s. And basically, what it is it used to be that you could take a product, whatever it was, you know a game or something like that. And they would set it aside for you, and then you would make monthly payments on it. And then when you paid it off, you took the product; now you can actually take the product home you can buy whatever it is you want.

And just about everything now is eligible for a buy now pay later, with companies like a firm afterpay and Klarna. In particular, you can literally buy almost everything, including a hamburger is by now pay later idea and so basically the way that they're set up and each company is different, they offer the ability to split up the payments into three to five different payments for example, and you wouldn't pay any interest like if you use it for your credit card. So that's the allure and the idea of the companies. So a firm is a newer company, and they are one of the leaders in this Buy now pay later space, and this has really gained a lot of traction in the last few years, and the way that a firm works are, you can go to online, or you can go into a store. And as one of your payment options, you can choose a company like a firm to buy your product; it tends to work better for larger purchases. It gained his first claim to fame with Peloton. So it was one of the ways that Peloton allowed people to buy the bikes two to $5,000 bikes using a firm, and it got Affirm a foothold into the retail space. And it allowed the Peloton to generate a lot of revenue quickly because the way it works is that a firm basically guarantees the payment. So if you buy a $3,000 bike with a firm through Peloton, Peloton gets the $3,000 from Affirm, and then you pay to Affirm back.

So now the Peloton has completely cut out of the equation, and Peloton is happy because they've gotten the money for the bike. And so it works great for the retailer. A firm makes money from the take rate, which is the percentage that they charge a company like Peloton for the ability to get their money upfront. And then a firm deals with collecting from us. So the market, I guess about two years ago, these Buy now pay later companies in the particular firm was one of the hottest companies out there, Twitter was all abuzz about a firm, in particular, that was the hot stock for a while, and everybody was all a flutter or all at Twitter, no pun intended about a firm, and it ran up in price huge. Now both of these companies, Carvana and Affirm, do have very, very nice revenue growth like they are growing fast.

There's no question about it; you can argue about that. But what is now happening in the markets with both of these companies, in particular with the Affirm, is they're getting hammered because they're starting to see a lot of things about both companies that are unprofitable, and it appears they may not ever get to profitability. So as much as I've bashed Tesla in the past, the company is not profitable; it's making money. And that's the whole goal of every business to make money because eventually, the money is going to run out. In other words, the money you can borrow from other people, whether it's a bank or private investors, it's going to run out. And if you can't produce enough money to pay your bills, you go out of business; it's pretty simple business economics.

And so what's happening in the market now is that Carvana, in particular, as low as 91%, from its high was trading at $370. Back in August of 2021. It's now trading around 23 bucks. And so it's fallen off a cliff, I would admit, I don't know much about the company at all, other than the fact that it's really the market sentiment against the company is very negative, a firm is become more negative, for sure over the last six months. So one of the issues with a firm, in particular, is it enables people to buy stuff they can't afford. And my biggest issue with it is the credit checks. So the Buy Now pay later companies are not regulated like credit card companies and banks in particular. And so those two entities have a lot of government regulations that oversee making sure they do not operate on a predatory level. In other words, allowing people to buy more than they can afford. And then they can't; they get in a lot of trouble.

And it causes everybody a lot of pain. Affirm, Afterpay, Klarna, a lot of these PayPal, Apple now, these companies are not regulated like American Express's, for example, or even Capital One. And so, they don't have the same regulatory requirements to offer credit checks for people. So one of the hindrances to credit cards is you have to have a decent credit score to get the credit; it's not free money; you got to pay it back. And there's interest in all this, and the Buy Now pays later; companies are offering, in essence, what they people think is free. And so my concern from the get-go after working in the banking industry for a while and seeing how poorly people are managing credit. And these are people that have decent enough credit that they can get a credit card.

A lot of the people that are qualifying for these by now payday loans are people that don't have either don't have credit scores or don't have good credit scores. And because these companies have basically allowed anybody to buy something that they can't afford, it puts more pressure on these people to try to pay these things back. And the allure is you're not going to get charged anything. You're not gonna get charged interest like you will with a credit card, and I get that, but the problem is, is that now these companies are accelerating their sales and especially during Christmas time ever. Everything came with the opportunity to buy this buy now, pay later stuff. And what's happening now is people are starting to do default, and they're starting to miss payments, and they're starting to get behind. And it's causing a lot of hardship and a lot of pain to people. And you could argue that it's not ethical. And that is where I started to have a big problem with these companies. Because I don't think it's ethical. And just because it makes it easy to give people credit doesn't mean that it's right.

Now, there are some people that can manage this. And there are some people that have gotten in trouble, Credit Wise, in the past for making poor decisions, and now they're in a better place, and they're trying to build ourselves out great, you know, fine, but the majority of these people are not in that position. And, in particular, young people that don't know how to manage their money or manage their payments start getting in trouble. And I was reading something online yesterday, about a week ago, from the San Francisco Chronicle. And it was highlighting a person that had bought five different things from five different final pay laters that they couldn't afford, and there's no regulation.

So, in other words, when you buy something on your credit card, you get a statement, you know how much it is, you know how much money you've borrowed with these Buy now pay later is because they're not connected, you can lose track of what you bought, and where and that's what happened to this person is that you know, this young woman went bought shoes for $300, and use Buy now pay later, then she went bought a $400 dress. And then she found some jewelry that she liked. And because of the way these companies present their products, with his Buy now pay later, it's like, it's free money. It's like, I don't need to pay this back. It's there's no interest, it's easy.

You know, I'm only paying $20 Now, and my next payment is $100. I can afford that easily. But what happened to her is she lost track of them. And the next thing you know, she had $2,000 in debt, and she couldn't afford the payments. And so now she's defaulting on the payments, and it's going to her credit and hurting her credit. So I guess all this to say, a firm is I don't like it. I think it's unethical. And I don't like the fact that of what they're trying to do. I'm worried that it's just weeding people down a path that they can't manage, and it's going to get them more in trouble. And so even though the market is really hammered them over the last few months, I think it's going to hammer him even more because Klarna, which is the other really big Buy now pay later company, their losses are tripling over the last few years because they're accelerating more. And they're trying to get more people into the system. The more people they bring into the system, the more people default. And it's gotten to the point now where England is considering banning it because it's become so harmful to people. And there's no regulation against it right now. And so I'm not a fan of Affirm; she could probably tell,

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Andrew

27:56

Really couldn't tell.

D

Dave

27:58

Yeah,A

Andrew

27:59

So safe to say, like, at least for the story of a firm, there's more to the story than whatever the numbers show, particularly because it's not a traditional type of business. It's a new innovation and finance in, you know, quote-unquote, new innovation, and finance, which you should always be skeptical of. And so maybe one of those situations where knowing about the business model is more important than looking at the numbers. And that kind of tells you more about how expensive you consider the SOC, yeah, for

D

Dave

28:35

Sure. There's a line in the first Jurassic Park movie a long, long, long time ago, where Malcolm, the guy that Jeff Goldbloom's character plays, he's discussing the ethicalness of creating these dinosaurs. And one of the things he says in the movie is that just because we could do it doesn't mean we should. And just because we can offer, you know, this kind of credit to people doesn't mean we should, and you know, just looking at the top line, and investing in companies, you have to look kind of at the whole story and understand the business model. And also look at the other parts of the financials of the company, because it's not just about sales, it's about what kinds of costs of the company running, and whether they can be profitable at some point. And you want to see an evolution towards profitability.

And I'm gonna give you an example really quick CrowdStrike, which is one of the companies that offer online security; just as a general rule, I'm not an expert on the company at all. But they've been growing very, very fast. But as they've grown, their losses are shrinking, which means that they're moving towards profitability, and probably in the next year or two, it's going to be a profitable company. So with a firm and with Carvana, they're not moving towards profitability; if anything, they're going the other way. And that's where the market is starting to kind of hammer these companies because they're not moving towards profitability. And that's ultimately what you want to see is

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Andrew

29:57

I'm not an expert in Carvana, but I pulled up some of their filings because I was curious. So you can look, and they owed close to $2 billion on this debt facility that they had to pay in the next 12 months; otherwise, they're gonna go bankrupt. So as of April 28, they have a filing that said they did borrow enough to pay that off at a 10% 10.25% interest rate. So that can potentially hurt profitability for a while.

And it kind of goes to that idea of those companies that are raising capital; I think you can safely say there's more risk involved with those types of companies, and also more reward. So it's kind of like that; you don't get the reward without the higher risks. So it is important to look at things like that; in my opinion, if you're gonna be looking at super-fast growers like that, take a look at what kind of debts they owe in the next year, two years? What do they owe in three years? If you don't know how to look that up? Which we have posted on our blog about that? If you don't know how to look that up? I probably wouldn't go for those kinds of highly speculative companies.

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Dave

31:12

Yep, I agree. So, Neil, I hope that we helped answer your question; I hope that I didn't turn you off on investing. But I did want you to know, my guess my thoughts on Affirm; I'm not a fan of any of those by now pay later things, as you could probably tell,

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Andrew

31:25

I think you just have to be careful in general, you know, we talked about the stock market returns of about 10% a year. And so when you're talking about companies are growing like five times that, like 55% 60%, like affirming Carvana, you have to be really, really careful about that, because of all of the things that we said.

So if that was all really overwhelming, it is because there's a lot of nuance to these kinds of high growers. So you can avoid a lot of that risk by sticking to some of the more boring, safe, established companies. And sometimes, you know, depending on the company, you don't have to know nearly as much in order to do well with it.

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Dave

32:09

Yep. Yep, I totally agree. That's well said. All right, folks. Well, with that, we will go ahead and wrap up our conversation for this evening. I wanted to thank everybody for taking the time to send us those great questions. Those were a lot of fun to talk about. And I hope you guys got some good information from all of that. And if you have any questions about anything that we talked about today, Andrew mentioned it, and I'll try re-mention it again. We do have a website called [Investing for Beginners.com](). We have this awesome search bar at the top of the page that follows you wherever you go on the website to answer any questions that you might have about the price to sales, income statements, balance sheets, debt, and all those kinds of things.

There are lots of great resources there to help you learn more about what we're talking about. And the more you learn, the more the compound will help you learn more. So it's a great resource for you. So I hope you guys can use it.

Alright, without any further ado, I'll go ahead and sign us off; you guys go out there and invest with a margin of safety. Susana safety. Have a great week. We'll talk to you all next week.