How I Think About Profits

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A simple question I ask when looking at companies is:

"Is this business profitable? If not, why not?"

For me, a business is designed to serve others. The most successful businesses are usually the ones where the customers are *glad* to be doing business with you. And the mark of a business doing that well is a *profit*. Chick-fil-A is a great example.

Therefore, the first thing I look for in a business is a demonstrated track record of profitability. This means long historical streaks of no EPS losses.

An unprofitable business is telling me one of two things:

a) The business is doing something that the world doesn't really care about. For whatever reason, it is not getting the recognition in the marketplace such that it can meet all its expenses and still have a margin of profit left over
b) The managers are not very efficient or good at running the business

I will not invest in a business that lost money in its latest fiscal year. This means I will miss out on big stock market winners such as Shopify. And that's okay. I rather be sure of a good result than hopeful of a great one.

I will also probably never invest in start-ups or early-stage companies. There are two reasons for this. First, many of them are unprofitable. Second, there isn't enough historical data for me to hang my hat on. I also do not rely on financial projections prepared by brokers, bankers, and consultants since they give an illusion of false precision. By the way, VC investing is a legitimate discipline but that is not what I do.

Let's switch gears and briefly look at the financials of some of the best and biggest businesses before they went public.

Google

	Year Ended December 31,		
	2001	2002	2003
Advertising revenues:			
Google web sites	$ 66,932	$ 306,978	$ 792,063
Google Network web sites	—	103,937	628,600
Total advertising revenues	66,932	410,915	1,420,663
Licensing and other revenues	19,494	28,593	45,271
Revenues	$ 86,426	$ 439,508	$ 1,465,934

Revenues up 17x in 2 years! Phenomenal growth.

	Year Ended December 31,		
	2001	2002	2003
Revenues	$ 86,426	$ 439,508	$ 1,465,934
Costs and expenses:			
Cost of revenues	14,228	131,510	625,854
Research and development	16,500	31,748	91,228
Sales and marketing	20,076	43,849	120,328
General and administrative	12,275	24,300	56,699
Stock-based compensation(1)	12,383	21,635	229,361
Non-recurring portion of settlement of disputes with Yahoo	—	—	—
Total costs and expenses	75,462	253,042	1,123,470
Income from operations	10,964	186,466	342,464
Interest income (expense) and other, net	(896)	(1,551)	4,190
Income before income taxes	10,068	184,915	346,654
Provision for income taxes	3,083	85,259	241,006
Net income	$ 6,985	$ 99,656	$ 105,648

EBIT margins were 13%, 42% and 23%.

According to a recent article in the Economist, "Google's peak cumulative losses were just $21m. By comparison, Uber has incinerated $15bn and still loses money."

Microsoft

	Year Ended June 30,			
	1982	1983	1984	1985
Income Statement Data:				
Net revenues……………………	$ 24,486	$ 50,065	$ 97,479	$140,417
Costs and expenses:				
Cost of revenues………….….	8,647	15,773	22,900	30,447
Research and development……………..….	3,597	7,021	10,665	17,108
Sales and marketing………..	4,009	11,916	26,027	42,512
General and administrative….	3,037	4,698	8,784	9,443
Total costs and expenses….	19,290	39,408	68,376	99,510
Income from operations………..	5,196	10,657	29,103	40,907

Revenues up 5.7x in 3 years.

EBIT margins were 21%, 21%, 30%, 29%.

Facebook

	Year Ended December 31		
$M	**2009**	**2010**	**2011**
Revenue	777	1,974	3,711
Cost of revenue	223	493	860
Marketing and sales	115	184	427
Research and development	87	144	388
General and administrative	90	121	280
Total costs and expenses	515	942	1,955
Income from operations	262	1,032	1,756

Revenues up 4.8x in 2 years.

EBIT margins were a mouthwatering 34%, 52%, 47%.

As shown above, Google, Microsoft and Facebook were all growing very fast, had healthy margins and were cranking out solid profits before they went public.

My advice for new investors is simple: stay away from unprofitable companies that are constantly raising funds – both in the public and private arena. I believe that companies like WeWork and Uber are designed to raise a lot of money from investors and are not set up to make money. Contrast this with Starbucks which makes money on every drink sold.

Lastly, watch out when “scale” is used to justify big losses. It is usually just a buzzword. The best companies are generally profitable very early on.