Go with the cash flow

Roger Montgomery likes businesses with strong revenue streams

WHEN RESEARCHING potential companies in which to invest, recurring revenue should be a key characteristic to look for. I will show you why it is so important. First, I want you to put the stockmarket to one side and think like a business owner. Consider the benefits of running a business that begins each year with a material amount of revenues, cash flows and profits already locked in.

Having absolute certainty that 70%, 80%, 90% or even 100% of your revenues are secure for any future period is an enormous "leg up" for a management team. Knowing that cash will continue to flow through your door each and every day, regardless of what events transpire, enables business goals, forecasts and budgets to be accurately prepared.

Flowing out of this is generally (but not always) an efficient, well-run entity with a strong financial backbone. A well-funded balance sheet, with predictable sources of future financing, provide an enviable platform for management to expand operations organically or by acquisition.

This may sound logical and simplistic, but keep in mind that stockmarket investors regularly lose sight of their core goal of long-term stable returns when they are being bamboozled by a constant stream of short-term negative global economic news.

Unless you can reliably predict the movements of share prices in the short term, you must give your portfolio the very best opportunity to weather the market fluctuations. Whether you are building a portfolio from the ground up or adjusting your current holdings, you must ensure your portfolio is always pointed in the right direction.

Stability and predictability are key ingredients to use in your investment process over the entire business cycle. And while there are many definitions of what constitutes "stable" and "predictable", in my mind "recurring revenue" certainly fits the bill on many levels.

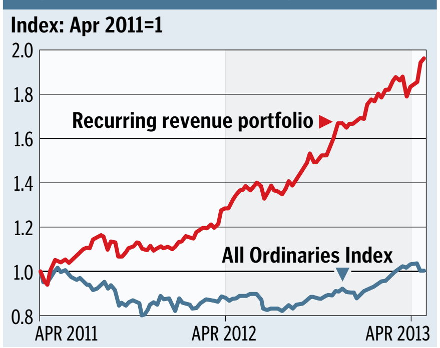
This is what sets companies in the telecommunications sector apart – companies like Amcom, BigAir, iiNet, M2 Telecommunications, Singapore Telecom, Telecom Corp, Telstra and TPG Telecom. All have a common redeeming characteristic – long-term contracts with their clients.

For telcos, the obvious long-term contracts are mobile phone plans and internet subscriptions, which are typically 12 to 24 months. Having hundreds of thousands of customers making payments each month like clockwork is a highly prized asset.

With this in mind, let's turn the stockmarket back on and question whether or not you, as an investor, should build a portfolio of such businesses?

The chart compares the performance of an equally weighted portfolio of the aforementioned stocks with the performance of the All Ordinaries Index over the past 24 months. My conclusion? The performance of businesses with large recurring revenue streams can be simply stunning.

COMPARATIVE PERFORMANCE



Some will argue that such conclusions are inappropriate given the short sample period and survivorship bias inherent in the analysis. While this may be the case, the reality is that these stocks and their underlying businesses have performed wonderfully over a period that saw budgetary turmoil in America, natural disasters in Asia and a debt crisis in Europe.

At Montgomery Investment Management, our investing experience (and subsequent returns) support the notion that businesses with earnings stability have a greater chance of providing outperformance over the long run. Why? Because investors gravitate to them like moths around a street lamp.

We will continue to be comfortable investing in business with recurring revenue streams. And if you can think of any we should take a look at, we'd be delighted to hear from you, so please call or, preferably, write.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*

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