Several years ago, some of us were beginning to wonder whether profit was indeed a “dirty word” on Wall Street. It was easy to draw that conclusion, with all those Internet stocks that tripled their share prices on day one of the IPO, without any clue as to when profits might begin showing up on the income statement. Perhaps it is time once again to talk about profits – specifically, how you as an investor can understand what profitability is all about, and how you can measure your company’s bottom line against its peers and other potential investments. This is not a subject that can be covered totally in one column, so let’s focus on some simple but essential concepts.

Operating Profits
Companies talk about “operating profits” or “profits from operations” all the time. It’s an important measurement because it gets right to the heart of how a company’s core business performed during a certain period. Operating profit represents the profit before taxes, interest and other charges that are not directly related to company performance. Essentially, operating profit represents the amount of money left after all the bills associated with running the business have been paid. Analysts look at operating profits to get a good sense of how well a company is doing. If operating profits are moving up during a given quarter, that’s typically a good sign. If operating profits are trending down, well, you’ve got some questions to ask.

Net Profits
You might have heard the term “net profit.” While that’s important, it can often obscure a company’s quarter-to-quarter performance. Suppose a company lost money from operations during a particular quarter. But during that period, it sold a building and generated enough money to cover the losses and actually report a net profit. No question, the chief executive can proclaim that his company made money that quarter. How many press releases have you read in which the CEO proclaims, “We generated significant net profits this quarter?” But a savvy investor needs to look at composition of these earnings to understand whether the profits came from running the business or selling off chunks of it.

Massaging the Numbers
There are certain circumstances where asset sales are critical to business, and profits from those transactions are quite important. I’m speaking mainly of real estate investment trusts and similar kinds of companies that make their living by buying or selling assets. But, in the large majority of cases, investors trying to get a handle on a company’s profitability need to focus on operating profits.

There’s more to this story, of course. Once you are able to look at operating profits over time, you need to analyze the numbers in the context of the company’s overall revenue growth. The relationship between top line (revenue) and bottom line (net income) can tell a lot about how the company is being managed. Suppose, for example, that a hot software company is growing revenue at 20 percent each quarter. Suppose that operating profits are growing at the same rate. What does that say – or not say – about the quality of management? Now suppose this same company, while generating revenue growth of 20 percent, is generating profit growth at a 40 percent rate. You can conclude that the company’s executive team is doing a better job of growing profits. But what can you conclude when a company, despite dramatic revenue growth, can’t seem to grow profits at the same or a higher rate? You could conclude that the management team is having trouble getting its arms around this rapid growth.

With all the online tools available to investors these days, it is easy to get copies of a company’s quarterly financial statements. All you need is a little spreadsheet savvy and some time, and by plugging in the names of the companies you follow, you can see what the trends show and which ones are doing the best job growing the top and the bottom lines.

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