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Growth Stocks That Won't Keep You Up at Night

They may have been tearjerkers last year, but don't dismiss growth stocks just yet. We've found five companies that should bring a smile to any investor's face.

by David Stires

When the turbocharged companies of the Internet Age suddenly hit the wall, it wasn't just Razor scooters and barely-drinking-aged CEOs that fell out of favor. So too did growth investing—the very bulwark of the bull market. With the dour headlines about miserable corporate profits and the skidding economy, investor sentiment has shifted to good old-fashioned value investing and its emphasis on low price/earnings ratios and slow but steady growth. “Buy like mad,” it seems, has been replaced with “Buy like Buffett.” Witness the money moving in and out of mutual funds. In the first half of 2000, growth funds saw net inflows of \$130 billion, vs. \$26 billion to their value cousins. Now, one year later, growth fund inflows have slowed to \$8 billion, while value funds raked in \$37 billion.

Which brings up a mighty provocative question: Should investors write off growth stocks completely? To that we say a resounding no. Even the most Graham-centric money managers advise clients to keep a balanced portfolio of value and growth stocks, large cap and small. Real growth investing, after all, isn't about ethereal benchmarks like eyeballs, mind share, and “price to engineer” ratios. It's about profits—or rather, the *increase* of profits. And in the end, that is what fundamentally moves share prices.

So with this in mind, we present FORTUNE's annual list of the 100 Fastest-Growing Companies. All the companies on the list, compiled by Zacks Investment Research, are based in the U.S.,

have been publicly traded for three years or longer, and have revenues and market capitalizations of at least \$50 million. To meet our requirements, they had to post at least 30% annual growth rates for three years in both revenue and earnings per share, and register positive earnings in the latest quarter and for the sum of the past four quarters. The final rankings derive from totaling the scores we gave them for revenue growth, growth in earnings per share, and total stock market return over three years.

Still, as appealing as a six-page list of high-octane stocks may be, we realize that savvy investors look for more when shopping with their hard-earned cash. The key is finding companies with sustainable growth rates and valuations that have yet to fully reflect their upside potential. In other words, the best of growth and value. So we scoured the list to find companies whose profits and share prices are still gaining altitude.

Our method was straightforward. First, we sorted all 100 companies by industry, focusing on those sectors likely to see the greatest expansion: energy, financials, health care, services, and technology. To identify the most promising stocks in those groups, we reranked each company according to what's known as the PEG ratio. That's the P/E ratio divided by analysts' long-term earnings-growth projections; a low ratio can be an indication of undiscovered value. We then discarded firms whose market caps fell below \$500 million,

Congratulations! It's a customer!
Newborn Brooke Godfrey wakes to the world in one of Province's 15 rural hospitals.

FORTUNE'S FASTEST GROWING

and any stock whose average analyst recommendation wasn't a buy or better. Finally we ran our candidates by a host of top stock pickers including, among many others, Mary Lisanti at ING Pilgrim, Ralph Wanger at Liberty Wanger Asset Management, and Dick Weiss at Strong Capital Management. The yield: five recommendations, one in each of the leading industries.

What's more, most of the companies on our list carry high price tags and higher risk. In fact, last year's ten picks are down 49% to date, compared with 47% for the Nasdaq. So this year we enlisted two well-known short-sellers, David Tice of the Prudent Bear fund and Manuel Asensio of Asensio & Co., to help identify a couple of stocks to steer clear of. Here, our picks and pans:

Energy

With earnings projected to grow 34% a year for the next five years, Calpine (No. 3 on the list) is anything but a boring utility. This San Jose electric-power producer is, in fact, in the sweet spot of the nation's energy shortage. With demand for electricity rapidly outstripping supply, Calpine is embarking on the largest power plant construction kick in U.S. history—aiming to have an astounding 70,000 megawatts of generating capacity by the end of 2005, up from 5,900 at the close of 2000.

Calpine has succeeded in meeting its goal so far. It cranked up two big plants this summer to fill part of California's acute shortage, and opened one in Arizona capable of sending power throughout the West. Also, Calpine's emphasis on long-term contracts enables it to predict future earnings better than rival generators, which sell power predominantly on the so-called spot market (where electricity purchases are supplied immediately). Ninety percent of Calpine's 2001 production has been sold under long-term contract, and the company has already locked up 65% of 2002 production in long-term arrangements.

The stock, however, has tumbled about 30% this year, mainly over concerns that weak demand and unseasonably cool weather would hurt profits. And that has created a buying opportunity, says Maura Shaughnessy, manager of the MFS Utilities fund. Given Calpine's ability to lock in rates, current market fears seem overblown. While the stock trades at a slight premium to its peers, Shaughnessy notes that its multiple is still lower than that of the S&P 500—and yet Calpine has three times the earnings-growth potential of the average large-cap company, she says. Sometimes "power hungry" is a good thing.

Financial Services

While the market's gyrations may have cooled America's love affair with day trading, the commitment to traditional buy-and-hold investing remains solid. Perhaps it's no surprise, then, that asset management is the fastest-growing segment of the financial services industry. Since its founding in 1993, Affiliated Managers Group (No. 23) has become a powerhouse holding company of midsized money-management firms, with a market cap of \$1.3 billion. Its

15 affiliates—which divide among retail firms like Managers Funds, high-net-worth firms such as Tweedy Browne, and institutional firms like Frontier Capital—manage a total of \$70 billion.

AMG's secret? Unlike companies that purchase firms whole, AMG leaves the executives of its new subsidiaries with a substantial piece of the business. That way they have a financial incentive not to spend their time—or at least not all of it—honing their golf game. In addition, AMG helps affiliates launch new funds and make acquisitions, providing advice not typically available to mid-sized investment advisors. This increases the affiliates' potential for earnings growth and, by extension, AMG's.

While the company's shares have roughly tripled in the past three years, Ralph Wanger, whose firm is one of the largest shareholders, says it's not too late to invest. Assets under management should continue to swell, he says, as the market rises over time and AMG continues its buying spree. The company's diversified revenue stream—with half its affiliates pushing growth investments and the other half, value—should help it prosper no matter what investing style is in vogue.

Health Care

The hospital sector has been consolidating for years. But with for-profits still constituting just 15% of the nation's nearly 5,000 hospitals, industry experts say the takeover game is in its early stages. Reeling from increasingly complex health-care regulations and low reimbursements from both the federal government and HMOs, many of the 4,000-plus nonprofit institutions have little choice but to sell or lease to the for-profits, which typically have greater financial and managerial resources.

One of a handful of hospital companies focused exclusively on non-urban markets, Province Healthcare (No. 76) buys hospitals in rural communities where HMOs and their stingy contracts have yet to fully penetrate. The company has a well-defined acquisition strategy. Its target markets have stable employment bases and growing populations, and Province makes sure it will be either the dominant or the only health-care provider in the area. Once a deal is done, Province cuts administrative costs, then expands services to discourage local residents from traveling to larger communities for medical care. Since starting in 1996, the company has built a chain of 15 hospitals in nine states.

Lookers and Losers

Following are five picks—and two pans. Lower PEG ratios are typically considered better.

| Company (ticker) | Price 7/31 | P/E ratio* | 3-5 yr. annualized growth est. | PEG ratio |
|----------------------------|------------|------------|--------------------------------|-----------|
| STOCKS TO BUY | | | | |
| Advent Software (ADVS) | \$57 | 60 | 33% | 1.8 |
| Affiliated Managers (AMG) | \$68 | 18 | 20% | 0.9 |
| Calpine (CPN) | \$36 | 20 | 34% | 0.6 |
| Province Healthcare (PRHC) | \$37 | 35 | 25% | 1.4 |
| United Rentals (URI) | \$23 | 13 | 15% | 0.9 |
| STOCKS TO AVOID | | | | |
| PolyMedica (PLMD) | \$35 | 13 | 28% | 0.5 |
| Providian Financial (PVN) | \$49 | 15 | 23% | 0.7 |

*Based on forward 12-month earnings estimates.

FORTUNE TABLE / SOURCE: ZACKS INVESTMENT RESEARCH





TODD HORN

Trading at 35 times next year's earnings forecast, the stock sells for a steep premium compared with its peers. But AIM Global Health Care fund co-manager Michael Yellen believes the higher multiple is warranted. With plans to acquire two to four hospitals per year, Province could well boost earnings an astounding 25% a year over the next three to five years. (The company itself estimates that there are 1,100 non-urban hospitals that make attractive acquisition targets.) Many Wall Street veterans believe Province could double in size over the next five years without pulling a muscle.

Services

The booming construction business and home-improvement craze have turned four-year-old United Rentals (No. 30) into the 70-ton dump truck of the equipment-rental industry. How did United pull it off? Largely through its wallet.

The Greenwich, Conn., company, which rents everything from small hand tools for do-it-yourselfers to backhoes for general contractors, has purchased 250 rival rental houses. Its 750 stores and \$2.9 billion in revenues now make it the largest machine-tool rental company in the world. But more important, United's many fans—including value investor David Williams of the Excelsior Value and Restructuring fund—say the company still has many years of strong growth ahead.

For starters, the \$25 billion equipment-rental industry remains highly fragmented. Since most of the estimated 15,000

Talking 'bout my generator

Long-term contracts have helped Calpine excel over peers.

rental shops are mom-and-pop operations, acquisition targets abound. Second, as a mammoth buyer of goods, United is able to negotiate favorable purchasing terms from

its suppliers—often as much as 30% cheaper than what its smaller competitors can secure. And United has streamlined the process as well, narrowing its equipment supplier base to 28 companies from 111 last year—lowering annual purchasing costs by \$150 million.

As investors have flocked to cyclical issues that might benefit from an economic recovery, United's stock has doubled from its \$12 low last December. Even so, shares are priced at half the S&P 500 multiple and are way off their all-time high of \$48 in 1998. What's more, the industry itself still has plenty of room to grow. As more and more industrial contractors conclude that renting equipment is more cost-effective than purchasing, United Rentals stands to benefit most of all.

continued

First Jordan, then Jeter ... now Jakks?
Open the foldout and learn about
our threepeating companies ▶



Technology

Once you get over the scarlet "T"—that badge of shame that every tech stock wears these days—Advent Software (No. 47) is nothing short of a head turner. The San Francisco company licenses its accounting, trade-order, and portfolio-summary software products to more than 6,500 institutions in 45 countries, from tiny money managers to global investment firms. It now boasts a 17% share of that market—a huge chunk in an industry where more than half of all money management firms rely on proprietary systems.

The company's biggest growth opportunities lie not in its flagship Advent Office software but with more advanced (and expensive) products like Geneva—a real-time accounting engine for large global investors that's being used by Salomon Smith Barney—and TrustedNetwork. The latter allows companies like Morgan Stanley to offer customers online statements that aggregate info from accounts across the Web.

Selling at 60 times expected earnings, Advent is by no means cheap. Given the continuing slowdown in corporate tech spending, many investors may want to wait to see if a better buying time emerges down the road. Still, Thornburg Value's Bill Fries, for one, sees plenty of potential for growth. Faced with increasingly complicated portfolio-management requirements, investment professionals will likely become even more dependent on Advent's products, says Fries, a longtime user of its software.

While there's still money to be made in this volatile market, there's also plenty to be lost. So we've zeroed in on a few "wonder stocks" that may be running out of magic. That's not to say you should short them. Shorting—in which investors borrow stock and sell it, hoping to profit later by buying the shares back at a lower price—is a complicated and dangerous game. (And one that's especially risky when it comes to fast growers.) The safest bet, we think, is simply to avoid them.

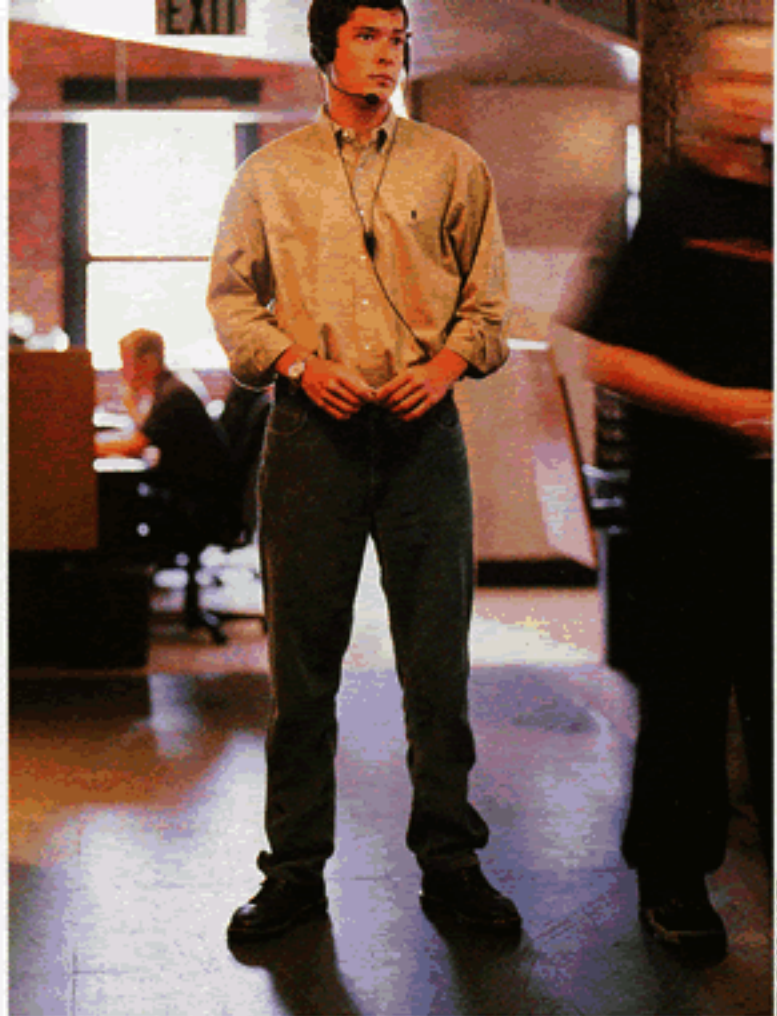
Take Providian Financial (No. 44), one of the nation's largest credit card issuers. Thanks to the booming economy and runaway consumer spending, this Providian Corp. spinoff saw its stock rise 250% since 1996—three times the rate of the S&P 500. An aggressive consumer lender, the company courted, among others, subprime customers—lower-income consumers with poor credit histories. Now, with the economy slowing, that group has been getting hit hard. Personal bankruptcies are up 20% this year, and the credit quality of Providian's portfolio has deteriorated sharply.

In the latest quarter, Providian's credit-loss rate—the percentage of its lending portfolio that it doesn't expect to be repaid—rose to 10.3%, up from 7.4% in the same period a year ago. The company's delinquency rate—the portion of accounts on which the minimum payment is not received by the next billing date—also accelerated dramatically.

A Providian spokeswoman says that the increasing losses had been expected, and the company believes the worst is over. She adds that while credit losses are an important piece of the company's financial performance, other components, such as net income and revenue growth, remain strong.

Providian's stock tumbled 15% when it revealed the bleak

FEEDBACK: dstires@fortunemail.com



Good call Advent's software is hot among money managers.

results in mid-July. But short-sellers are betting the stock has even further to fall. The company is facing its first economic slowdown since entering the subprime market, and next year the number of bankruptcies is expected to set a new record, according to SMR Research, a firm that studies consumer financial-services markets. While analysts expect Providian to earn \$4.11 a share next year, Prudent Bear's David Tice, for one, believes earnings could actually go negative.

Another stock popular among the short crowd is PolyMedica (No. 75), the country's largest provider of diabetes home-testing kits and a three-time entry on our fastest-growing list. It has been shrouded in controversy since last November, when *Barron's* reported that the FBI was investigating allegations of fraudulent Medicare billing practices. The stock plunged about 50% on the news. (PolyMedica denies any wrongdoing; the FBI, as a matter of policy, won't comment.) Then in March, just as the company was pulling out of its slump, CIBC World Markets analyst John Calcagnini dug up four Department of Health and Human Services reports from 1999 detailing customer complaints over billing practices.

In an e-mail, a PolyMedica spokeswoman said that with its volume of business—shipping to over 100,000 customers a month—some dissatisfied customers are to be expected.

A *Barron's* follow-up story in August sent the stock plunging again. It was recently down, more than 50% from its \$48 high this year. But short-sellers such as Manuel Asensio are still gleefully down on the stock for reasons that don't involve the Feds. He points to PolyMedica's curious yet legal accounting practice of capitalizing advertising costs instead of expensing them, as most companies do. PolyMedica responds that it's following GAAP accounting rules and that its auditors approve. But in the past the SEC has objected to such methods, causing at least one company (AOL, which is now the parent of FORTUNE's publisher) to take big charges against earnings.

Yes, as investors have painfully learned, stocks go down as well as up. With growth stocks, it just happens a lot faster. **F**



VISX

Cutting its licensing fees from \$250 to \$100 per procedure in 1999 spurred growth for the leading laser-system manufacturer in the country. It took 42 months (from when the FDA granted approval in 1996) to reach the one-million mark for procedures—and only 14 months more to reach the next million. It helps that over **8,000 eye-care doctors and staff** have gone under the VISX laser themselves.

Biogen

Biogen has been determined to kick a nasty (and costly) biotech habit: licensing drug discoveries to Big Pharma. With its first drug, multiple sclerosis treatment Avonex, Biogen has **hung on to the manufacturing and global-distribution reins**. That means the company isn't forced to carve up its revenues (which, incidentally, are expected to top \$1 billion in 2001).

75

PolyMedica

Data have given this direct-to-consumer medical-products company an edge. A long-running TV ad campaign (and meticulous notes about the consumers who call its 800 number) has yielded a **wealth of demographic info** for use in new-product marketing. The question is, Has the company's streak run its course? (For more, see "Growth Stocks That Won't Keep You Up at Night.")

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Schuler Homes

This Hawaii-based homebuilder became one of the top 15 nationwide by leaving the islands. Well, not entirely. But when Hawaii's economy began to slump some three years ago, Schuler **bought and grew its way into hot markets** like California, Colorado, and Washington. It's now among the top five builders in those states.

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