



Surprise, surprise

Jay Hennick's FirstService has delivered higher-than-expected earnings for the past six quarters

Ever notice how some companies routinely report earnings that are higher than the consensus forecast of the analysts who cover them? Since many of the valuation models used by analysts depend on their best guesses of a company's future profits, a positive surprise suggests the stock is undervalued. The typical result is an upward bump in the price. One study found stocks with higher-than-expected earnings outperformed the market in the quarter following the surprise by an average of 12%. The results were the exact opposite for companies that reported negative surprises. The phenomenon has not been lost on managers at Microsoft and Dell, who mysteriously come up with positive earnings surprises quarter after quarter.

A firm with a recent history of higher-than-expected earnings is Toronto-based FirstService Corp. (TSX:FSV), which owns leading brands in various service-related industries, including property management and commercial security. According to Thomson Baseline, FirstService has had earnings surprises in each of the past six quarters. The share price impact ranged from increases of 2.8% in September 2003 to 11% in March 2003. When I brought up this interesting little trend in a chat with FirstService CEO

Jay Hennick, and asked whether it reflected a new corporate strategy, the amiable exec laughed. "Well," he said, "one of our values is to under-promise and over-perform."

Beating expectations in a service business is a great way to win people over—whether they're customers or investors. And Hennick knows what happens when you disappoint stakeholders. Back in December 2002, FirstService had a negative earnings surprise and the stock tumbled 21%. But 2002 was a bump on an otherwise smooth road of growth. Margins came under pressure, partly because of a tough economic environment south of the border, where 75% to 80% of the company's revenue is derived.

The economic rebound in 2003 put FirstService back on track, and Hennick is expanding once again. In mid-October, the company announced the purchase of 70% of Vancouver-based commercial real estate broker Colliers Macaulay Nicolls Inc., the largest member of the Colliers network, with 80 offices in 20 countries and annual revenue of US\$280 million. The transaction is significant for FirstService for a couple of reasons: 1) it puts the firm into the billion-dollar club in terms of annual revenue—an

important size threshold—and 2) it will give Hennick and his team a global platform on which to build. "We're going to get comfortable operating internationally," he says.

FirstService is already a success story, with an impressive record of acquiring and managing service companies in the States, where many Canadian firms have failed. One key is Hennick's strategy of partnering with management, ensuring they have an ongoing equity stake in the companies he buys.

FirstService has a five-year earnings growth rate of 14%, and analysts who follow it seem upbeat. In an August report, William Blair & Co. in Chicago estimated continued profit growth in the mid-teens, through a combination of 5% to 8% organic revenue growth, margin expansion and potential acquisitions. Although the report argued the shares were undervalued, they have risen about 15% since then. A conservative discounted cash flow analysis and other metrics suggest the shares are no longer undervalued—but they're not hugely overpriced either.

Of course, accurate valuation partly depends on reliable profit forecasts. When asked about the string of positive surprises, Hennick explains the company's contractual revenue base allows for very predictable income, but finding ways to manage the business more effectively allows for small positive swings. (FirstService's surprises typically are modest. If there were large gaps, it would raise questions about whether analysts were paying attention, or whether management was out of touch or misleading them.)

Then again, if FirstService continues to deliver positive surprises, it might suggest a fun strategy for your mad money account: buy the stock just before the quarterly numbers; after the surprise, sell. Doing this over the past four quarters would have returned around 20%, less transaction costs. Then again, you would have been better off buying and holding the stock. It's up about 36% over the past year.



Peter Verburg is investment editor of Canadian Business.



FirstService is now a member of the exclusive billion-dollar revenue club