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PDV *OBSERVATIONS*

While Momentum Falters, Value Resurges: *Long Live Value!*

It turns out value's demise has been greatly exaggerated, as value stocks resurge. Just a short six months ago, the overwhelming consensus among the investment masses, professional and amateur alike, was that value investing was dead. With people abandoning value investing in droves for seemingly greener pastures with the momentum investing crowd, even legendary value investors with spectacular long-term records like Julian Robertson and Warren Buffett were widely criticized.

Responding to this onslaught against value investing, I had commented in the Winter 1999 issue of ***Observations*** that "the current malaise affecting [the value] style of investing, while protracted, is not unprecedented. During every past lackluster period, many skeptics wrote value investing off only to see its resurgence [emphasis added] each and every time. This time will be no different."

The recovery of value stocks and value investing is now fully underway. Previously undervalued sectors like real estate, financials and utilities have been some of the best performing since March (coinciding with the collapse of the speculative areas, like tech stocks). In the midst of what is generally recognized as a terrible stock market so far this year, value stocks have performed well. The momentum strategy of chasing what's hot and ignoring risk or price, which worked so well the past few years, is seriously floundering. Business and market fundamentals have finally caught up with the "play now, pay later" crowd. Valuations matter after all.

We know that we're only in the very early stages of the value recovery as few Wall Street or momentum "investors" are believers. They continue to chase last year's story of techs and yet more techs, seeing every tech dip as a buying opportunity, even though there is clear evidence that overvalued tech companies are having trouble meeting elevated business expectations embedded in their still sky-high stock prices. Even some of the highest quality tech companies have resorted to accounting tricks to meet earnings expectations. More specifically, they have raided the huge unrealized capital gains in their securities portfolios to boost earnings.

The "well" of unrealized capital gains is running dry for these companies, and in fact have already turned into unrealized losses in some cases because of the lousy market; the game is just about over. As the weakening of these companies' business fundamentals become clear to the investment masses all leaning the same way, the continued collapse of the market's speculative segments will further refocus investor

Inside This Issue:

- **While Momentum Falters, Value Resurges:** ***Long Live Value!*** **p. 1**
- **Wall Street Hates the Retail Sector:** ***Time to Go Shopping*****, p. 2**

attention on ***risk management, fundamental security analysis and business valuations***, thereby further fueling ***the recovery of value stocks.*** Since value investing has been out of favor for the past 4-5 years, we expect the powerful rebound for value stocks to continue for at least the next few years. ***Therefore, now would be an opportune time to consider increasing your commitment to value stocks.***

Wall Street Hates the Retail Sector: *Time to Go Shopping*

In the past few months, business in the retail sector has slowed across the board in response to the series of Fed interest rate hikes. Such hikes dampen consumer spending, which is the engine behind retail demand.

The stock market, being a discounting mechanism, has already decimated the prices of many retail stocks in anticipation of the business slowdown now materializing. Many retail stocks are consequently selling near their 52-week lows. Wall Street's universal pessimism surrounding this sector has created selective opportunities among the retailers.

However, retailing is a very tough and competitive business, requiring you to do your homework and be very selective as you rummage through the rubble. Here are the factors to focus on when analyzing retail companies as potentially rewarding investments.

Total Sales Growth; Same-Store Sales Growth

Any attractive retailer should be growing its total sales over time at a decent pace. Total sales growth signifies long-term growth potential of the business and allows fixed costs to be spread over a wider and wider revenue base, thereby producing increased earnings and profit margin expansion. A retailer with potential should be able to generate sales growth by taking a successful format/operation in certain locations and replicating it in new locations.

Perhaps more important than total sales growth, however, is same-store sales growth. This metric is calculated by comparing year-over-year sales from a chosen set of stores that have been open a pre-determined time period (usually one year). This metric gives the investor some additional insight into a retailer's earnings growth potential, since the retailer can always increase total sales by simply opening more stores, even if they are unprofitable. It is a better indicator of how the more "seasoned" part of the retailer's business is performing, and whether the demand is strong enough to justify the expense of opening additional stores.

Financial Strength

The financial strength of any potential investment is always of paramount importance, but particularly so with retailers, which generally operate in a fiercely competitive environment. Retailers' fortunes are also necessarily tied closely to the business cycle, which strongly influences the level of consumer demand. Even the best retailers must be prepared to weather some down business cycles from time to time. Without the requisite financial strength, the retailer won't be able to "live to fight another day," and benefit from the eventual upcycle.

When looking at a retailer's financial condition, it is not sufficient to look at just the aggregate amount of debt on its balance sheet and the interest coverage adequacy. You must also take into account the operating leases that are often not included on the balance sheet (aka "off-balance sheet liabilities").

While leases with favorable terms or covering attractive locations might have "bonus" value and legitimately be viewed as a valuable asset, the corresponding lease obligations are real liabilities that accrue regardless of how the retailer's business is faring. These "fixed costs" introduce the risk of "operating leverage" (as opposed to financial leverage), making the retailer's profit margin extremely sensitive to small changes in sales level. Any slowdown (or reduction) in sales would adversely affect margins, and could easily plunge the retailer into heavy operating losses.

When analyzing potential investments in the retail sector, focus on those that can fund their working capital requirements (e.g. inventory) and long-term capital expenditures (e.g. store renovation and expansion) primarily via internally generated cash flow, rather than external debt obtained through banks or the public markets. You should make sure the operating cash flow amply covers all fixed expenses and required capital expenditures and lease payments with a comfortable margin, in case the retailer has to endure a period of slow economic growth.

Margins

Retailers operate in one of the most competitive industries, generally having to live with thin profit margins. Those with the thinnest margins succeed by selling a high volume of products and "turning their inventory over quickly," in industry parlance. This means they need to sell a lot of products quickly, get the cash flow to repay their vendors and other costs and replenish their shelves with fresh products obtained from vendors on credit.

Retailers with such thin margins are not per se poor investments, but they can get into trouble more quickly if their inventory is not moving fast enough. You must pay special attention to how fast they are "turning over their inventory" and what is the long-term trend of their inventory turnover ratio, which is defined as the cost of goods divided by the average inventory level.

Growth of Inventories vs. Sales

Inventories are the life-blood of the retailing business. The trick for the retailer is to minimize or eliminate inventories of slow-selling products, while at all times keeping adequate inventories of goods in demand. This of course is easier said than done; all retailers inevitably have too much of certain products and not enough of others. Insufficient inventory of popular products means lost sales, while too much of the unpopular means they eventually have to be discounted, perhaps heavily, to be sold. Slow-moving inventory ties up cash flow and valuable shelf space, and hurts profits.

Inventory levels growing greatly in excess of sales which cannot be explained away by seasonal factors or the addition of new stores should raise caution flags that the company is about to take a hit to its earnings and confront a forced write-down of its assets.

Growth of Receivables vs. Sales

Retailers are often able to cover up (at least temporarily) weak demand by offering generous financing terms to spur consumer spending. Some of this is to be expected, as no retailer, no matter how good, will be perfect in making merchandising decisions. Of course, vagaries of the business cycle are also out of the retailer's control, and offering financing can be a legitimate tool in dealing with slow periods.

However, growth of receivables far outstripping the growth in sales should sound off alarm bells, at least prima facie suggesting the retailer may be too lax or aggressive in financing consumer demand. The likely result is that some of the sales booked on the income statement are "not real" in the sense the corresponding receivable will never be recovered in full. Such warning signs, coupled with an inadequate loss reserve set up for recovery of doubtful accounts,

should alert you to potential trouble.

Economies of Scale/Cannibalization

When evaluating potential investments in the retail sector, the size of the retailer matters in a number of ways. First, if the retailer sells goods that are available in other stores, then the retailer must compete on price. The retailer whose size allows it to negotiate the lowest prices from its vendors can afford to out-maneuver smaller competitors with lower prices, eventually eliminating them by driving them out of business. Vendors, eager to gain valuable shelf space inside a distribution venue with a lot of foot traffic and high volume sell-through potential, would also be more willing to give discounts.

Second, when it comes to hot products in short supply, the larger high-volume retailers are likely to get more than their proportionate share of the goods in demand.

Third, in the shopping mall area, national retailing chains that generate a lot of foot traffic often get preferential treatment on choice locations, and favorable lease terms.

On the other hand, a retailer that is too large or growing its store count too quickly could lead to cannibalization, especially in mature markets. Cannibalization occurs when a retailer floods a particular market with so many stores that they start competing for the same customers. Cannibalization can be a serious concern as each new store involves a huge amount of pre-opening costs upfront, not to mention some long-term escalating minimum lease obligations that accrue regardless of the level of business.

A retailer is unable to recover its costs and generate a return from an investment in a new store until it matures and begins to produce the requisite level of sales. Cannibalization prevents such a level of sales from being achieved, often resulting in a negative return on the new store due to operating leverage (explained earlier).

Business Cycle Timing

The health of the retailing business in large part tracks business cycles. The time to invest in retailers is when business is slow, the stock prices have already been beaten down in anticipation of this, and before the next upcycle is evident. Concentrate on those retailers that have the financial wherewithal to withstand the down cycle and are dominant enough to benefit from the upcoming upcycle.

No single retailer you analyze will score highly on all the above criteria. No investment is perfect, and you must weigh the positive against the negative, reaching some reasoned conclusion regarding the investment's long-term potential given its long-term business prospects and current stock price. However, buying high quality companies in an out-of-favor industry usually offers good risk/reward characteristics. As Wall Street hates the retail sector right now, it's time to do some homework and go shopping!

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