94/01-Prospecting in California

The worlds's seventh latgest economy is bottoming out. Get ready for the rebound.

By Peter Lynch

Recently, the decline and fall of California made the front page of the New York Times, in a three-part series, no less. It made me want to buy some California stocks.

The Decline and Fall of California bears an uncanny resemblance to the Decline and Fall of New England, which made the front page of the New York Times on July 23, 1990. In four years, New England had gone from economic miracle to economic disaster, and all the talk on the news was about the lost jobs and the death of the real estate market. You would have thought that Massachusetts, my home state, would have to be liquidated.

Now that New England has bounced back and Massachusetts is still in business, we can view the "disaster" with more dispassion. Housing prices never did collapse, except in the high end of the market, and even the fancy houses are selling again at somewhat fancy prices. People have cheered up and resumed shopping. The amazing part is, the recovery in New England has occurred without the jobs coming back.

The same sort of thing happened in Old England in the 1980s. The British economy looked so hopeless that people were delighted when it managed to muddle through. British stocks did brilliantly after that.

California in 1993 reminds me of New England in 1990 or Old England in the early '80s. Out of 14 million jobs in California, 560,000 have been lost, so that part of the disaster is hardly imaginary. But in the drumbeat of total despair--more layoffs in the defense industry are expected, for example--people are terrified that soon there will be no jobs left in the state.

Housing prices have declined in California, but mostly in the high-end houses, and after more than doubling in the 1980s they were due for a pullback. If what happened on the East Coast is repeated on the West, the California real estate market will stabilize as soon as there's a change in psychology. Then we'll see a modest rebound in consumer spending and a bigger rebound in the stock prices of a variety of California companies as investors anticipate a more prosperous future.

The New England psychology began to improve about the time our state government reduced its deficit and balanced its books. That's where California is right now. After several years of a double whammy--raising taxes and cutting the state payroll--the California government is about to balance its budget. The deficit has fallen from $2.6 billion in 1993 to a projected $560 million in 1994, and a zero deficit is projected for 1995.

I profited from New England's recovery by investing in regional banks and neighborhood savings and loans. Many were selling at tantalizing prices: below book value and with very low price-to-earnings ratios. Those with the wherewithal to survive have been remarkable performers. Problem loans have declined, earnings have skyrocketed, and stock prices have doubled, tripled, and in a few cases quadrupled. All this in less than three years.

There's no reason to believe California S&Ls; won't follow the same script. As of this writing, half are selling below book value. I'm told by Joe Jolson, the S&L; analyst at Montgomery Securities in San Francisco, that for the first time in five years, California thrifts are able to sell their foreclosed real estate. The worst may be over for loan defaults.

In particular, Jolson likes SFFED, a stock that I recommended earlier this year. He also touts two lenders that specialize in California auto loans: CTL Credit, recently trading at $12.50, and Westcorp, trading at $10.50. These have been steady growers in a weak auto market that will benefit from a pickup in sales.

Other analysts are bullish on California's bigger thrifts, beginning with the nation's largest, H.F. Ahmanson, which writes 74 percent of its loans in California. Like its counterparts in New England, Ahmanson learned an expensive lesson and has been staying away from commercial real estate lately. The company recently unloaded another heap of trouble by selling $1.2 billion in delinquent single-family mortgages to Bear Stearns. This transaction may have broken all records for largest onetime disposal of bad home loans in modern financial history.

The drastic move will take a chunk out of Ahmanson's $19.50-a-share book value, but in the long run it will strengthen the company and prepare it for a huge boost in earnings later. Two other large S&Ls;, Great Western and Golden West Financial, also stand to benefit from a recovery in real estate. Golden West is so well managed it has avoided all trouble.

A slightly more far-fetched play on a California turnaround is Fannie Mae, my perennial favorite stock. While Fannie Mae has been a great investment--up twentyfold in nine years and more than fivefold in five-- the true value of the company is still not reflected in the price. Based on projected 1994 earnings, if Fannie Mae traded at the market multiple, it would be a $125 stock. But a cloud of doom always hangs over Fannie Mae, the way the cloud of dirt hangs over Pigpen.

People remember that Fannie Mae got hurt in the Texas recession, when battalions of homeowners walked away from their houses, defaulting on some Fannie Mae mortgages. Wall Street is worried that the same thing will happen in California, but I say it won't. Fannie Mae has tightened its underwriting standards since stubbing its toe in Texas. The delinquency rate on its mortgages has been going down for six years in a row, continuing to drop throughout the latest recession. Currently, the rate is less than six-tenths of one percent, a ten-year low. Meanwhile, Fannie Mae's mortgage-backed-securities business is booming.

In playing the New England recovery, I invested in a few retailers in addition to the banks and S&Ls;, but it was hard to find companies that were exclusive to the region. California is full of them. It has the seventh largest economy in the world and is home to a variety of businesses that derive most if not all of their revenues in-state. Thirty-one million Californians have a chance to monitor these companies firsthand.

The Good Guys is an electronics retailer with locations primarily in the Los Angeles and San Francisco areas. It offers excellent service and low prices, and the stock itself is selling at half its 1992 high of $22.50. The Good Guys will benefit when consumers resume shopping for nonessentials.

One grocery-store chain, Vons, operates almost exclusively in California, and a second, Albertson's, has a major presence in the state. Nordstrom< /wam-co>, a department-store chain based in Seattle, does 50 percent of its business in California, Dayton Hudson of Minneapolis gets 30 percent of its sales there, and Carter Hawley Hale, which just emerged from bankruptcy, does 90 percent of its sales in the state. Nordstrom is a well-managed company with a great record, and its stock has been trading at a below-market price-to-earnings ratio of 19.

California is also the land of the discount warehouse clubs. A majority of the Price Club outlets are located there, so Price Co. may benefit from a California turnaround, as well as from its recent merger with rival Costco. HomeBase, a West Coast version of Home Depot (owned by Waban< /wam-co>, which also operates the BJ's Wholesale Club in the East), has cloned itself around the state.

A discount retailer of a different kind that I've touted for two years running is Supercuts, a hair salon. One fourth of all Supercuts stores are found in California, and the recession may have helped their business, because people who can't afford the $100 stylist are coming in for the $13 shampoo and trim. Perhaps some of them will never return to the $100 stylist, but in any event, Supercuts is expanding across the country and its same-store sales are on the rise. The stock recently traded around $16.25.

Another way to profit from a turnaround in a depressed region or state is by acquiring shares in companies that own sizable parcels of real estate. During the go-go 1980s, raw land in California was priced so high it could have been sold by the ounce.

Today, there's a lot of land in California that's selling for a lot less than it was five years ago, and two publicly traded companies, Newhall Land and Farming and Tejon Ranch, have large inventories on the outskirts of Los Angeles. Newhall was a spectacular stock for two decades, and now it can be bought for half its 1989 high price.

This brings us to the California home builders. While the Decline and Fall gets most of the publicity, California has quietly become the best place in the country to build houses, with cheap land and a labor force willing to work for modest wages. Many former defense contractors are wielding hammers these days.

In the earlier recessions in Texas and New England, we've seen the marginal home builders go bankrupt, creating more business for the well- capitalized survivors. In California, the largest survivor is Kaufman & Broad (the Broad rhymes with toad, but the company is managed like the prince). Kaufman & Broad dominates the market for entry-level houses, and it plans to build several new communities in the next few years. It keeps costs low and quality high, a combination that's hard for competitors to beat.

While the New England recovery has been anemic, California's may be more robust. Its favorable location north of Mexico and at the gateway to the Far East, an impressive array of high-tech industries, and an experienced work force give California plenty of appeal.

If you miss the California recovery, don't despair. Sooner or later there will be another Decline and Fall, in the Sun Belt, perhaps, or in the Pacific Northwest, which already is slumping, or in Maryland and Virginia if we can ever lay off a few federal bureaucrats. When the calamity makes the front page of the Times, it's a signal to start your research.

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