

94/10-What Goes Around Turns Around

How to catch companies that are on their way back and avoid companies that are on their way out.

By Peter Lynch

Investing in troubled companies that show signs of turning around can be a profitable pastime. But turnarounds are a tricky business in which timing is everything and patience is not necessarily rewarded. Flower children at the first Woodstock have gotten gray hair waiting for Avon Products to come back. Rip Van Winkle would still be waiting for Bethlehem Steel, whose stock hit its all-time high in 1956.

The first challenge in analyzing a company in distress is to figure out if it's going to survive long enough to work out its problems. This is where large, well-known companies have an advantage over smaller ones. Big companies got that way by being successful, and most of them own valuable assets: real estate, subsidiaries, cash in the till. Chances are they've got a good credit rating, and bankers will lend them money in a pinch.

Small companies are more likely to be living in rented office space with rented equipment. They have limited amounts of cash, which will soon run out if they need to use it to cover their losses. Their bankers may not be so eager to rescue them with new lines of credit, and their competitors would love to put them out of their misery. That's why troubled small companies declare bankruptcy in droves and disappear from the stock exchanges, whereas I can think of only a handful of big companies (Pan Am, Eastern Airlines, First Executive, Bank of New England, and a couple large Texas banks) that have gone kaput in recent years.

So when I'm looking at a possible turnaround, I do a solvency check right away. Generally, it's the big outfits that have the resources to muddle through, but you can't assume that. In the early 1980s, when Chrysler's survival was in doubt, its shares were selling for \$2 apiece. People who were daring enough to buy Chrysler on its deathbed made 20 times their investment -- but they could have lost everything. I waited until Chrysler got an infusion of cash, thanks in part to a government bailout loan. By then its shares were selling for \$4, so eventually I made only 10 times my money, but at less risk.

Chrysler turned around relatively quickly, but most big companies don't. This is where investors get fooled. They see a famous company with a glorious history that's fallen on hard times, and they notice the share price has dropped, and they snap up this supposed bargain in the belief that a turnaround is imminent. A decade, two decades, three decades later, it still may not have happened. International Harvester, now Navistar, ran out of steam in the 1960s. General Motors began to lose its pizzazz around the time the Beatles first landed in New York. Sears reached its pinnacle of \$61 in 1973, when Richard Nixon was in the White House erasing the Watergate tapes.

The bottom fishers who bought Sears at \$45 a year later, in 1974, and held on to their shares through all the ups and downs have nothing to show for their patience. In 1990, Sears was selling for the same price it fetched 16 years earlier. You would have missed the bull market in the 1980s by investing in Sears.

It's one thing for a company's earnings to decline in a recession or because of a temporary misfortune such as a labor strike or a hurricane or a bad marketing decision. But when there's a steady and prolonged drop in revenues, then you're looking at a serious, fundamental setback that won't be corrected overnight. The key lesson here is, you don't have to rush in to buy shares. You can afford to wait. In some cases, you can't afford not to wait.

Once a troubled company faces up to its predicament (this, too, can take time), it will announce a plan for recovery, which usually involves taking an ax to the budget. Here again, the would-be investor must be careful, because while cutting the budget may boost profits in the short run and create the impression that the company has put its troubles behind it, the real work has scarcely begun.

The hard part is winning back customers and reversing the decline in sales. A company that continues to spend less to make less will eventually have nothing to spend and nothing to make.

I should have reminded myself of this lesson before I invested in 50-Off Stores, a company that couldn't be more aptly named. 50-Off sells discount clothing in a chain of outlets strung across the southwestern U.S. The stock price hit a high of \$32 in 1992, and then 50-Off went into a tailspin. Customers lost interest in its inventory of bargain-basement merchandise, and the stock itself fell to a bargain-basement level: \$12. Or so I thought.

I visited three 50-Off stores in Texas and was impressed with a snazzy kid's shirt that I bought for a friend. More to the point, the company announced major changes and budget cuts and an exciting new array of bargain dry goods. Yet instead of waiting for results of these reforms to show up on the earnings line, I bought the stock posthaste, along with the shirt. The next thing I knew, the stock had two 50-off sales in a row, dropping to \$6 and then to \$3. It is currently at \$4, slightly above book value.

Another lesson I've learned from experience is not to expect too much from companies on the mend. Occasionally, you'll stumble onto a Chrysler or a Fannie Mae, where you can make 10 to 20 times your money, as Magellan's shareholders did during my tenure at the fund. But comebacks are rarely that lucrative. A double or a triple is normally a great result. You get your ten-baggers from young companies in their fast-growth phases, not mature companies in a midlife crisis.

Turnarounds don't always happen once and for all. Sometimes there are false starts. Sometimes there are lapses and relapses. Chrysler, for instance, has had two turnarounds since the early 1980s. Kmart has had at least two since its heyday in the 1960s. Pier 1, a perennial favorite of mine, is going through its third. I own the stock, and it's on my list of favorite turnarounds. The company has closed unprofitable stores and revamped the merchandise. Sales are up, and Pier 1 has a good chance of making record earnings this year. The stock is selling for half its price of five years ago.

Here are three more of my current favorites, each with concrete evidence of a turnaround and each of which I own:

GM: I've been touting GM since 1992, when it was selling for \$32 a share. The way I see it, GM's diversification gives it an advantage over a one-dimensional enterprise like IBM. While GM's U.S. auto business has been a constant source of headaches and losses, its other operations (Hughes Aircraft, GMAC, Electronic Data Systems, U.S. trucks) have been highly profitable all along. For GM to rise again, all it has to do is break even on cars in this country.

GM has taken all sorts of steps to reduce costs, but what got my attention was how it turned around its European auto business a few years ago, then brought the key players from the team that accomplished this feat back to the U.S. to do the same at home. In the second quarter of 1994, GM wowed Wall Street by reporting the best quarterly earnings in its history: \$1.9 billion. I suspect the best is yet to come.

SEARS: Sears closed its famous catalog, which was losing money, and added 200 small stores in rural areas to serve its former catalog customers. It sold 20 percent of its insurance subsidiary, Allstate, to the public in the biggest initial public offering in history and used the proceeds to improve its balance sheet. It has remodeled its stores and brought in new merchandise. It is doing well in Mexico. The outlook for Allstate, which contributes half of Sears's earnings, is favorable.

If everything continues to click, Sears has a chance to break its record and earn \$5 per share in 1995. Meanwhile, the stock sells for \$46, \$15 below the record price.

TANDY: Tandy has overhauled its basic business by selling off its computer-manufacturing operations. It is now a pure retailer, with 6,500 Radio Shack stores and \$250 million in excess cash. Radio Shack has become a kind of 7-Eleven for household electronics, and soon all these outlets will offer repair service for items that are normally a hassle to get fixed. Bring your portable phone, VCR, answering machine, etc., to the neighborhood Radio Shack, and Tandy will ship it to one of its centralized repair shops and return it in working order.

Moreover, the company has trotted out a couple of megastore retail ventures: Computer City for computers and Incredible Universe for electronics and appliances. Both are growing fast. It looks like Computer City will rack up \$1 billion in sales this year, and Incredible Universe nearly half that.

Because the Radio Shacks are doing well already, Tandy's earnings are on the rise without either of the new ventures contributing much. If both prove profitable, it's easy to imagine Tandy becoming a growth company again, a remarkable achievement for a turnaround. Even if only one new venture succeeds, it will be a big boost to earnings and presumably the stock price. The company has also announced a plan to buy back 10 percent of its shares -- usually a very good sign.

There's no harm in taking a "show me" attitude toward turnarounds. Once in a while you'll miss a few dollars of profit by not getting in at the bottom of the successful cases. But in the unsuccessful cases, you'll save yourself a lot of money and frustration. Missing the bottom on the way up won't cost you anything. It's missing the top on the way down that's always expensive. ----- Peter Lynch writes the Investor's Edge column with John Rothchild for each issue of Worth. From 1977 to 1990, Lynch managed the Magellan Fund, the top-performing mutual fund in the industry. He is vice-chairman of Fidelity Management and Research and the author, with Rothchild, of two books on investing. "Beating the Street," the latest, is published by Simon & Schuster.