

And now the stories. My introductions of the stock pickers are followed by their introductions, in their own words, of the stocks they believe deserve your attention.

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Peter Lynch: Hope You Guess Our Name

By Peter Lynch

The markets know, or think they know, the meaning of a brand name to a company. The value of the name Coca-Cola, for example, or La-Z-Boy or even Warren Buffett is built into the price of the company's stock. But what about a brand name that hasn't been well tended? One that doesn't mean what it once did, or what it could?

In other words, what about H&R; Block?

You know what this company does: There's only one name that says "taxes" to more people than H&R; Block (nyse: hrb), and that's the name you write on your check in April. In 1997, 13.3 percent of all the individual tax returns submitted to the IRS were prepared by H&R; Block. That came to 14.3 million returns. I've owned Block shares for some time, and a big reason is its phenomenal combination of brand recognition and business reach. Who else, anywhere, has a franchise like this?

And yet, until last year, the stock mostly watched the great market rally from the sidelines. Earnings were generally lousy, and that fed into what might have been an even bigger problem: H&R; Block had begun to look like a company that didn't know where its strengths and weaknesses lay. Perception matters a lot, and most investors, if they were asked what they knew about Block, wouldn't have described the skill Block had shown in managing its core business for 43 years. They wouldn't have said that at the height of tax season Block maintained an office within ten miles of 80 percent of all Americans, or that in 1997 the company transmitted 50 percent of all returns sent to the IRS electronically, or that the value of a share of H&R; Block has increased 1,400-fold since the company went public in 1962. They would have been more likely to offer some impressions of Block's long, costly struggle to maintain its presence and investment in the new territory of online services, a struggle the company finally gave up this year when it sold its remaining stake in CompuServe to WorldCom.

There are plenty of lessons here. Memories are short. A poorly performing business can drag down a whole company. Failure attracts more attention than success. And perhaps the most important one: A brand name should be treated with the utmost care.

If H&R; Block becomes the stock some people think it can, that will be because the company now understands this. Block is in the early stages of an aggressive, far-reaching process of leveraging its brand name-- making that name mean something specific, positive, and, to a certain extent, new. Can the company pull it off? In these brand-oriented times, Block will be putting on a kind of public clinic. We all stand to learn something--and maybe earn something.

The basic fact of H&R; Block's business model is that the company takes in 80 percent of its \$1.1 billion in annual revenue and more than 100 percent of its profits during tax season. In other words, Block makes money hand over fist in January, February, March, and April, and sees it dribble away the rest of the year. If it seems that H&R; Block offices pop up in your city like mushrooms and disappear the same

way, that's probably because they do. In the heart of tax season, Block operates about 8,800 offices in the U.S. After April, most of these offices shut down or at least staff down.

The basic fact of Block's brand identity is that tax preparation is the whole shooting match. That's all most people think of when they hear the name H&R; Block.

The way out of each of these boxes is the same. Block needs to develop new products and services that make sense to its loyal customers. In the U.S. alone, better than 15 million people a year sit across a desk from a Block employee (the difference between that number and the number of returns prepared by Block is that some people stop in just for filing; they pay, of course). Between two-thirds and three-quarters of each year's customers return the next year--the more complicated the tax codes and/or the customer's return, the more likely the repeat visit. This deep reach into people's lives is what distinguishes Block from nearly any other company with a well-known name--it's why I say Block isn't just a great name but one of a handful of truly great franchises in American business.

But what the company needs to do now is build wisely on the relationships it has established over the past 43 years. That has always been the sticking point. Block has made some mistakes. In particular, it has occasionally been too attracted to the idea of diversifying its business rather than exploiting its name. You might not have known that Block once owned Hyatt Legal Services, a chain of walk-in law offices. Or that it was an aggressive buyer of personnel companies, which it folded into a company called Interim Services. Those ideas are a long way from tax prep.

Then there's the CompuServe story. Block bought the company in 1980 for \$23 million, then picked up a software outfit called Spry for \$102 million and merged it into CompuServe. The evolution of CompuServe is not a simple story, but suffice it to say that America Online came along and ate CompuServe's lunch. CompuServe lost \$186.5 million in 1997 alone. In hindsight, it seems clear that Block's expertise in tax preparation wasn't of much use when it came to a fight with AOL. Moreover, CompuServe--a big company and a highly visible one--made it difficult for investors to evaluate and value Block. Was H&R; Block a service company? A technology company? It was, in fact, an uncomfortable blend. So Block humbly unloaded its 80 percent stake in CompuServe. (The sale wasn't, by the way, the absolute disaster that some people made it out to be. WorldCom paid Block \$1.1 billion in stock, which was quickly converted to cash--and add to that the \$552 million Block received in 1996 when it sold 20 percent of CompuServe in an initial public offering.)

The sale of CompuServe, which was completed just a few months ago, marks a turning point for H&R; Block. The decks have been cleared. Block's balance sheet is very clean, though that's to be expected--management has traditionally been conservative. The company is now awash in cash-- about eight dollars' worth a share from the CompuServe sale and another couple dollars a share from the recent tax season. Think about what \$10 a share in cash means. The stock is trading at about \$47. Based on 1998 consensus earnings estimates provided by First Call, the price-to- earnings ratio is around 25, about the same as the market as a whole. But take the cash off the top and you'll see that shareholders are paying just \$37 for Block's earnings. So the effective p/e on this stock is about 20, comfortably below that of the market. Given this, and the company's announcement that it will buy back up to 15 million of its own shares (out of about 105 million shares outstanding), it's no surprise that the market likes Block again. For the 12 months ended April 1, 1998, Block's stock was up 55.1 percent.

Block has a few dozen businesses, but for our purposes it can be thought of as having two sides. The first is the tax side. The second is the financial-services side.

The tax side is the cash cow and always has been. But for the past decade or more, management has been worried that the company's market might be moving toward maturity--in other words, that 13 percent of the taxpaying public is a heck of a lot and that more customers will be tough to find. What will the source of growth be?

The government, at least in part. The best thing to happen to H&R; Block's tax-prep business in years was the Taxpayer Relief Act of 1997. There was a lot of talk about tax simplification in Washington, but in the end the tax code just got more unwieldy, meaning that more Americans will have to file more-complicated returns. On top of that, many of the changes in the Taxpayer Relief Act will be phased in over several years. The door will be open at H&R; Block.

If serious tax simplification ever does come about, then, yes, Block will be vulnerable. The tax return on a postcard--that could be a company killer. So if you know something the rest of us don't about when the talk about flat taxes and national sales taxes might come to something, then you have reason to be skeptical about Block's ability to keep growing in this area. But for now, the IRS is driving ever larger numbers of taxpayers into the arms of H&R; Block.

This could fit nicely with the company's expansion plans for its core business. You think 8,800 offices is a lot? Look for more. Block will also acquire local competitors. And it will selectively acquire franchisees. For many years, the company was an aggressive franchiser (it's a cheap way of opening offices), and close to half of the offices now operate under franchise agreements, but Block thinks it will get more out of some offices if it owns them outright. Finally, Block is working hard to expand internationally. There are already more than a thousand offices in Canada, more than 300 in Australia, and a couple handfuls in the United Kingdom, the beginning of what the company hopes to make a big incursion. Block plans to move into developing countries, too, as the governments of those nations introduce their citizens to the pleasures of the income tax.

All right, but what about the threat from technology, specifically do-it-yourself tax software, which is growing in popularity? This looks like a problem for someone, but that someone probably isn't H&R; Block. Tax-return software costs up to about \$50 a year for the federal version, half that much again for the state version. The average tax-preparation fee at H&R; Block is about \$72. Typical Block customers, then, don't have much financial incentive to make a switch. And who's to say they don't have other kinds of incentives to stick with Block? Maybe they think that Block will provide them with expertise that will pay for itself. Maybe it's worth money to them just to avoid the time and irritation that inevitably attend doing your own taxes, computer program or not. Maybe they don't have the souped-up home computer most tax software demands. Maybe there's just a tax preparer they really like at the local Block office.

As a matter of fact, tax software is directed at the kind of individual least likely to come to H&R; Block--a person with a fairly substantial income and a fairly complex return. Block serves the middle-income customer. So the people who prefer to use tax programs are unlikely Block clients anyway. It's the independent tax preparer, the accountant doing returns for \$200 to \$1,000 a pop, who is likely to feel a pinch from tax software.

Besides, Block owns TaxCut, the second-most-popular tax-return program (it has a market share of about 30 percent). Sales of TaxCut increased by 150 percent in 1997. High-income people may not be walking their business into H&R; Block storefront offices, but through TaxCut, more and more of them are contributing to Block's bottom line.

And they're starting to do that in the storefronts, too. The company is expanding a division of its tax-prep business called H&R; Block Premium, which, as the name suggests, is designed to attract customers with more-challenging (and more-expensive) returns. Block now has about 600 Premium offices.

This all adds up to a plan that a lot of people think will work for Block's core business. And as I said, the market likes Block's recent direction. But let's not get too giddy about that 55 percent one-year jump in the share price: For the three years ended April 1, the compound annualized return was just 6.2 percent--pretty miserable given that the Standard & Poor's 500 Stock Index rose an annualized 32.8 percent for the period. Block's five-year annualized return was just 9.1 percent; the S&P; gained 22.4 percent. If Block is going to be a long-term growth story, the financial-services side of the business will have to pull its weight. As will the H&R; Block name.

Alexander Paris Jr., a senior investment analyst at Barrington Research Associates in Chicago, follows Block as carefully as anyone I know. With the sale of CompuServe, he points out, H&R; Block becomes not just a more profitable company but a pure play in financial services. That makes the company easier to understand, easier to value, easier to place in a portfolio. The company earned an estimated \$1.50 a share in calendar year 1997. Paris expects to see a 23 percent increase (to \$1.85 a share) for 1998 and another 19 percent increase (to \$2.20 a share) for 1999.

Paris looks approvingly on the specifics of what he calls Block's "transition from being purely a tax-preparation business to a financial-services business." He likes, for example, the recent acquisition of Option One Mortgage. People buy houses 12 months a year--this could keep the doors of more Block offices open. Paris expects Option One, a mortgage originator with more than 5,000 mortgage brokers in 46 states, to bring in better than \$100 million in revenue during Block's first year of ownership.

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Block has also begun, in a toe-in-the-water fashion, to sell financial planning out of a few offices--advice on mutual funds, annuities, IRAs, even household budgeting. Paris sees this as a logical step for the company, and he envisions Block taking it further--not just peddling advice but perhaps competing, ultimately, with the discount brokerages. Block is buying small accounting firms. And it has a referral program with Geico, the auto insurer, perhaps as a prelude to offering insurance on its own.

It's all about having enough to offer those millions of people who already take a seat before an H&R; Block employee each year, and it all makes sense. The financial lives of Americans are becoming more complex--you'd better believe that H&R; tax customers are buying equities and mutual funds, trying to get their financial houses in order and worriedly planning for retirement.

There's one more piece to the puzzle--perhaps as important as any of the others--and that is the recent decision by Block management to really work the brand. The top decision-makers at Block have always been people with financial backgrounds, but to head up marketing, Block has brought in a whiz from Procter & Gamble, a company that knows a thing or two about branding. Don't be surprised if you find yourself one slow afternoon humming a new H&R; Block jingle.

Block has begun to attract more interest on Wall Street; Salomon Smith Barney and some other firms have officially added analyst coverage. If they haven't already, those analysts will probably begin to see what I've been seeing--that a strong H&R; Block is a heck of a takeover candidate. I'm sure you've noticed the consolidation in the financial- services industry--not just such things as the merger of Travelers Group and Citicorp but also Cendant's purchase of Jackson Hewitt, the closest thing Block has ever had to a national competitor. Think what a company gets when it picks up H&R; Block: instant dominance of the tax-prep field, a huge network of offices, all that cash, an hour of face time each spring with millions of financially active adults, and the name. Don't forget the name.

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