

# The Turnaround Letter

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## VALUATION COMPRESSION: SPRINGBOARD TO FUTURE GAINS?

Last month's recommendation of Johnson & Johnson got us thinking about other high quality companies that have suffered from "valuation compression" over the last decade or so. Valuation compression refers to a change in investor perception that reduces the valuation multiples that people are willing to pay for the stock. In other words, a stock that used to trade at a relatively high price-to-earnings ratio, now trades at a relatively low P/E ratio, even though there has been little change in the company's business prospects. It turns out that there are a lot of good companies out there whose stocks have suffered from this phenomenon.

Valuation compression can happen for a number of reasons. Sometimes, the company's stock valuation just gets too far ahead of the underlying value in the company, and it takes awhile for the value to catch up and support the stock price. This was the case with some of the technology stocks and other hot growth companies in the 1990's. While many of those stocks will never justify the prices where they traded just before the tech bubble burst in 2000, others have been steadily creating value as their stocks declined, so that now the stocks finally look cheap.

In other cases, the company stumbled or perhaps the whole sector fell on hard times. In those cases, a tweak to the company's operations can get things back on track. Tech giant IBM is a good example of this kind of stock – in fact it has been through this cycle a couple of times. Most recently, IBM's stock languished for a decade after the tech bubble burst. Then, coming out of the recession in 2009, the company re-focused its services business, and the stock has more than doubled.

Sometimes, investors just change their mind about a company and boost the multiple that they will give the stock. If this happens in conjunction with steady business growth or a positive change in the business model, or both, the stock can shoot up dramatically.

In the paragraphs below we discuss ten stocks that have been victims of valuation compression over the last decade or longer. In each case, the company has a solid business – often with a dominant brand or brands – that could propel the stock to much higher prices if the compression reverses. →

### IN THIS ISSUE:

<i>High Yield Bonds</i> .....	3
<i>Bank Warrants</i> .....	4
<i>Recommendations:</i>	
<i>Buy: Corning, Inc.</i> .....	5
<i>Sell: Solutia</i> .....	6
<i>Sell: Radio Shack</i> .....	6
<i>News Notes</i> .....	6
<i>Performance</i> .....	7

### Valuation Compression; A Spring Board To Profits?

Company	Symbol	Recent Price	12 -Year Range	Market Cap. mil.	Dividend Yield	Forward P/E
Amgen*	AMGN	68.33	86.92 – 30.57	54,390	2.1%	10.1
Applied Materials*	AMAT	12.06	57.50 – 7.80	15,750	2.6	10.7
Cardinal Health	CAH	42.60	55.52 – 17.71	14,720	2.0	12.1
Coca-Cola*	KO	67.46	71.77 – 37.44	153,220	2.8	16.5
Johnson & Johnson*	JNJ	65.71	72.76 – 33.06	179,540	3.5	12.1
Microsoft*	MSFT	29.61	51.59 – 14.87	248,450	2.7	9.9
Procter & Gamble	PG	63.21	75.18 – 26.38	181,060	3.3	14.3
Sysco*	SYO	30.14	41.27 – 19.39	17,660	3.6	14.2
Walgreens	WAG	33.63	51.60 – 21.28	29,380	2.6	11.2
Wal-Mart Stores	WMT	61.30	63.94 – 42.09	209,930	2.4	12.5

\* Previous TL Recommendation

**AMGEN**, a leading biotechnology company, saw its stock soar during the technology bubble. By 2003, the stock was trading at 73 times earnings. Since then, revenues have more than tripled to roughly \$15.5 billion. Today, Amgen has five of the world's best selling biotech drugs, and boasts outstanding financials. With the stock now trading at just 11 times earnings, we expect investors to warm up to the stock's attractive value proposition.

**APPLIED MATERIALS** is the world's largest maker of semiconductor manufacturing equipment. Since we recommended AMAT in April 2010, the stock has been stable but undistinguished. We are now seeing evidence of a bottoming in technology capital expenditures. AMAT has a strong presence in equipment for a number of rapidly growing markets including touch screens and solar. The company is also well positioned globally as evidenced by its ownership of the largest solar research center in China.

**CARDINAL HEALTH** is a leading manager of the nation's health-care supply chain, delivering drugs and medical products to more than 60,000 locations on a daily basis. The stock has been largely flat or down since 2001, but

revenue has more than doubled over that period to over \$100 billion. As a result, valuations have fallen to below market multiples, including a 0.14 price/sales ratio. Solid financials, and a decent and growing dividend and strong customer relationships all bode well for long-term gains.

**COCA-COLA** was once considered the epitome of growth stocks, but the stock has yet to regain its 1998 high. To be sure, management failed to respond to competitive threats around the turn of the century, and earnings did decline. However, operating results grew strongly over the last decade, but investors didn't seem to care. That may be changing: the stock has shown good relative strength since we recommended it last April (+3.4% versus a loss for S&P 500). We like the firm's outstanding brands and strong financials, which will support continued stock buybacks and a growing dividend.

**JOHNSON & JOHNSON** was last issue's purchase recommendation. We continue to rate J&J as a buy up to \$85.

**MICROSOFT** is still the 800-pound gorilla in the technology space, despite the headlines devoted to others such as Apple and Google.

The stock has gone nowhere since the tech bubble burst in 2000, but it has begun to show a little life since late November. With a P/E ratio of roughly ten and a dividend yield of 2.7%, this former darling of growth investors is now definitely a value play. We think it is a good one.

**PROCTER & GAMBLE** has long been the preeminent marketer of household, personal care, food and paper products with annual sales in excess of \$82 billion. However, declining valuation multiples have prevented the stock from making much progress since 1999. Meanwhile, revenues have more than doubled and earnings tripled. P&G's strong financials, product and geographic diversity, innovation and powerful brands provide a solid foundation for appreciation in the stock price.

**SYSCO** is the nation's largest foodservice distribution company. With its activities centered primarily on restaurants – 62% of sales – operating results are closely tied to general economic conditions, which have been challenging in recent years. Nonetheless, management has engineered consistent profitability by making accretive acquisitions and taking steps to significantly boost pro-

ductivity. The stock is only up a little since we recommended it in late 2009, but the dividend remains generous. We expect patience to be rewarded here.

**WALGREENS** is the largest U.S. drug retailer and distributor. Revenues have more than tripled since the turn of the century, but the stock is more than 20% below its 2000 high. Management has revamped its business model by, among other things, allowing for customization for local tastes and up-scaling its product offerings. It has also implemented a major cost-reduction program. Improving profits should be bolstered by stock buybacks.

**WAL-MART** was riding high into the turn of the century and investors were willing to pay nearly 40 times earnings for the stock. But the growth story ran into headwinds, including resurgent competitors and political road bumps. The stock stagnated and multiples have swung to historical lows. Management is capitalizing on the company's scale and reach by moving into new product areas such as medical care and financial services. Earnings growth remains steady, and the decent dividend is a bonus.

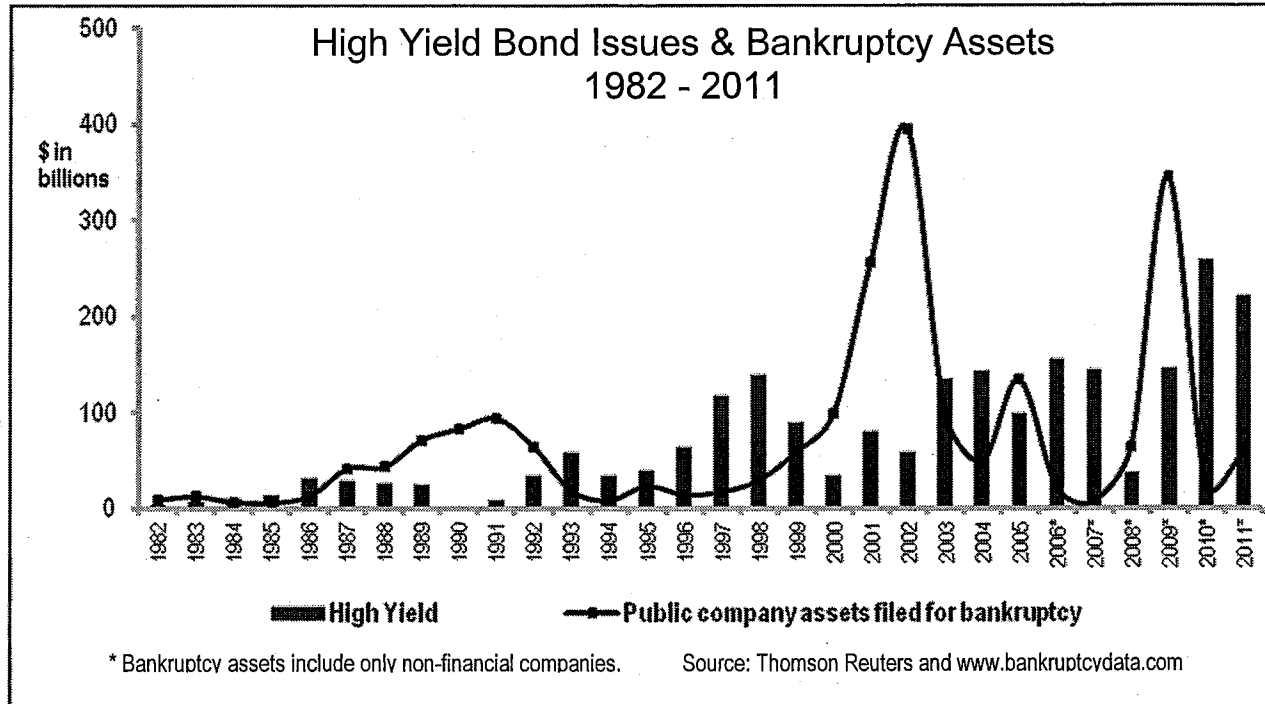
## **HIGH YIELD BONDS: BE CAUTIOUS**

From time to time we comment on high yield bonds (sometimes called “junk bonds”) because they are akin to turnaround stocks in several ways. While they are called bonds, many high yield issues have return – and risk – characteristics closer to those of stocks than to those of other fixed income instruments. Also, many companies that issue high yield debt are in the process of turning around, or at least trying to. Some high yield issuers don't make it, file for Chapter 11 and eventually provide interesting post-bankruptcy stock opportunities.

In general, high yield bonds were a decent place to put your money in 2011. As meas-

ured by the Merrill Lynch Master High Yield Index, junk bonds gained an average of 4.5% last year. However, like many asset classes, they did better in the first half of the year than the second, with the Merrill index gaining 4.9% through June and then losing 0.4% thereafter.

Just as returns turned down in the second half of the year, so did the issuance of new high-yield bonds. Through July, issuance was on a pace to blow through the record set last year. But then the volatility that began in August virtually shut down the new issue market for the rest of the year. Even with the shut-down, →



however, the total issuance for 2011 was not far below the record – see the graph above.

As the graph also shows, high levels of junk bond issuance have historically led to high levels of defaults and bankruptcies. And, when defaults are high, most junk bonds lose money. Maybe things will be different this

time – or maybe the high yield market can squeeze out another decent year before things head south – but we wouldn't want to bet on it. We believe that, over the long-term, high yield bonds should be part of most investors' portfolios, but we would not advise adding money to the sector right now.

## **REVISITING TARP BANK WARRANTS**

In the September 2010 issue we highlighted a number of bank warrants that the federal government received as part of the Troubled Asset Relief Program (known as "TARP") during the 2008 financial crisis and later re-issued to the public. Now that bank stocks are beginning to show some signs of life again after a rough ride in 2011, it is worth taking another look at the TARP warrants. As we've mentioned before, warrants can be a good vehicle for aggressive investors because they magnify the price movement of the underlying stock. The downside to warrants is that they expire, and if the stock is below the exercise (or "strike") price at expiration, the warrants

will be worthless. One of the most attractive features of the TARP warrants is the fact that they do not expire for quite a long time (mostly 2018 or later – see the table below). That gives the stock plenty of time to move up through and well beyond the exercise price.

We think that most bank stocks are still very cheap from a long-term prospective. If we are right, these warrants have significant appreciation potential.

**Disclosure Note:** Accounts managed by an affiliate of the Publisher own a number of the warrants discussed in this article.

Bank TARP Warrants:						% gain in warrant IF stock at Expiration is		
Name*	Symbol	Expiration Date	Strike Price**	Stock Price	Warrant Price	+50%	+100%	+200%
Wells Fargo	WFC/WS	10/18	34.01	29.25	8.8	12.1	178.3	510.7
JP Morgan Chase	JPM/WS	10/18	42.42	37.01	10.03	30.6	215.1	584.0
Bank of America	BAC/WS/A	1/19	13.3	7.08	3.17	-100.0	-72.9	150.5
PNC Financial	PNC/WS	12/18	67.33	59.02	11	92.7	361.0	897.5
Capital One Fin.	COF/WS	11/18	42.13	44.8	15.39	62.9	208.4	499.5
Comerica	CMA/WS	11/18	29.40	27.83	5.93	108.2	342.8	812.1
Signature Bank	SBNYW	12/18	30.21	57.17	34.75	59.8	142.1	306.6
Valley National	VLY/WS	11/18	16.92	12.08	1.44	-16.7	402.8	1241.7
Washington Federal	WFSW	11/18	17.57	17.82	5	83.2	261.4	617.8
TCF Financial	TCB/WS	11/18	16.93	10.34	2.2	-100.0	70.5	540.5
Texas Capital Banc.	TCBIW	1/19	14.84	31.58	19.5	66.8	147.8	309.7
First Financial	FFBCW	12/18	12.90	17.4	5.45	142.2	301.8	621.1

\* Listed in order of market cap; largest first      \*\* Subject to adjustment for dividends paid.

## RECOMMENDATIONS

### Purchase Recommendation: Corning, Inc.

One Riverfront Plaza, Corning, NY 14831  
607-974-9000 [www.corning.com](http://www.corning.com)

**Category:** Large-Cap (\$19.7 Bil.)

**Symbol:** GLW **Exch.:** NYSE

**Business:** Glass & Ceramic Products

**Annual Rev.:** \$7.89 Bil. (12/31/11)

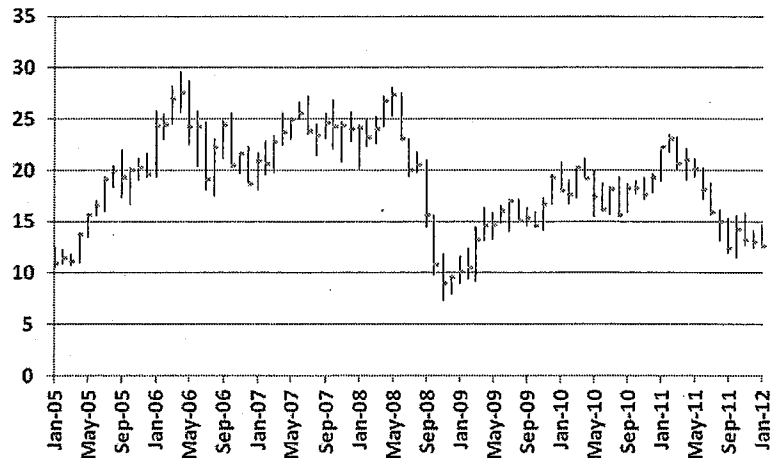
**Earnings:** \$2.8 Bil.

**1/30/12 Price:** 12.61

**12-Mo. Range:** 23.43 – 11.51

**Max. Rec. Price:** 18

**Est. Div. Yield:** 2.4%



**Background:** Tracing its roots back more than 160 years, Corning is the world's leading producer of specialty glass and ceramics.

Weakness in global LCD (liquid crystal display) shipments for TV and other screens has spooked investors, and Corning's stock declined for much of 2011. Then last week it lost approximately 14% of its value when the

company announced disappointing results for the fourth quarter.

**Analysis:** In spite of the recent disappointments, Corning's stock has a lot going for it if you are willing to be patient. The company is a world leader in all of its main markets, and it has strong growth prospects in most of those segments. →

Even the LCD market may not be as bad as many investors fear. Much of the weakness in that market in 2011 came from disruptions in the global supply chain (caused by earthquakes and floods among other things) rather than declining consumer demand. From a longer-term perspective, consumer preferences for ever larger and brighter TV screens play into Corning's strengths. In the meantime, Corning is reducing capacity for the coming year, which should improve LCD pricing.

The company's other markets look solid. Sales for autos and trucks – which utilize Corning ceramics in their pollution control systems – are on the rise as aging vehicles are replaced in the developed markets and new demand emerges in less developed markets. Telecommunications companies are racing to upgrade their fiber optic networks – where Corning is a leading supplier – to meet the demand for higher data speeds. Corning also benefits from the growing demand for tablet

computers, smart phones and other devices that need rugged screens. Its *Gorilla Glass* product is a big seller in these markets.

One of Corning's strengths has always been its research and development program. The company regularly spends about ten percent of revenues on R&D.

Corning's finances are very strong. It has more than twice as much cash (and short term investments) on the balance sheet as it has debt. Cash flow is strong, and it can be used to fund strategic acquisitions as well as to develop new products. In addition, the company recently increased its dividend by 50%, and authorized a \$1.5 billion stock buyback program.

We view the recent weakness in the stock as a buying opportunity. The stock now trades at a P/E ratio of less than 10, which is very cheap for a company with Corning's potential. We recommend buying Corning up to 18.

## Sale Recommendation: Solutia

Solutia has agreed to be purchased by Eastman Chemical for \$22 in cash plus 0.12 share of Eastman for each Solutia share. The Solutia stock is trading quite close to the deal

price, and we recommend selling it now. We think the likelihood of a higher bid is quite small, and there is some risk that the deal could fall through.

## Sale Recommendation: Radio Shack

Radio Shack announced weak fourth quarter numbers, and the stock is falling sharply as we write this. Recently the company has relied heavily on cell-phone sales, and that business

is becoming increasingly competitive and has shrinking margins. We expect things to get worse for Radio Shack before they get better, and so we recommend selling the stock now.

## NEWS NOTES & UPDATES

**Carnival** has been in the news recently because the stricken cruise ship, *Costa Concordia*, is owned by one of its subsidiaries. We think the market has over-reacted to the news, and believe that this could be a good time to buy Carnival stock. For more on this, see our recent "TL Corner" post on the website.

We put out a special report on the Kodak bankruptcy, which is available on the website (see the bottom right corner of the home page).

Other news updates are available on the website in the "Purchase Recommendation Updates" section under "Subscribers Only."

**PERFORMANCE**

The tables below and on the next page show the performance of all of our currently active recommendations, plus recently closed out recommendations. Categories are based on market capitalization on the recommendation date, except that recommendations made prior to August, 2004 are categorized by their 8/20/04 market cap. For copies of past recommendations, at \$15 per copy, please call (617) 573-9550 ext. 550.

**SMALL-CAP (under \$1 billion) - CURRENT RECOMMENDATIONS**

RECOMMENDATION	Symbol/ Exch (1)	Rec. Issue	Price at Rec.	1/30/2012 Price	Total % Return (3)	Current Status (2)
Bristow Group	BRS/N	11/86	0.75	48.10	+6373	Hold
Kadant Inc.	KAI/A	4/02	14.28	24.25	+70	Hold
Presstek	PRST/O	6/05	8.58	0.65	-92	Buy (6)
Newpark Resources	NR/N	6/06	5.65	8.30	+47	Buy (10)
Electro Scientific Ind.	ESIO/O	2/07	21.24	15.13	-28	Buy (20)
CTS Corp.	CTS/N	11/07	12.54	9.98	-17	Buy (15)
Midas	MDS/N	7/08	13.50	8.75	-35	Buy (20)
Solutia	SOA/N	9/08	15.58	27.37	+76	Sell
US Airways	LCC/N	5/09	3.79	8.52	+125	Buy (12)
Wet Seal	WTSLA/O	10/09	3.93	3.57	-9	Buy (6)
Winn-Dixie	WINN/O	1/10	10.14	9.44	-7	Buy (15)
ACCO Brands	ABD/N	3/10	7.17	10.44	+46	Buy (12)
M/I Homes, Inc.	MHO/N	7/10	10.08	11.24	+12	Buy (20)
Superior Industries	SUP/N	9/10	14.75	18.11	+27	Buy (30)
Kemet	KEM/N	2/11	14.75	9.52	-35	Buy (23)
Drew Industries	DW/N	3/11	23.13	26.02	+12	Buy (33)
FairPoint	FRP/O	7/11	9.42	4.10	-56	Buy (14)
OfficeMax, Inc.	OMX/N	11/11	5.12	5.99	+17	Buy (12)

**MID-CAP (\$1 billion to \$10 billion) - CURRENT RECOMMENDATIONS**

RECOMMENDATION	Symbol/ Exch (1)	Rec. Issue	Price at Rec.	1/30/2012 Price	Total % Return (3)	Current Status (2)
Newell Rubbermaid	NWL/N	6/04	23.24	18.60	0	Buy (20)
Goodyear Tire	GT/N	7/04	9.14	13.31	+46	Buy (20)
Tenet Healthcare	THC/N	9/04	10.27	5.33	-48	Hold
Janus Capital Group	JNS/N	8/05	15.27	7.92	-43	Buy (17)
Portland General	POR/N	11/06	25.70	24.88	+16	Buy (33)
Interpublic Group	IPG/N	12/06	11.94	10.45	-10	Buy (14)
Tellabs	TLAB/O	2/08	6.66	4.19	-35	Buy (10)
RadioShack	RSH/N	4/08	15.87	10.23	-25	Sell
Federal-Mogul	FDML/O	5/08	21.00	16.85	-20	Buy (28)
Old Republic	ORI/N	6/08	14.64	9.79	-17	Buy (20)
Terex Corp.	TEX/N	2/09	12.57	20.41	+62	Hold
Tyco International Ltd.	TYC/N	3/09	20.05	49.21	+159	Buy (52)
Calpine	CPN/N	12/09	11.12	14.68	+32	Buy (18)
Lear	LEA/N	6/10	33.84	41.70	+25	Buy (58)
Boston Scientific	BSX/N	8/10	5.60	5.99	+7	Buy (9)
Owens Corning	OC/N	12/10	26.31	33.83	+29	Buy (40)
MGIC	MTG/N	1/11	10.11	3.95	-61	Buy (17)
Delta Airlines	DAL/N	10/11	8.11	10.77	+33	Buy (12)
MetroPCS	PCS/N	12/11	8.38	8.79	+5	Buy (14)

## LARGE-CAP (over \$10 billion) - CURRENT RECOMMENDATIONS

RECOMMENDATION	Symbol/ Exch (1)	Rec. Issue	Price at Rec.	1/30/2012 Price	Total % Return (3)	Current Status (2)+
Carnival Corp	CCL/N	1/01	30.50	30.13	+26	Buy (45)
AT&T, Inc.	T/N	5/03	23.05	29.34	+83	Buy (44)
Bristol-Myers Squibb	BMJ/N	8/03	26.07	32.25	+63	Buy (35)
Ford	F/N	12/03	13.00	12.29	+3	Buy (20)
Schwab	SCHW/N	3/04	12.20	11.64	+15	Buy (20)
Time Warner	TWX/N	12/04	53.46	37.43	-8	Buy (40)
Campbell Soup	CPB/N	4/05	28.14	31.57	+35	Buy (42)
Taiwan Semiconductor	TSM/N	12/05	9.29	13.98	+80	Buy (14)
Sara Lee	SLE/N	4/06	15.28	19.00	+43	Hold
Microsoft	MSFT/O	10/06	27.94	29.61	+16	Buy (40)
Pfizer	PFE/N	3/07	25.84	21.58	+1	Buy (25)
General Electric	GE/N	7/07	38.12	18.90	-42	Buy (25)
Motorola Solutions	MSI/N	8/07	68.52	45.96	-32	Buy (49)
Amgen	AMGN/O	10/07	56.56	68.33	+21	Buy (70)
DuPont	DD/N	1/08	45.07	50.97	+28	Buy (60)
Sprint	S/N	3/08	8.09	2.16	-73	Buy (7)
Kraft	KFT/N	8/08	31.82	38.18	+31	Buy (40)
Bank of America	BAC/N	10/08	35.00	7.07	-79	Buy (21)
Emerson Electric	EMR/N	8/09	36.03	51.72	+56	Buy (65)
Sysco	SYI/N	11/09	27.01	30.14	+20	Buy (36)
Marsh & McLennan	MMC/N	2/10	21.71	31.60	+53	Buy (35)
Applied Materials	AMAT/O	4/10	13.45	12.06	-5	Buy (20)
ExxonMobil	XOM/N	10/10	61.79	85.49	+42	Buy (90)
Fifth Third	FITB/O	11/10	12.56	12.99	+4	Buy (17)
Coca-Cola	KO/N	4/11	65.72	67.46	+5	Buy (80)
General Motors	GM/N	5/11	32.09	24.23	-24	Buy (40)
Xerox	XRJ/N	8/11	9.58	7.73	-19	Buy (14)
Sony	SNE/N	9/11	22.01	18.11	-18	Buy (32)
Johnson & Johnson	JNJ/N	1/12	65.45	65.71	0	Buy (85)

## RECENTLY CLOSED OUT RECOMMENDATIONS (ALL CATEGORIES)

RECOMMENDATION	Symbol/ Exch(1)	Rec. Cat.	Buy Issue	Price at Buy	Sell Issue	Price at Sell	Total % Return (3)
Parametric Tech.	PMTC/O	Mid	5/04	11.63	11/10	21.52	+85
Flextronics International	FLEX/O	Mid	1/09	2.27	1/11	7.87	+247
Teradyne, Inc.	TER/N	Small	12/08	3.79	2/11	16.23	+328
Motorola Mobility	MMI/N	Large	2/11	57.29	2/11	29.59	-48
JDS Uniphase	JDSU/O	Mid	2/05	17.52	3/11	24.67	+41
Williams Companies	WMB/N	Mid	6/09	16.25	3/11	30.36	+92
Ariba	ARBA/O	Mid	5/10	14.27	4/11	33.96	+138
Global Crossing	GLBC/O	Small	9/09	11.49	5/11	23.38	+103
Primedia	PRM/N	Small	6/03	19.80	6/11	7.04	-59
On Assignment, Inc.	ASGN/O	Small	1/04	5.15	8/11	10.24	+99
Zhone Technologies	ZHNE/O	Small	5/05	11.40	10/11	1.27	-89
MF Global Hldgs.	MF/N	Mid	6/11	7.71	11/11	1.20	-84

## Footnotes:

- (1) Exchanges: N = New York; A = American; O = OTC; (2) Maximum recommended buy prices in parentheses  
(3) Total Return includes dividends as well as price changes

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