Company Focus

10 companies snapping up their own stock

By Michael Brush

Despite doubts about the economy, one thing is certain: Companies have more financial muscle now than they've had in years.

What will they do with their cash? Perhaps wary of a post-election slump, they're not spending much on new hires and equipment.

So instead, more companies may soon turn to the share buyback. Though buying back shares seems like punting, it is an excellent buy signal for investors.

Research by former MSN Money columnist Victor Niederhoffer, the chief speculator at his hedge fund Manchester Trading, shows that **S&P 500** ($INX) companies that announced buyback plans in 2002 outperformed their peers by 13% as of last week. Candidates from 2003 have bested the index by 4.3%.

A strange thing about this investing signal is that it keeps on working, suggesting it's a good tool for buy-and-hold investors. "What is very unusual is that it continues to work," says Niederhoffer. "Because a lot of systematic, fixed rules get anticipated away once everyone finds out about them."

For a look at the full lists of S&P 500 buyback stocks and regular monthly updates, as well other insights on investing and speculating, visit Niederhoffer's Web site. But there's a little problem with the full lists. Most investors can't afford to deploy cash into 130 stocks.

Fortunately for small investors, there's a newsletter dedicated to them -- the Buyback Letter, published by David Fried. Fried has produced some spectacular results using this strategy, which explains why he's consistently ranked a Top 10 newsletter writer by Hulbert Financial Digest.

As of Aug. 2, his Buyback Premium Portfolio was beating the S&P 500 by more than 107% since it was launched four years ago. All six of his portfolios are beating their benchmarks.

Shopping for buyback stocks
So why does the indicator work, and what are the best things to look for in buyback candidates?

Fried is coy about how he selects stocks for his winning portfolios. But he does say he waits until a buyback begins, then looks at financial strength, cash flow, prospects for growth and management -- basically, good old fundamental analysis.

We thought the best way to explain was to take a quick tour of one of Fried's portfolios. We chose his "Best Buys" portfolio because it has relatively low turnover. That way, you can mimic Fried without worrying that your holdings will be yanked next month. (By the way, Fried thinks you need at least 20 to be well-diversified, so you have some work cut out for you if you plan to use this strategy.)

10 Best Buys stocks

Company	Aug. 31 price	Buy limit	2-4 year target price
Luby's (LUB, news, msgs)	$6.55	$6.75	$10
Cardinal Health (CAH, news, msgs)	$44.50	$55	$100
Deluxe (DLX, news, msgs)	$43.17	$50	$70
Kmart Holding (KMRT, news, msgs)	$81.14	$85	$150
Papa John's (PZZA, news, msgs)	$30.37	$30	$60
RadioShack (RSH, news, msgs)	$27.95	$30	$50
Rex Stores (RSC, news, msgs)	$12.99	$13	$25
Sears (S, news, msgs)	$36.48	$50	$100
SkyWest (SKYW, news, msgs)	$14.13	$20.50	$35
Washington Mutual (WM, news, msgs)	$38.80	$40	$70

Buybacks boost earnings per share
By taking shares off the market, companies automatically boost earnings per share and knock down valuation metrics. Take
Deluxe (DLX, news, msgs). The company works in a ho-hum sector,

printing checks and forms for small businesses. Though net income in the second quarter was down slightly from last year, it posted an impressive 13.8% growth in earnings per share. Chalk it up to share buybacks.

Deluxe says it will take a break from buybacks for a year, as it pays off debt from a recent acquisition. After that, don't be surprised if the buybacks return -- one reason Fried keeps Deluxe on his buy list.

Buyback stocks are often value names
Next, buybacks often signal that a board thinks its stock is cheap. Following buybacks in some ways is little more than backdoor value investing, which may explain part of its success. Value investing, after all, often outperforms.

So it is no surprise to see three of Fried's 10 "Best Buy" stocks in the portfolio of John Buckingham, a value manager who runs the **Al Frank Fund** (VALUX, news, msgs). The fund has posted impressive annualized returns of 17.65% over the past five years, beating the S&P 500 by 20 percentage points, according to Morningstar.

The first is **Washington Mutual** (WM, news, msgs). Thanks in part to rising interest rates that have eroded demand for mortgage loans, shares of Washington Mutual declined to the $38-$39 range from $46 in the past 10 months. The bank is now cutting jobs and opening new branches. Prudential Equity Group analyst Bradley Ball thinks this transition will run through 2005.

But the stock offers a dividend yield of 4.5%, so Buckingham doesn't mind "getting paid to wait." Plus, the possibility of a takeout is in the air. Based on recent takeout premiums in the sector, Washington Mutual could go for around $50 per share (it's been trading recently in the high $30s). Meanwhile, the bank has bought back less than half of the 100 million shares it is authorized to repurchase.

Next is **Rex Stores** (RSC, news, msgs), an odd blend of a discount retailer and a manager of synthetic fuel energy partnerships whose rapid growth supported a 28% increase in earnings in the most recent quarter. But the stock is cheap. At $12.70 per share, it trades for just 5.5 times earnings.

The third, **Sears Roebuck** (S, news, msgs), trades at 12 times earnings. Same-store sales are in decline at the retail chain, thanks to weak apparel sales and competition in appliance sales from the likes of **Home Depot** (HD, news, msgs) and **Best Buy** (BBY, news, msgs). But the stock carries a 2.3% dividend yield, and that's one reason Buckingham doesn't mind holding the stock until things improve. What might make that happen?

The retailer is rolling out "Sears Grand," off-mall superstores that carry the usual Sears lineup, as well as basics such as basic foods, cards, books and magazines. Sears also is adding new apparel lines and counting on a financial-services partnership with **Citigroup** (C, news, msgs) for more growth.

Fried likes to follow management's lead in buying back shares when they dip. Hit by rising fuel costs and worries about the financial strength of partners **UAL Corp.** (UALAQ, news, msgs) and **Delta Air Lines** (DAL, news, msgs), shares of **SkyWest** (SKYW, news, msgs) recently plummeted to under $14, from $20 last spring. Then the company reiterated its buyback program, signaling to investors it thought its shares had gotten too cheap to pass up. Fried is telling subscribers to follow suit.

Good buyback candidates have solid financial strength
Shares of **Cardinal Health** (CAH, news, msgs), a drug distributor and producer of surgical supplies, have plummeted to $45 from $75 in the past four months thanks to an ongoing accounting investigation. But the company has the financial strength to hang in there, says Morningstar analyst Curt Morrison. Morrison suggests investors buy the stock under $45. "We feel it's still basically a good company with a continuing excellent cash flow, and we're betting that when the dust has settled, we'll come out on the upside," agrees Fried.

The pizza chain **Papa John's International** (PZZA, news, msgs) has little use for its strong free cash flow because it relies on franchisees to fund new restaurants. That is why the company is well into a $425 million annual buyback program that expires in December. It's been doing buybacks since 1999, so expect them to keep going.

Good buyback candidates have assets that protect against downside
According to Deutsche Bank, **Kmart Holding** (KMRT, news, msgs) is sitting on real estate worth $150 per share. That doesn't mean Kmart shares are worth that much. (The stock recently went for $77.) But it sure does provide a cushion of support -- just like the strong financials and low valuations you find so often among the best buyback candidates.

Kmart promises it is committed to turning around its stores. But the truth is, the chain will keep generating lots of cash by selling stores to the likes of Home Depot and Sears, which are having trouble finding decent locations for new outlets. And some of that money will go to share buybacks. Kmart also has cash per share in the mid-$30 range.

Sears itself has real estate worth anywhere from $3.8 billion to $5.7 billion, estimates J.P. Morgan analyst Shari Schwartzman Eberts. After debt, that works out to around $8 to $17 per share. Sears also took in $32 billion recently from the sale of its credit-card division. It is using some of the proceeds to fund a $4 billion share buyback program. It has bought back about $3.5 billion worth so far.

Buybacks keep management out of trouble

Managers often do dumb things with cash, so it's often safer to take it away from them. Again, Papa John's is a good example. It got into trouble in the 1990s by trying to grow too fast. "We got sloppy on some things," says finance chief David Flanery. Quality and service slipped, for example.

Now, he thinks his company's use of buybacks and dividends to deploy cash to shareholders serves as a restraint on management. "It leads to more disciplined growth," he says. The chain is expanding internationally, but it is growing moderately at home.

Thanks to share buybacks at **RadioShack** (RSH, news, msgs), analyst Aram Rubinson at Banc of America Securities is warming up to the stock. He recently bumped the rating to "neutral" from "sell," in part because RadioShack's purchase of 10% of its stock over the past two years is "a sign that the company has become more fiscally responsible." The company will announce a three-year plan in September. In the meantime, the shares "are fairly cheap" for a longer-term holding, says SG Cowen analyst Joseph Feldman.

A few warnings

Don't reject a stock you like simply because it ends its buyback program. Restaurant chain **Luby's** (LUB, news, msgs) has discontinued its buyback, but Fried keeps it in his portfolio because he thinks the company has potential. Luby's looks cheap; it trades for around $6.45, but it has a book value of $5.49 per share. Sales at restaurants open more than a year recently increased 4.8%. And the company is closing down less productive restaurants and paying down debt.

Also, avoid buybacks where insiders are selling, says Fried.

And finally, watch out for companies that are buying back shares just to offset dilution caused by generous stock-option grants. According to research by Douglas Skinner, an accounting professor at the University of Michigan Business School, companies regularly buy back shares to meet estimates when it looks as though they might miss because of options dilution. These buybacks are about managing earnings and aren't necessarily a good deal for shareholders.

At the time of publication, Michael Brush did not own or control shares in any of the equities mentioned in this column.