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Circuit City Highlights Doubts about Analysts

RateFinancials Presents Contrarian View on Quality of Gadget Chain's Earnings

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By Steven D. Jones

One stock-research firm thinks Circuit City Stores Inc. relies too much on warranty revenue, and questions the electronics retailer's frequent accounting changes. The other 28 firms that follow the company tend to think its stock is a pretty safe "buy."

In a report that was to be sent to its clients today, RateFinancials Inc. of New York, which bases its research only on information obtained from companies' securities filings, gives low marks to Circuit City, based in Richmond, Va.

The report differs strikingly in tone from the far rosier view of the company offered by analysts at a range of Wall Street brokerage firms, which, among other factors, cite a good outlook for sales of big-screen TV sets and other pricey gadgets.

The contrast serves as a reminder that three years after a landmark lawsuit brought by New York Attorney General Eliot Spitzer over tainted stock research, there remains a sameness to analysis from Wall Street firms. RateFinancials is an independent research firm, with no trading or underwriting operations.

The RateFinancials report raises concerns about the frequency of adjustments for lease-accounting errors, which Circuit City made in fiscal 2005 and 2006 and again in the first quarter of its current year, fiscal 2007. RateFinancials mentions accounting policies and changes more than 20 times in its report and ranks Circuit City at 13 on a 40-point scale for performance and earnings quality.

By comparison, a survey of recent reports on Circuit City by seven major Wall Street brokerage houses shows none discussed the accounting changes and only one report noted the changes in a table of performance metrics. As a group, the analysts expect Circuit City to outperform other stocks in its sector, according to Thomson First Call, and have a median price target over the coming year of \$30.50 for the stock. Circuit City's stock fell 2.6%, or 60 cents, to \$22.70 a share in New York Stock Exchange 4 p.m. composite trading.

The Spitzer suit over stock research was aimed at removing the tight relationship between research and investment banking, and put the research focus on performance. Wall Street agreed and paid \$1.4 billion to settle the case. But Victor Germack, founder and president of RateFinancials, says that even if the hand-in-glove relationship with bankers has ended, analysts are still using kid gloves on corporations they cover.

"No one seems to report on the quality of earnings. Most of the focus is on understanding an industry and the competition," says Mr. Germack, who started his firm four years ago. RateFinancials' clients include hedge funds, pension managers and insurance companies.

RateFinancials' methodology excludes from earnings analysis so-called one-time events such as a gain or loss on sale of assets or restructuring charges. Analysts there also study disclosure of vendor allowances and accounting changes. They don't talk to corporate management because, according to Mr. Germack, "the numbers should and do speak for themselves."

At Circuit City, for example, sales of warranties on products sold last year made up only 3.6% of total sales but provided more than 100% of the company's operating income, offsetting losses elsewhere in the business, according to RateFinancials.

The bottom line: the warranties at times appear to be Circuit City's sole source of profit. But that detail of the warranties' outsize impact on earnings is only mentioned by the company in footnotes in its filings.

Also, Circuit City's nearly \$3 billion in operating leases don't appear on its balance sheet as long-term obligations, even though they are, Mr. Germack says.

And the retailer's habit of closing underperforming stores in the final days of its fiscal year wipe troublesome outlets off the books before year end, distorting performance measures of the company, the report adds. Circuit City closed 19 stores in the fourth quarter of 2004 and another 19 in 2005, but closed only one store in fiscal 2006.

Looking at Circuit City's fiscal 2006 earnings, RateFinancials deducted the company's cost of employee stock options and adjusted for gains and accounting changes, arriving at what it calls "normalized" earnings of \$64 million, or 36 cents a share. By comparison, the company reported earnings of \$139.7 million, or 79 cents a share.

Circuit City spokesman Bill Cimino says it's standard practice to review store performance in January and announce closures when necessary before the end of its fiscal year in February.

The practice is "driven by the retail cycle," he says, and has nothing to do with removing poor performing stores from year-end comparisons. Closing costs are always included in the period when the stores are closed not stretched into later quarters, he adds.

While some may consider store leases a type of long-term debt, regulators don't require it be listed as such on the balance sheet, Mr. Cimino points out. Circuit City discloses its lease obligations in footnotes to its filings.

Mr. Cimino also plays down warranty sales, saying the company treats them as part of sales transactions, not a separate unit of business. Warranty revenue has made up between 3% and 4% of total sales for the past four years, he says.