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These Days, Detective Skills Are Key to Gauging a Stock

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By Herb Greenberg

When Circuit City Stores Inc. reported an unexpected fiscal fourth-quarter loss this past week, with its stock in the doldrums, Victor Germack felt vindicated. Last summer, when quite a few analysts were upgrading their ratings on the electronics retailer's stock, his research firm, RateFinancials, published a report blasting Circuit City for “very poor quality of earnings” and “poor accounting policies, footnotes and management discussion and analysis.”

The report was featured in a Wall Street Journal article, prompting at least one prominent brokerage analyst to minimize the concerns, which included a preponderance of year-end lease terminations and the disproportionate influence the sale of extended warranties had on earnings. As it turns out, both those issues reared up in the latest results, with a large charge related in part to lease-termination costs and the warranty issue narrowing the company’s profit margin. Mr. Germack, who once ran the world’s largest Angus-cattle-breeding operation, takes pride in going against the herd. Circuit City’s stock, which was hovering at multiyear highs at the time of his firm's report, now is bouncing around near the 52-week low at $18.47.

Like many private research outfits, RateFinancials doesn’t recommend that investors buy or sell a stock, it just points out what it sees as any risks and rates a company on a scale of one to 40, with 40 being the best. (Circuit City got a 14.) While those risks may not always lead to stock-rattling events, and in fact often are ignored by Wall Street until it is too late, “investors in a company with poor earnings quality start off with one strike against them,” Mr. Germack says. To be sure, when it comes to earnings, the bottom line is important, but it is the quality of that number that really counts. So, rather than talk to management, which can be prone to “tell you what they want you to hear,” Mr. Germack and his analysts stick to the facts – or, as the case may be, numbers. With stricter disclosure rules in part because of the hotly contested Sarbanes-Oxley corporate-accountability law, “Our feeling is . . . [a company’s] financial reports should speak for themselves,” he says.

In the wake of the government’s efforts to help clean up corporate America, he says there is no shortage of red flags to be found. The underlying problems haven't changed, but there is “more detail in footnotes” of Securities and Exchange Commission filings and management’s discussion of financial results. Still, as anybody who spends time poking around the underbelly of financial statements knows, just because something is disclosed doesn't mean it is right; it simply means the company has dropped more bread crumbs, which Mr. Germack believes could come in handy for financial sleuths in any economic downturn. If there were a downturn, he says, Sarbanes-Oxley or no Sarbanes-Oxley, “companies will want to meet earnings forecasts, someway, somehow.”

Back at Circuit City, spokesman Bill Cimino says there were other factors, including a faster-than-expected decline in pricing for flat-panel television sets, that played havoc with its results. And while he doesn't remember the details of Mr. Germack's report, rather than quibble with his analysis, Mr. Cimino says, "That's the great thing about Wall Street. A number of people can look at the data and parse it differently and believe they have insight into it. That's what makes free markets work."

Finally, someone who gets it.