"Business Momentum: When is a Value Stock a Value Trap?"

by GEOFF GANNON

One of the biggest risks for a value investor is buying into a business with poor momentum. Not momentum in the since of an upward movement in the price of the stock – that is often a problem, but it's a difficult one for an investor (as opposed to a speculator) to evaluate and then count on – but, poor business momentum. Value investors – because they focus on the P/E ratio, the P/B ratio, EV/EBITDA, and many other measures of price – often find themselves buying into a business that looks cheap based on past measures of profitability rather than being cheap on future measures of profitability. The problem is that everything we know about a business is about that business's past. And yet, for an investor, everything that matters about a business is that business's future. In a previous article, I listed a series of stocks that are typical of value stocks. Value stocks can be defined in many ways. I think the simplest is the "Graham Number". Ben Graham talked about the importance of not overpaying for a stock in terms of either its asset value or its earning power. There is no completely correct number to gauge earnings power. For a cyclical business, this year's earnings might not be a good guide as to what normal "earning power" really looks like. Nor is there any one completely correct number to gauge asset value.

However, there are some numbers that can be helpful. A stock that trades at a meaningful discount to its tangible book value is more likely to be cheap than most other stocks. The likelihood of its cheapness becomes greater if it also trades at a meaningful discount to what would be a normal multiple of its earning power. Earning power isn't precisely the "e" in the P/E ratio. But, for many typical value stocks – it could be pretty close. So, if we combine the P/E ratio and the P/B ratio – by multiplying the two factors together – we can sort out those stocks that look especially cheap on a combination of both asset value and earning power value. These stocks – the stocks with some of the lowest Graham Numbers – are most likely to be true value stocks. However, the businesses these stocks are in may sometimes be experiencing a great deal of negative business momentum. In fact, that is one of the most common reasons for a low stock price. There are other reasons. But, decelerating earnings growth or declining earnings or shrinking margins or a hundred other poor business "vital signs" are common reasons for why investors – and speculators – abandon a stock. And that abandonment is what leads to a low stock price. So, our job as value investors should be to find those stocks with low Graham Numbers – low P/E ratios and low P/B ratios – where the business momentum is either not that bad or where it is likely to reverse at some point. The sooner that point is, the higher the compound annual growth rates in the stock price we are likely to get out of an investment in such value stocks. Often, it is too difficult to determine timing. If the price we pay for a stock is low enough – we can afford to wait. But, we can rarely afford to buy into a stock where the business momentum is bad and getting worse.

I'll be using QuickFS.net for the figures I quote in this article. And I'll be referring to some of the same stocks I talked about as being value stocks – in the sense of having a low Graham Number (P/E times P/B) – from that earlier article.

Let's start with a very cyclical stock: **Miller Industries (MLR)**. Paying members of the FocusedCompounding.com website can read a write-up I did on that stock. You'll find it in the "Stocks A-Z" list on the website under "M". The P/E ratio of Miller Industries is 9.1. The P/B ratio is 1.3 So, the Graham number is 11.8. A typical Graham Number might be something like 22.5 (P/E of 15 and P/B of 1.5). So, we are talking about a stock here trading at about a 50% discount to what might be considered a normal price. Why is this?

Miller Industries could just be a bad business. Maybe the return on invested capital, return on equity, etc. here is simply poor. That would justify a low Graham Number regardless of the point in the cycle. QuickFS says the 10-year average ROIC here is 12.6%. The 10-year average ROE is 10.2%. Because the long-term return in the stock market is lower than the ROE of this stock (that is, lower than 10%), the 10-year average return figures for this business would suggest the Graham Number here should be normal, not low. Instead they're low. So, past performance doesn't explain the pricing discount. But, does poor business momentum explain it? Last year (2019) earnings were a record best for Miller Industries. EPS grew 16%. The return on equity was 16%. It wasn’t a bad year. And earnings – though not always returns on assets, equity, etc. – had been improving at least a little bit each year for the last 7 years. So, no, the stock isn’t cheap because of any poor business momentum we can see in the past several years. Often, a worsening business performance over the last 3 years or 5 years is what drags a stock to cheaper and cheaper levels. That’s not the case here. So, maybe it is cyclicality. Cyclicality could definitely justify the stock price we see now at Miller. In the recession of the early 2000s and again in the recession around 2008, Miller either lost money or barely made any money. Results in recessions were so bad that a P/B ratio of 2 or more would lead to only a normal looking or even high P/E in recession years. Whether that is a legitimate justification for a long-term investor to ignore Miller stock in recession years is another question. Recessions do end. So, buying the stock at a high P/E (but low P/B) in a recession and then hanging on to it till selling in a boom might actually be a good strategy. But, we have found a reason why short-term investors would avoid the stock. If they thought we were in a recession that was going to get worse, last a long time, etc. – they might want to avoid a highly cyclical stock like Miller Industries during those years in which earnings would be poor. If you take a 10-year average of past operating earnings (EBIT) at Miller and apply today’s tax rate and then divide by the current shares outstanding – you get a price of 12-13 times the last decade’s earnings. This till seems very cheap. It’s a lot higher than this year’s P/E of 9. But, it’s still a low number based on past earnings. So, here, we can say that a big reason investors might be avoiding Miller stock is that this is a business that will show very bad (or no) earnings during recessions. The most recent year’s EPS is probably an overstatement of normal earning power. But, Miller still looks cheap on a long-term average. So, for the shorter term investor who doesn’t want to be in a stock as its earnings decline – avoid Miller Industries. But, for the long-term investor who doesn’t mind holding a cyclical stock through a recession as long as he knows the central tendency of normal earnings in the next full cycle will be high versus today’s stock price – Miller looks cheap.

Next, let’s take **Tandy Leather (TLF)**. Paying members at FocusedCompounding.com can read a 10,000 word report on this one in the “Stocks A-Z” section under the letter “T”. Tandy is a case of really bad business momentum. Since 2014, earnings per share have been: $0.75, then $0.63, then $0.69, then $0.48, and finally $0.21. With COVID and such this year – expect earnings (if there are any at all) to be worse than last year’s EPS of 21 cents. That 5-year EPS record I just gave you for Tandy is typical of a stock with bad business momentum. The stock is obviously cheap. At $3.13, it is less than 6 times the 5-year average earnings. It is only about 4 times peak earnings. That’s incredibly cheap for almost any stock that has much hope of reaching its previous peak earnings. So, investors may believe something permanent has happened to change Tandy’s earnings power. Business momentum is bad, though slightly mixed. The “slightly mixed” part is probably due to a lack of competition in Tandy’s markets. Gross margins have only declined from 63% to 61%. And, honestly, they’ve been as low as 61% plenty of times in the past when business was going pretty well. Revenue stalled – but did not materially shrink – in the last 5 years. However, the way that revenue was maintained at the company level shows problems at the store level. At Tandy's peak it turned $52 million of gross profit into $12 million of EBIT. Last year, it turned $51 million of gross profit into just $4 million of EBIT. That's consistent with a business where the cost of operations below the gross profit line keeps rising. This happens if you are only keeping revenue – and gross profit – the same by opening more and more stores, investing more and more in corporate functions, marketing more, increasing SG&A, etc. This could be a sign of problems generating revenue. It can also just be a sign of sloppiness in expense control, a poor corporate culture, etc. But, this is typical of bad business momentum. Tandy's a bit interesting because the decline in reported earnings is extremely severe relative to an extraordinarily small decline nearer the top line. Usually, a business that is experiencing severe and permanent deterioration would show worse drops at the gross profit level. Usually, a lot worse. This may mean that Tandy's problems are more internal and operational than due to competition eating their lunch. Since the leatherworking market doesn't grow much over time – it may even be shrinking – it's also clear Tandy isn't really losing a lot of market share. So, here is a company with clearly bad business momentum (extremely bad, in fact) at the bottom line and a more mediocre (but, still by no means good) performance nearer the top line. Things have clearly been going badly at Tandy for the last 5 years. But, this is not a good example of what really bad business momentum looks like. In fact, Tandy's results over the last 5 years are pretty similar to **Chipotle's (CMG)** results over the last 5 years. Both went from growth to completely stalled gross profits accompanied by worsening operating results. There is a big difference though. Chipotle experienced a sharp drop in earnings accompanied by quick improvement. The severity of Chipotle's decline in earnings was much, much worse than at Tandy. But, the recovery – though long – has been continual. Tandy has been getting a bit worse each year. Chipotle a bit better. The actual 5-year record at Chipotle sucks. In almost all respects, the business is dollar for dollar and store for store only about half as profitable as it was a decade ago and that is after a nearly 5-year climb out of a disastrous hole. But, here's the difference. Chipotle's results – though very bad – have been getting a bit better each and every year. Tandy's results have been getting a bit worse. And this improving business momentum is often what gives a stock a higher multiple. There is another factor – pure growth. Chipotle has put more and more capital into its business and kept on growing. This is not surprising. Even if the business never again creates as much value as it once did – even if its margins, ROIC, etc. are only ever again half of what they used to be – it will be creating some value by growing. Tandy combined bad business momentum (worrying investors about the downside) with poor future growth prospects (limiting the upside). Chipotle has a lot of upside, because it's in a gigantic industry where it has only small market share. Tandy is in a tiny industry where it has huge market share.

Movado (MOV) is another example of limited upside and bad business momentum. There's another factor here. It is in watches – which some may see as an industry headed for obsolescence. This perception of watches as a dying industry is not entirely inaccurate. For a long time, the Swiss watch industry has grown through pricing increases rather than selling more units. The industry has also depended more and more on fewer and fewer markets for a lot of its profits. Movado isn't a Swiss watch business. It is mostly in the business of selling Asian made watches in the U.S. often under licenses of fashion brands in addition to its own name. There's also a 10,000 word report on Movado over at FocusedCompounding.com. Paying members can find it under "M" in the "Stocks A-Z" list.

Movado has a very, very mixed business momentum record. By most measures, profitability has been wobbly from year-to-year but essentially similar for the last 7 years. In fact, sales and gross profits were at a record last year. But, return on equity fell to the single digits. Of the businesses I've talked to you about today, Movado has the worst returns on equity. The 10-year average (according to QuickFS.net) is just 9%. This is due, in part, to holding a lot of cash. ROIC has been closer to 15%. If the company operated with neither net cash nor net debt – you'd expect the ROE to be around 12% over a cycle. It hasn't been, because the company hasn't used debt but has held cash. The stock seems to trade at a bit less than 5 times "normal" earning power. With a price of $10.50 a share, that means normal earnings would be something like $2.10. That isn't what the 10-year record shows. But, unlike something like Tandy – Movado has actually grown a lot. The company is about double the size it was a decade ago (suggesting the business is growing about 7% per year). There is obviously more upside potential in Movado than in Tandy. But, there is also a heck of a lot less upside potential in Movado than in Chipotle.

Which of these stocks have the best business momentum? Not the best business. But, which are moving most in the right direction and which are moving most in the wrong direction. Chipotle's momentum is best, then Miller, then Movado, and finally Tandy. You would expect the stock price multiples to follow that same sort of pattern – Chipotle should be a popular stock, Miller less popular, Movado even less popular, and Tandy outright unpopular.

The difficulty in picking stocks is not in identifying what is cheap or expensive. Chipotle is expensive. Miller is cheap. Movado and Tandy are really, really cheap. Anyone can see that. Likewise, most peole can easily see business has been getting better over the last 5 years at Chipotle and worse at Tandy.

The difficulty in picking stocks is the handicapping. Chipotle has a P/E of 125 and P/B of 19. Miller has a P/E of 9.1 and P/B of 1.3. Is Chipotle the better business than Miller? Definitely, yes. But, is Miller the better stock than Chipotle. Probably, yes.

But, that's a value investor talking.