



# Magic Formula Stock Reviews 2009

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<b>USA MOBILITY INC (USMO) .....</b>	<b>0</b>
<b>MOSAIC COMPANY (THE) (MOS) .....</b>	<b>0</b>
<b>VOLCOM INC (VLCM).....</b>	<b>0</b>
<b>DELUXE CORP (DLX) .....</b>	<b>0</b>
<b>RADIOSHACK CORP (RSH) .....</b>	<b>0</b>
<b>KNOLL INC (KNL).....</b>	<b>0</b>
<b>MAXYGEN INC (MAXY) .....</b>	<b>0</b>
<b>THESTREET.COM INC (TSCM) .....</b>	<b>0</b>
<b>HEARTLAND PAYMENT SYSTEMS INC (HPY).....</b>	<b>0</b>
<b>WESTERN DIGITAL CORP (WDC).....</b>	<b>0</b>
<b>SOHU.COM (SOHU) .....</b>	<b>0</b>
<b>FOREST LABORATORIES INC. (FRX).....</b>	<b>0</b>
<b>DECKERS OUTDOOR CORP (DECK) .....</b>	<b>0</b>
<b>QLT INC (QLTI).....</b>	<b>0</b>
<b>POLO RALPH LAUREN CORP (RL) .....</b>	<b>0</b>
<b>OMNICOM GROUP INC. (OMC).....</b>	<b>0</b>
<b>DISH NETWORK CORP (DISH).....</b>	<b>0</b>
<b>DICE HOLDINGS INC (DHX) .....</b>	<b>0</b>
<b>KBR INC (KBR).....</b>	<b>0</b>
<b>NOKIA (NOK).....</b>	<b>0</b>
<b>HERBALIFE LTD (HLF).....</b>	<b>0</b>
<b>QIAO XING MOBILE COMMUNICATION CO LTD (QXM) .....</b>	<b>0</b>
<b>KORN/FERRY INTERNATIONAL (KFY) .....</b>	<b>0</b>
<b>AGRIUM INC. (AGU).....</b>	<b>0</b>
<b>BIDZ.COM INC (BIDZ).....</b>	<b>0</b>
<b>MICROSTRATEGY, INC. (MSTR).....</b>	<b>0</b>
<b>CHEROKEE, INC. (CHKE) .....</b>	<b>0</b>
<b>AMEDISYS INC (AMED) .....</b>	<b>0</b>
<b>GT SOLAR INTERNATIONAL INC (SOLR) .....</b>	<b>0</b>
<b>FLUOR CORP. (FLR).....</b>	<b>0</b>
<b>JOY GLOBAL INC (JOYG).....</b>	<b>0</b>
<b>VIRGIN MOBILE USA INC (VM) .....</b>	<b>0</b>
<b>GARMIN LTD (GRMN) .....</b>	<b>0</b>
<b>GRAHAM CORP (GHM).....</b>	<b>0</b>
<b>JACKSON HEWITT TAX SERVICE, INC. (JTX) .....</b>	<b>0</b>
<b>ALLIED HEALTHCARE INTERNATIONAL INC. (AHCI) .....</b>	<b>0</b>
<b>QLOGIC CORP (QLGC) .....</b>	<b>0</b>
<b>PAIN THERAPEUTICS INC (PTIE) .....</b>	<b>0</b>
<b>SHAW GROUP INC. (THE) (SHAW) .....</b>	<b>0</b>
<b>GIGAMEDIA LTD (GIGM) .....</b>	<b>0</b>
<b>CUBIST PHARMACEUTICALS INC (CBST) .....</b>	<b>0</b>
<b>HILLENBRAND INC (HI).....</b>	<b>0</b>
<b>SEPRACOR INC. (SEPR).....</b>	<b>0</b>
<b>LINCARE HOLDINGS INC. (LNCR).....</b>	<b>0</b>
<b>UNITED ONLINE INC (UNTD) .....</b>	<b>0</b>
<b>CGI GROUP INC. (GIB).....</b>	<b>0</b>

<b>CORUS ENTERTAINMENT INC (CJR)</b> .....	<b>0</b>
<b>DRESSER-RAND GROUP INC (DRC)</b> .....	<b>0</b>
<b>QUESTCOR PHARMACEUTICALS INC. (QCOR)</b> .....	<b>0</b>
<b>FOSTER WHEELER LTD (FWLT)</b> .....	<b>0</b>
<b>MIPS TECHNOLOGIES INC (MIPS)</b> .....	<b>0</b>
<b>DUN &amp; BRADSTREET CORP (THE) (DNB)</b> .....	<b>0</b>
<b>DYNCORP INTERNATIONAL INC (DCP)</b> .....	<b>0</b>
<b>AEROPOSTALE INC. (ARO)</b> .....	<b>0</b>
<b>WORLD FUEL SERVICES CORP (INT)</b> .....	<b>0</b>
<b>LINN ENERGY LLC (LINE)</b> .....	<b>0</b>
<b>CEPHALON INC (CEPH)</b> .....	<b>0</b>
<b>STURM RUGER &amp; CO INC. (RGR)</b> .....	<b>0</b>
<b>TIME WARNER INC (TWX)</b> .....	<b>0</b>
<b>ITT EDUCATIONAL SERVICES INC (ESI)</b> .....	<b>0</b>
<b>SYNTA PHARMACEUTICALS CORP (SNTA)</b> .....	<b>0</b>
<b>CORPORATE EXECUTIVE BOARD COMPANY (THE) (EXBD)</b> .....	<b>0</b>
<b>NATHAN'S FAMOUS INC (NATH)</b> .....	<b>0</b>
<b>PDL BIOPHARMA INC (PDLI)</b> .....	<b>0</b>
<b>VALUECLICK INC (VCLK)</b> .....	<b>0</b>



## INTRODUCTION

In the years I've run MagicDiligence.com, the simple genius of Joel Greenblatt's Magic Formula Investing (MFI) strategy in finding quality companies when they are cheap has been evident. The strategy works on so many levels. For consistently great companies, MFI only turns them up when they are truly cheap - such as Intel (INTC), which entered MFI when the stock reached a 13-year low, subsequently returning investors over 60% in the next 12 months. The strategy digs up great spin-off businesses that have not yet entered Wall Street's radar, like Teradata (TDC), a spin-off of NCR (NCR) which delivered 67% 12-month gains to MFI investors. And perhaps the greatest feature of MFI is its ability to find great small-cap businesses, a notoriously difficult but lucrative endeavor in stock investing.

In the process of searching for the very best Magic Formula stocks for MagicDiligence Members, I review dozens of MFI companies, from tiny micro-cap companies like Nathan's Famous (NATH - market cap \$80 million) to huge multi-nationals like Time Warner (TWX - market cap \$37 billion). By far, most of them are truly attractive investment opportunities. Many have strong, stable businesses that pay good dividends and buy back stock, even though they may not have explosive growth potential. Others may be mired in the downside of the business cycle, but have no major problems that threaten the viability of the business. Still others are in an industry that has been broadly sold off by the market, fairly or unfairly. And, finally, some are indeed fads, one-time flukes, dying businesses, or so financially unhealthy as to be a bankruptcy candidates.

While I save the very best Magic Formula stocks - those that fulfill the trinity of strong growth potential, sustainable competitive advantages, and strong financial health - for recommendation as Top Buys, the other stocks I've reviewed for MagicDiligence and compiled here represent a collection of great investment ideas sprinkled in with some stocks to avoid. The MagicDiligence take on these stocks has been justified, for the most part. Just a few examples:

Maxygen (MAXY), recommended to avoid stock February 3 at \$8.52. Has fallen 36% since then, during a wild bull market.

Western Digital (WDC), recommended to buy stock February 17 at \$15.64. Is up 147% since then.

Polo Ralph Lauren (RL), recommended to buy stock March 17 at \$37.52. Is up 114% since then.

This compilation serves a number of purposes for investors. Most importantly, it provides fundamental analysis and informed opinions on a lot of stocks that are not covered by the large research houses and investing services. Numerous great small cap companies are profiled within these pages, at a small fraction of the hundreds or thousands of dollars charged by most small cap research services.

Secondly, a lot of these stocks are still a part of the Magic Formula Investing screen, indicating that the stock price is still cheap. In particular, the later reviews contain some investing opportunities that are still attractive today. It often takes the market months or even years to realize the value underlying a business, particularly small businesses.

The third purpose is for education. I hope that the stock analysis provided here gives a good framework for how to fundamentally evaluate and value a business, no matter how big or small. The competitive dynamics of different industries discussed within these reviews can be applied to other companies engaged in similar sectors.

Finally, I hope that discovering and learning about companies is as entertaining for you as it is for me. Investing should be fun, not a chore.

All the best in life and investing for 2010!

Steve Alexander  
Editor, [MagicDiligence.com](http://MagicDiligence.com)

## **DISCLAIMER**

The information in this e-book is for informational purposes only. No warranty is provided or implied as to the accuracy, completeness, or timeliness of this information. This information may not be construed as investment advice of any kind. The author of these materials is not responsible in any way for losses or damages resulting from the use of this information. MagicDiligence.com is not a registered investment advisor.

## HERMAN MILLER INC (MLHR)

**Date Reviewed:** January 2, 2009

**Growth:** C-

**Competitive Moat:** D

**Management:** B+

**Financial Health:** C

**Opinion:** No moat business and highly competitive. Look elsewhere.

Herman Miller is one of the largest designers and manufacturers of office furniture products worldwide. The company is known for its innovative designs, including the Aeron chair and the first cubicles. Herman Miller is the third largest competitor in the office furniture industry, trailing Steelcase (SCS) and HNI (HNI). More specifically, MLHR can be lumped into the "premium" segment of the market, where it is the largest player by sales but trails primary rival Knoll (KNL, another Magic Formula stock) in profitability.

Office furniture design and production is a fundamentally unattractive business for several reasons. First, sales volumes are heavily dependent on overall economic conditions, particularly non-residential construction and office space turnover rates. This adds a sharply cyclical challenge to valuing the stock, which we generally like to avoid (the more predictable, the better). In the near term, these macro factors are forecast to be pretty weak. Office vacancy rates are over 13%, non-residential construction has grind to halt, and more companies are holding on to their cash instead of expanding into new and larger office spaces.

However, the biggest black mark on the business itself is the complete lack of any kind of built-in durable competitive advantages. There are no switching costs - offices can easily buy from a competitor for new or replacement furniture. There are obviously no regulatory barriers, unique assets, or economies of scale to benefit from. Herman Miller has tried to set itself apart from its competition with innovative designs. However, this can only be effective over short periods of time. Competitors can easily copy any new designs that Herman Miller's labs produce, and at lower cost because they do not have to pay for the R&D to create them. Barriers to entry are low. You or I could easily start up an office furniture design house with the right amount of capital and expertise, both of which are in abundant supply. Competition is brutal, with several larger competitors and countless smaller ones. For many office buyers, price is the main concern, which limits the amount of extra profit that can be wrung from good design. Regardless of how well Herman Miller is run or how good its designers are, the industry is just not one that lends itself to long periods of sustained high profitability. This is illustrated by looking at the long term picture. Over the past 10 years the company has delivered just 1.3% compound annual revenue growth and anemic 1.9% free cash flow growth.

For those that aren't scared away by these factors, Herman Miller offers some attractive qualities. Operating costs are fairly scalable, as employee compensation is based to an extent on royalties and company performance, which means that when revenues are down, expenses drop accordingly. This flexibility helps maintain profit margins, which have been on a steady march upwards from 5.3% in 2004 to nearly 13% currently. The company is expanding both in addressable markets and geographically. By purchasing Brandrud in fiscal

2008, Herman Miller gained a solid foothold in health care furniture. International sales account for nearly a quarter of revenues today and the company recently opened a headquarters in China and announced a strategic partnership with local furniture provider Hong Kong POSH. Management hopes to drive over half of growth from international sources over the next few years.

Financially, Herman Miller is in reasonably good shape. Debt is high at 744% of equity (MagicDiligence looks for a figure under 80%). The cash to debt ratio is \$163 million to \$376 million. About half of the debt is due in 2011. However, coverage ratios are still comfortable, with operating earnings covering interest 14 times over. The company generates good cash flow, converting about 7.5% of sales to free cash, allowing a solid dividend (2.6%) and share buybacks (5% annual reduction in shares over past 5 years). Capital is managed well, with MFI return on capital averaging nearly 65% since 2004, and a current figure over 90%. These statistics point to excellent management, a must in such a competitive business.

Herman Miller is well run and shareholder friendly, with a history of innovative design. But this is such a poor industry, and there are so many more attractive stocks on the MFI screen, that I recommend that [members](#) avoid it and look elsewhere.



## MARTHA STEWART LIVING OMNIMEDIA INC. (MSO)

**Date Reviewed:** January 6, 2009

**Growth:** C-

**Competitive Moat:** C

**Management:** D

**Financial Health:** B+

**Opinion:** Solid intangible assets but concentrated and historically unprofitable. Look elsewhere.

Martha Stewart Living Omnimedia is the media empire created and built on the back of homemaker extraordinaire Martha Stewart. The company operates in three segments. Publishing (52% of trailing twelve month revenues) consists of several magazines, most prominently *Martha Stewart Living* with a large circulation over 2 million. Merchandising (28%) licenses the Martha Stewart name to third party manufacturers and other retailers for the production of products in several consumer segments, including home & garden, kitchen, decorations, paints, and so forth. Broadcasting (15%) produces several cable television shows including *Martha*, *Everyday Food*, *Petkeeping*, the newly acquired *Emeril*, and also syndicates older shows such as the original *Martha Stewart Living*. Finally there is the Internet segment (5%), consisting of *MarthaStewart.com*, which is now primarily an ad-driven site after the catalog business was shut down a few years ago.

Martha has some attractive qualities to be sure, the foremost of which is the Martha Stewart name and image. A hero of sorts to the company's target audience of affluent women aged 25-54, Martha's ideas and recommendations carry tremendous weight and are highly sought after by advertisers. Since this demographic is responsible for a large portion of household purchases, MSO targets a lucrative audience. This allows the company to attract more advertisers and charge higher ad rates than competitors.

I also really like the Merchandising business, which is the most profitable of the company's units. Licensing is a wonderful business model when done carefully. It costs little to license Martha's name to producers of products ranging from furniture to paints to bed sheets. Growing sales at little cost (scalability) is a very profitable thing indeed. With the recent acquisition of Emeril Legasse's cooking franchise, MSO has yet another well known and respected intangible asset that it can leverage through its Merchandising unit.

Alas, despite these positives, Martha Stewart has an even larger pile of negatives that prevent a recommendation here. The first and primary reason is pretty easy to understand: the company has only been profitable in one year out of the last 5 (a meager profit in 2007)! Some of this was probably due to Martha's "incarceration" in 2004, but the fact is that this company has never been extraordinarily profitable. Publishing is a dying business as ad dollars and readers move onto other sources like the Internet and cable television. Less than stellar management has also been a factor, as well as strong competition like *Oprah* and *Better Homes and Gardens*.

Speaking of management, the situation at the top of MSO is a bit perplexing. Former CEO Susan Lyne abruptly stepped down earlier this year, for no obvious reason. While her 4 years were filled with operating losses, she had managed to grow sales and the Emeril acquisition was an important step towards diversification. The CEO replacement is a two headed monster of media president Wenda Harris Millard and merchandising manager Robin Marino. This is an odd situation with all kinds of potential for executive suite battles, especially considering the stark contrast in profitability between the two units. Sitting above all this is Martha herself, who wields complete control through a dual share voting structure, and Charles Koppelman, the well compensated chairman who both CEOs report to. (For those who suffered through *Apprentice: Martha Stewart*, Koppelman was Martha's right hand man in that show.) This is quite a logjam at the top, with the potential for much conflict.

The merchandising segment has benefited tremendously from a favorable contract with Kmart (SHLD), with very large minimum royalty payments (over \$65 million a year guaranteed) written in. Kmart is responsible for 3/4ths of MSO's merchandising revenues. However, Kmart has been a poorly performing retailer, closing nearly a third of its stores and suffering even worse comparable store sales than its peers. In reaction to this, the deal with MSO has been restructured to much lower minimum payments closer to \$15-20 million a year, starting in 2009. While the company is trying to make up for this with deals with Macy's (M) and Costco (COST), the Kmart deal was a sweetheart one and it will be difficult to replace those guaranteed revenues.

And finally, Martha Stewart Living is extremely dependent on the eponymous founder's image. As Martha's image goes, so goes the image of the company. It has already faced serious challenges stemming from her conviction from insider trading, and any additional problems could send her off the radar. Additionally, the Kmart deal has been responsible for a significant portion of revenues in the past. These concentration risks are being mitigated through the Emeril purchase and the new retailer deals, however.

I generally like media companies, and almost always like licensing businesses, but the risks here are just too great to ignore. The big business, publishing, is a dying one with ad dollars and readers going onto the Internet, where MSO is weak. The merchandising business is attractive but dependent on a sweetheart legacy contract (and yet the company has still been unprofitable!). Brand concentration is a concern, as is a perplexing management situation. In short, buy Martha's magazines, not the stock.

