Who's Ripe for A Takeover

We crunched some numbers and identified 15 candidates. **BY TODDI GUTNER**

TAKEOVERS ARE BACK with a vengeance, and investors smart enough—or lucky enough—to own stock in a company that is being pursued can make handsome gains.

While no one can say with certainty what companies will be acquired, a variety of financial measures offer ways to narrow the field. With the help of Richard Sloan, a professor of accounting and finance at the University of Michigan's Stephen M. Ross School of Business, we screened for candidates using the FactSet Research Systems database of 5,875 companies. We included only American companies listed on the three main stock exchanges in the U.S.

Sloan zoomed in on a handful of characteristics common to companies that get bought out. Among them are familiar measures such as price-to-earnings and price-to-book-value ratios, and some lesser known, such as price-to-net tangible assets. Armed with such financial facts and figures, an investor can begin to ferret out companies that have good assets that could be bought at a reasonable price.

That narrowed the list to 1,656. From that universe, we took companies with the lowest valuations for each measurement. The result: a list of 15 businesses that could be attractive acquisition opportunities for another public company or a private equity firm (table, page 124).

Of course, number-crunching goes only so far. A well-constructed stock screen simply gives you a starting point to begin your qualitative research. "These screens are not foolproof and are [in] no way guaranteed," says Sloan. "But they can turn the probabilities in your favor."

Nearly half the companies on the list are specialty retailers, from Payless ShoeSource and Jo-Ann Stores to Charming Shoppes and Stage Stores. Each caters to a niche and is up against unique challenges. Payless, for example, the mass-market shoe retailer, reaps 25% of its revenues from athletic footwear. Competition has heated up as Nike teamed with Wal-Mart Stores and started to manufacture and distribute a new line under the Starter brand of athletic footwear and apparel. Still, with 4,700 stores across the country, Payless is the largest shoe seller in the U.S.

PRICE RESISTANCE

SEVERAL OF THE 15 companies on our list lead their industries. American Greetings is the largest publicly traded maker of greeting cards, yet with Wal-Mart and Target selling cards for as low as two for $1, customers are becoming resistant to the higher-priced cards that American Greetings sells. Freescale Semiconductor, a recent spin-off from Motorola, is one of the largest semicon-

ILLUSTRATION BY ROBERT NEUBECKER

ductor makers for networking equipment, automobiles, and cell phones. Investors worry that, with 28% of its revenues coming from its former parent, Freescale could be vulnerable if Motorola shifts business elsewhere.

PRIVATE EQUITY PREY

ANTITRUST REGULATIONS may keep a market leader from falling prey to a major competitor. But private-equity funds, flush with an estimated $200 billion bankroll, could buy such companies without riling the watchdogs. One leader on the list, bookstore chain Borders Group, gets 16% of its revenues from selling recorded music. With the music business in the dumps, Borders is in more pain than its main rival, Barnes & Noble, which earns less than 5% of sales from music. Borders didn't follow some of Barnes & Noble's winning strategies, such as a self-publishing unit and a readers' advantage discount program, which offers rewards for frequent purchases. If Borders management doesn't fix these problems, perhaps a buyout artist will.

Nearly half the stocks are specialty retailers

Some outfits may come cheap, but they're not easily fixed. Archer Daniels Midland (ADM), a processor of agricultural products, has problems in its ethanol business, which accounts for 25% of the company's operating profit. Typically the price of ethanol correlates with crude oil and gasoline prices. But ethanol must be blended with gasoline at an oil refinery to make it usable as a fuel. With the shortage of refining capacity in the U.S., ADM has an oversupply of unrefined ethanol.

Although our list here highlights only 15 companies, BusinessWeek Online showcases 100 undervalued companies identified through the same screen. These outfits missed the parameters we set, but they still have many of the attributes that acquirers are known to value. Two recognizable names on the BusinessWeek Online list are King Pharmaceuticals and Circuit City Stores, which were pursued by acquirers this past year until the deals fell apart. The numbers suggest they could be in play again soon.

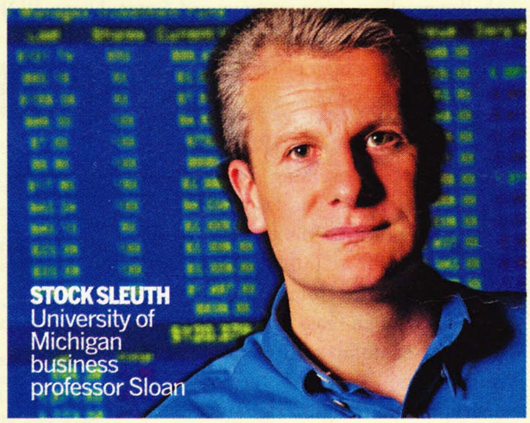
BusinessWeek online For more on undervalued stocks, please visit us online at businessweek.com/extras

Cash-Rich, Good Assets—And Cheap

To find potential takeover targets, we screened a database of 5,875 companies, looking for low valuations on each of the following six financial measures:

COMPANY/SYMBOL	PRICE/ EARNINGS RATIO*	PRICE/ FREE-CASH FLOW	PRICE/ BOOK VALUE	PRICE/ NET TANGIBLE ASSETS	PRICE/ WORKING CAPITAL	TOTAL DEBT/ ASSETS (%)
American Greetings AM	14.2	3.3	1.06	1.29	1.81	19.6%
Archer Daniels Midland ADM	12.3	7.9	1.38	1.43	2.75	23.3
Belden CDT BDC	12.8	8.0	1.07	1.94	2.00	17.8
Borders Group BGP	13.4	15.7	1.62	1.84	3.10	7.5
Charming Shoppes CHRS	12.4	8.6	1.25	1.87	2.08	17.4
Freescale Semiconductor FSLB	18.9	6.7	1.27	1.36	1.70	19.1
Imation IMN	19.4	18.0	1.48	1.56	2.17	0.0
Jo-Ann Stores JAS	12.0	11.8	1.42	1.53	1.89	11.9
Micron Technology MU	16.7	14.4	1.01	1.06	3.33	14.8
Offshore Logistics OLG	12.7	9.3	1.31	1.38	2.09	23.2
Payless ShoeSource PSS	16.1	5.9	1.54	1.62	2.34	16.7
Solectron SLR	18.3	2.3	1.25	1.33	1.17	21.0
Stage Stores STGS	13.3	8.0	1.42	1.77	3.09	0.0
U.S. Steel X	4.9	5.0	1.16	1.11	2.19	12.2
Zale ZLC	12.8	17.2	1.76	1.99	2.47	9.2

*Based on next 12 months' earnings **Data:** Richard Sloan, Stephen M. Ross School of Business, University of Michigan; FactSet Research Systems Inc.


STOCK SLEUTH University of Michigan business professor Sloan

DONNA TEREK

Richard Sloan, a professor at the University of Michigan's Ross School of Business, teaches MBA students how to use the tools of investing—and of course, he uses them himself. About six months ago, his own search for cheap stocks led him to Spartan Stores, a Michigan-based supermarket chain. He invested, and soon after, so did a private-equity firm. Since then, management has whipped the company into shape, profits are up, and the stock has doubled.

Want to know how Sloan looks for stocks? First he sets a minimum market capitalization of $500 million. That assures there will be liquidity in the stock. He also limits insider ownership to 20% of the stock, so management would be less able to block a sale. Then he continues to sort the stocks on these metrics:

PRICE-TO-EARNINGS RATIO. The lower the price-earnings ratio, the more attractive the company may be to potential buyers. We used a cutoff of 20.

PRICE-TO-FREE-CASH-FLOW RATIO. Earnings alone may not produce much cash. The figure is a reality check on the p-e. The maximum here is 20.

PRICE-TO-BOOK-VALUE RATIO. The lower the price-to-book ratio, the lower the cost of the company's assets. We set a maximum of 2.

PRICE-TO-NET-TANGIBLE-ASSETS RATIO. Starts with book value, but then subtracts goodwill and other intangible assets such as patents, copyrights, and trademarks. The lower the price to the tangible assets, the better. We set the bar at 2.

PRICE-TO-WORKING-CAPITAL RATIO. This ratio identifies the value of a company's liquid assets —those you expect to convert to cash within 12 months. The ratio has to be less than 4, but most of them are well below that.

DEBT AS PERCENT OF TOTAL ASSETS. The higher the debt as a percentage of assets, the less attractive the company. We set the bar at 25% or less.