An SSG Analysis in Retrospect

True Confessions of a Safeskin Buyer

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***Editor's Note:** Our thanks to NAIC member Laura Berkowitz, an active participant on NAIC's I-Club-List (an e-mail discussion group), for sharing this remarkably candid look back at an investment decision she made, and what went wrong. We think many of our readers may find this to be one of the most educational articles we have published this year.*

Isn't hindsight wonderful! Some of my best SSG work is done in hindsight. It's part of my learning process. Sure, I move on when I make a mistake. But, I'm not one to say, "I never look back," because I do.

When I prepare an SSG, I believe I've done my best analysis using clear, logical thinking in my judgment. When I buy a stock based on my SSG, I feel confident the stock will do well and I have made the correct decision.

I bought Safeskin Corporation in December, 1998. In March, 1999, it crashed.

The NAIC "Rule of Five" states that out of five companies I purchase, most likely three will do as expected, one will be a superstar, and one will not meet my expectations. I accept that for companies I purchase for sound reasons based on my SSG analysis. Stuff happens. However, when I purchase the laggard fifth stock right out of the starting chute, it's time to go back to SSG school.

Now, months later, I understand what I did wrong. The information I needed to apply correct judgement to my Safeskin SSG was available to me when I prepared it. All the "clues" as to what might happen were present. Why did I ignore them? I sabotaged my own SSG and made it look great! I preformed the entire research, SSG preparation, and judgment "process" predetermined to buy that stock. I ignored lessons from my education, business background and sales experience because I wanted that "Wall Street darling" at a good price!

So that I never make this mistake again, I must understand what happened with my Safeskin Corporation analysis. I must be able to do this without a lot of fancy financial analysis; just the basic facts and some critical thinking. That's what this article is about.

About Safeskin Corporation

Forbes magazine placed Safeskin in the top 10 of its "200 Best Small Companies in America" in 1996 and 1997. (*Better Investing* featured the company as an Undervalued Stock in August 1995.)

On Safeskin's home page, http://www.safeskin.com, the company claims it ". . . is the leading manufacturer of high quality disposable latex exam gloves for the medical, dental, scientific and high-technology markets in the United States." The company believes it is the "market share leader, in both dollars and units, of medical gloves to acute care facilities (hospitals) in the United States."

Most U.S. sales are made to large distributors such as McKesson and Owens & Minor. These distributors buy Safeskin's gloves in quantity, then resell them to their end users. As part of its marketing strategy, Safeskin educates the end users on the benefits and best usage of Safeskin gloves.

Timeline of Events 1998 - 1999

April 1998	2-for-1 stock split; stock trades at 35.6
July 1998	Stock trades as high as 47.
October 1998	Melissa Wilmoth, a Salomon Smith Barney analyst, went public with her concerns about rising inventory & receivables at Safeskin. Two distributors told her they received one-time shipments of gloves at the end of September. One acknowledged receiving special discounts and extended payment terms. It agreed to take the shipment in excess of its inventory needs. After Wilmoth's comments, stock trades in the low 20s.
November 1998	*Barron's* Nov. 23, 1998 article, "The Gloved One, Competition Threatens Safeskin's Stellar Growth" by Barry Henderson, discusses the problems and indicators. Many other articles spread the news.

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March 1999	On March 12, Safeskin announces sales and earnings below analysts expectations for first quarter 1999 and full year 1999. Company cites higher distributor inventory and slower orders from new customers as reasons. Stock tanks to the 8 range.
April 1999	Safeskin restates 1998 third quarter and reduces earnings for full-year 1998.
	Many lawsuits are filed.

My Initial Research

In December, 1998, when I studied Safeskin, I reviewed its second and third quarter SEC 10-Q reports. This is always part of my SSG research. I access these from http://www.freeedgar.com. After reading the text, I remember thinking Safeskin was experiencing a lot of changes in 1998. First, it contracted with Perot Systems to manage its information technology systems. Second, it moved its facilities from Malasia to Thailand, where latex prices and tax advantages were more favorable. Third, it acquired AQL, a company with an established reputation manufacturing synthetic gloves. This gave Safeskin an entry both into synthetic glove manufacturing and added marketing segments in high technology and scientific applications. Fourth, it built and instituted new production systems, called Grand Master TM. Safeskin stated the three machines it had on line to date could produce in excess of one billion gloves annually. Whew! That's a lot of changes for a company Safeskin's size to absorb without glitches.

My First Error in Judgment

I know that when a company, especially a small company, experiences rapid growth, expansion of product lines, expansion of customer base, coupled with physically moving plant, relocating staff, instituting new information technology and reporting systems, and bringing new manufacturing equipment on line with requisite training, there are going to be rough spots. I also know that this type of growth requires changes in management and staff reporting for information requirements. I choose to ignore these thoughts, and assume that because in the past Safeskin's management had been successful, it would continue to be. In hindsight, I didn't give weight to this transition upheaval and assumed the existing management was in control.

I also know that Safeskin's huge growth in recent years was partially due to it filling a product niche during a time when more stringent health requirements necessitate the use of rubber glove products. Gloves are, well, gloves are gloves. I knew Safeskin differentiated its products by referring to "high quality," sold on value, and considered itself the low cost producer of gloves. When customers purchase on perceived quality and value attributes, it's only a matter of time before competition drives the price lower. Gloves are very much a commodity. So, I know eventually Safeskin's profit margins will have to come down, if for no other reason than to meet price competition. The rapid growth, high margins can't continue forever. But because I wanted to buy Safeskin, I ignored the possibility that December's drop in price could be the market recognizing the possibility of future slower growth and lower margins for Safeskin.

My Second Error in Judgment

Oh yes, stuffing the channel. How well I know about making quotas. I have been a sales representative.

I worked for a very large company. From my experience, top management knows what numbers it needs to make for each quarter and year. These goals are passed down to each division manager, each branch manager, each unit manager, and finally to the sales representatives. Going back the other way, as a sales representative, each month I filled out a sales forecast showing where I was in the sell cycle with each customer and when I would close business and put product on order. These monthly forecasts would cumulate into quarterly forecasts and the quarterlies into yearly reports. During a year, as these monthly and quarterly forecasts were passed back up to top management, top brass would readjust, reassign and pass the new quota allocations back down the line. At all time everyone knew within reason where they stood with their customers and what had to be done to make the necessary numbers. So how could Safeskin's management be so far off? After all, it is a small corporation with variations on only one product.

I came up with two answers. First, with the upheaval and rapid growth I alluded to earlier, Safeskin's information systems might not have been sufficient. Also, top management may have been busy managing through the change. This, of course, is no excuse. However, it is innocent enough and sometimes what happens as small companies grow rapidly.

Second is Wilmoth's scenario. Top management knew they had to make their earnings numbers for the third quarter, so distributors were asked to take more inventory. Safeskin representatives or management may have given them extra rebates, price breaks or extended payment terms to entice them.

I was aware of all this, but discounted the information when applying my SSG judgment. After all, I wanted to buy the stock.

Since I'm using hindsight in my learning process, I look at Safeskin's 1998 Annual Report which was not available when I was preparing my SSG. Under the section "Liquidity and Capital Resources," management explains what happened after coming out of their allocation period and as they ramped up production in 1998. Safeskin entered into three-way contracts covering supply and pricing with its distributors and end-users. The distributors increased their orders, Safeskin shipped product and recorded sales, but the end-users didn't purchase from the distributors as anticipated. Safeskin management makes no mention of aggressively pushing product in the third quarter.

Now, I make three more assumptions I wish I'd made last December. First, Safeskin's accounts receivables are up because distributors under contract were probably granted payment terms depending on end-user purchases. Second, Safeskin was able to push too much product into the distributor channels by granting the distributors favorable payment terms. Beginning in the third quarter of 1998, Safeskin could no longer get distributors to take more gloves; distributors had too much on hand, so inventories began to rise. I follow Wilmoth and assume Safeskin pushed inventory to the distributors in September to boost third quarter sales. Third, management's information systems upon which it relied to understand how much product was being used and needed to be produced, production forecasting and inventory control, were all not working!

Hindsight Helpers

Immediately after Safeskin management made its announcement, several very good articles were published on the web. These articles alluded to how I could have focused my analysis to anticipate the problem. On March 17, 1998, Louis Corrigan, writing for the Motley Fool's "Fool on the Hill" column, explained that by using year-over-year, and quarter-over-quarter analysis of sales, accounts receivable and inventory I would have caught the downward trend. His article is worthwhile reading, and can be found at http://www.fool.com/eveningnews/foth/1999/foth990317.htm.

Another source of suggestions came from an article published in both *Better Investing* and in *BITS* by Philip J. Keating, CFA, entitled "Regina – Cleaning Up, or Getting Cleaned Out?" I learned about this article from my favorite education source, the NAIC I-Club-List. During discussion on the list about Safeskin, Don Quinn mentioned the article in a post, and I found it at the NAIC Web Site by doing a search on "Regina." Regina's problems were different than Safeskin's, but Mr. Keating puts forth a universal caveat: "Ignore the Balance Sheet at Your Peril!" His "Moral of the Story" is specific to successfully completing an SSG on a company like Safeskin. Read the article, but I will quote his statement: "Calculate the comparative changes in sales, inventories and receivables, year-over-year and quarter-to-quarter." Hey, I am starting to get the message!

Back in October, 1996, Maury Elvekrog, CFA, wrote an article for *Better Investing*, "Psychological 'Unbalance' in Investing: A Matter of Emotion, Not Analysis." Find it in the NAIC archives. Although it does not address my specific case, the article does make it clear that psychology enters into our investment decisions. It's important that I understand why I tuned out Safeskin's negative clues and used such rosy judgment for my SSG.

Barron's online, a subscription site (free with an online subscription to *The Wall Street Journal*), has a deep archive and many good articles covering Safeskin during this period.

The Comparison I Should Have Done

My first stop is the easiest. I look at Value Line, left column, "Current Position." That gives the last two years, plus current through the last reported quarter, cash assets, receivables and inventory. These are balance sheet numbers I must look at. If a company is having problems, sometimes it will show up in these numbers in Value Line by the third quarter. I look to see if cash is down, inventory is up or receivables are up. These trends would require more research. Just the fact that an analyst publicly questioned Safeskin's third quarter numbers is reason enough to check further. The next step is to pull the yearly and quarterly numbers from the SEC reports.

For SEC reports, I normally use: http://www.freeedgar.com.

SALES

	$ (mil.)	Yr./Yr. %	Prev. Qtr. %
'97 Q1	$41.2	—	—
'97 Q2	44.9	—	9.0%
'97 Q3	46.9	—	4.5
'97 Q4	50.0	—	6.6
'98 Q1	53.3	29.4%	6.6
'98 Q2	58.6	30.5	9.9
'98 Q3	61.6	31.3	5.1
'98 Q4	58.2	16.4	(5.5)
'99 Q1	41.8	(21.6)	(28.2)

RECEIVABLES

	$ (mil.)	Yr./Yr. %	Prev. Qtr. %
'97 Q1	$24.1	—	—
'97 Q2	22.0	—	(8.7)%
'97 Q3	21.1	—	(4.1)
'97 Q4	22.2	—	5.2
'98 Q1	25.6	6.2%	15.3
'98.Q2	24.9	13.2	(2.7)
'98 Q3	40.1	90.0	61.0
'98 Q4	32.5	46.4	(19.0)
'99 Q1	32.3	26.2	(0.6)

INVENTORY

	$ (mil.)	Yr./Yr. %	Prev. Qtr. %
'97 Q1	$21.1	—	—
'97 Q2	21.2	—	0.5%
'97 Q3	22.2	—	4.7
'97 Q4	21.2	—	(4.5)
'98 Q1	26.5	25.6%	25.0
'98 Q2	31.2	47.2	17.7
'98 Q3	34.8	56.8	11.5
'98 Q4	37.0	74.5	6.3
'99 Q1	44.8	69.1	21.1

Another great site is: http://www.edgarscan.tc.pw.com. Here, key in "SFSK," then either access the individual filing or what I like to do is click on "hypertextual table." This gives me a great quarterly comparison. (See chart above for my comparisons.)

During a recent discussion on the NAIC I-Club-List about another topic, R&D expenses, I saved a quote from Dean Beeman, a retired CPA. It is something I want to remember. Discussing in-depth financial studies of companies, Dean said in his Aug. 12, 1999 message, "R&D-a Contrary View" thread, "I think most of us don't have the knowledge or information to make the required judgments as to inventory levels, accounts receivable levels, etc. On the other hand, if an analyst or astute investor points these things out to us, we should look at them." I agree. I think it is noteworthy that Wilmoth put her credibility on the line when making public her concerns about Safeskin. I should have followed her lead and investigated her side of the story.

My accounting books tell me ideally, sales, inventory and receivables should increase steadily together. For example, if sales increase 10 percent, inventories and receiv-

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ables should increase about 10 percent. Safeskin's business model hasn't changed, so I expect consistency.

The analyst forewarned me and the numbers bear it out. Sales rise until third quarter 1998, then trend down. I believe this is because distributors have been oversold, can't sell the product or found other competitive sources of product. At any rate, distributors won't take more.

Inventory is climbing in 1998, and reaffirms my thinking. Worse, in third quarter 1998 receivables increased 90 percent year-over-year and 61 percent quarter-over-quarter, again confirming the analyst's warnings. The Solomon analyst was particularly concerned about the 61 percent increase in receivables, only a 5 percent gain in sales, and increasing inventory levels. I must decide if the situation is a temporary blip or a chronic problem. Either way, I should have taken these third quarter downtrends into consideration on my SSG projections and I did not.

QUARTERLY DATA

Last Quarter of Data: Fourth Quarter 1998

Quarter	Sales (Mil.)	Earnings Per Share	Pre-tax Profit
First Quarter FY 1997	$41.2	$0.17	9.61%
Second Quarter FY 1997	44.9	0.18	10.32
Third Quarter FY 1997	46.9	0.22	12.99
Fourth Quarter FY 1997	50.0	0.23	13.33
First Quarter FY 1998	53.3	0.25	14.79
Second Quarter FY 1998	58.6	0.28	16.66
Third Quarter FY 1998	61.6	0.30	16.48
Fourth Quarter FY 1998	58.3	(0.05)	(2.60)

Using quantitative data from the previous chart (if only I had done this in December), coupled with qualitative opinions from my reading, had I been thinking critically, I would have lowered my fourth quarter entry projection for 1998 (after all, making the assumption for fourth quarter sales and earnings is definitely part of using "judgment"), and my SSG would have set off an alarm. I might have considerably lowered my sales and earnings projections going forward. I certainly would have lowered my average high P/E projection for the next five years.

My SSG: What I Did Wrong, and Why

I used bad judgment. That's it, plain and simple. How? I ignored all the negative information I had read about Safeskin's problems during my research, and because in December I had only quarterly information through the third quarter ending September 1998, I projected (and it was my own judgment to do so) the fourth quarter using Value Line's fourth quarter sales numbers. Of course, this resulted in a very, very nice SSG. (Remember, I wanted a reason to buy Safeskin. After all, it had a successful past!) Well, garbage in, garbage out. Had I done my comparative study of sales, inventories and receivables, my fourth quarter projections would trend negative, indeed.

Since I'm working with hindsight, I plug in my May issue of the S&P Datafiles and bring up the quarterly data screen through the fourth quarter in Investor's Toolkit. Remember that I only had third quarter results when I prepared my original SSG, but now I want to see what really happened *(see chart above).*

Yes, there it is. Note in the third quarter sales rose 5.1 percent over second quarter (to $61.6 mil. from $58.6 mil.), and EPS rose 7.1 percent (to 30 cents from 28 cents), but pre-tax profit went down (16.48 percent from 16.66 percent). That one small drop in pre-tax profit, coupled with Wilmoth's predictions in October, should have prompted me to look further into what might happen in the fourth quarter. Looking back, pre-tax profit had been steadily growing right up until the third quarter.

Had I not filtered out Wilmoth's warning and accepted Safeskin management's explanation, I would have compared those balance sheet items quarter-to-quarter and as I noted before, I would have projected the fourth quarter to show a downtrend. Moreover, I would have taken a "wait and see" attitude, and not purchased shares unless the situation turned around.

The Decision I Should Have Made

Sometimes the proof is in the "process." Or should I say, "the proof is in the pudding?" In the December, 1998 period, Safeskin's SSG looked good because third quarter sales were up (remember, sales are booked when inventory is shipped, not paid for) and because I didn't make the proper comparisons to discover a negative trend. I simply used Value Line's fourth quarter estimate to close the year. The quantitative SSG analysis is a snapshot at a point in time, and in December it was the qualitative issues that were key. Those issues were the harbinger of events to follow. In the January, 1999 period, Safeskin's SSG was beginning to alert investors to the trouble that came to pass.

Blindly forecasting the fourth quarter after third quarter 1998, using Value Line's quarterly revenue figures proved disastrous. The real trend was higher inventory and receivables, with lower sales and cash. I projected just the opposite. As I said before, garbage in, garbage out. So I had a great looking SSG because it was built on false assumptions.

If receivables are increasing faster than sales, I should expect trouble. If inventories and receivables are rising, that is even worse. That situation signals not only that the product is not selling, but customers are not paying. In Safeskin's case, is it a problem with products, price competition from competitors, poor management information used to manage sales, inventory and production numbers? Is the problem temporary or long term? Whatever the real reason, the numbers are real and signal trouble ahead.

I sold my Safeskin stock, but I keep it on my watch list. ☐