Pages from the Past

Regina: Cleaning Up? Or Getting Cleaned Out?

by Phil Keating
Southeast Florida Council

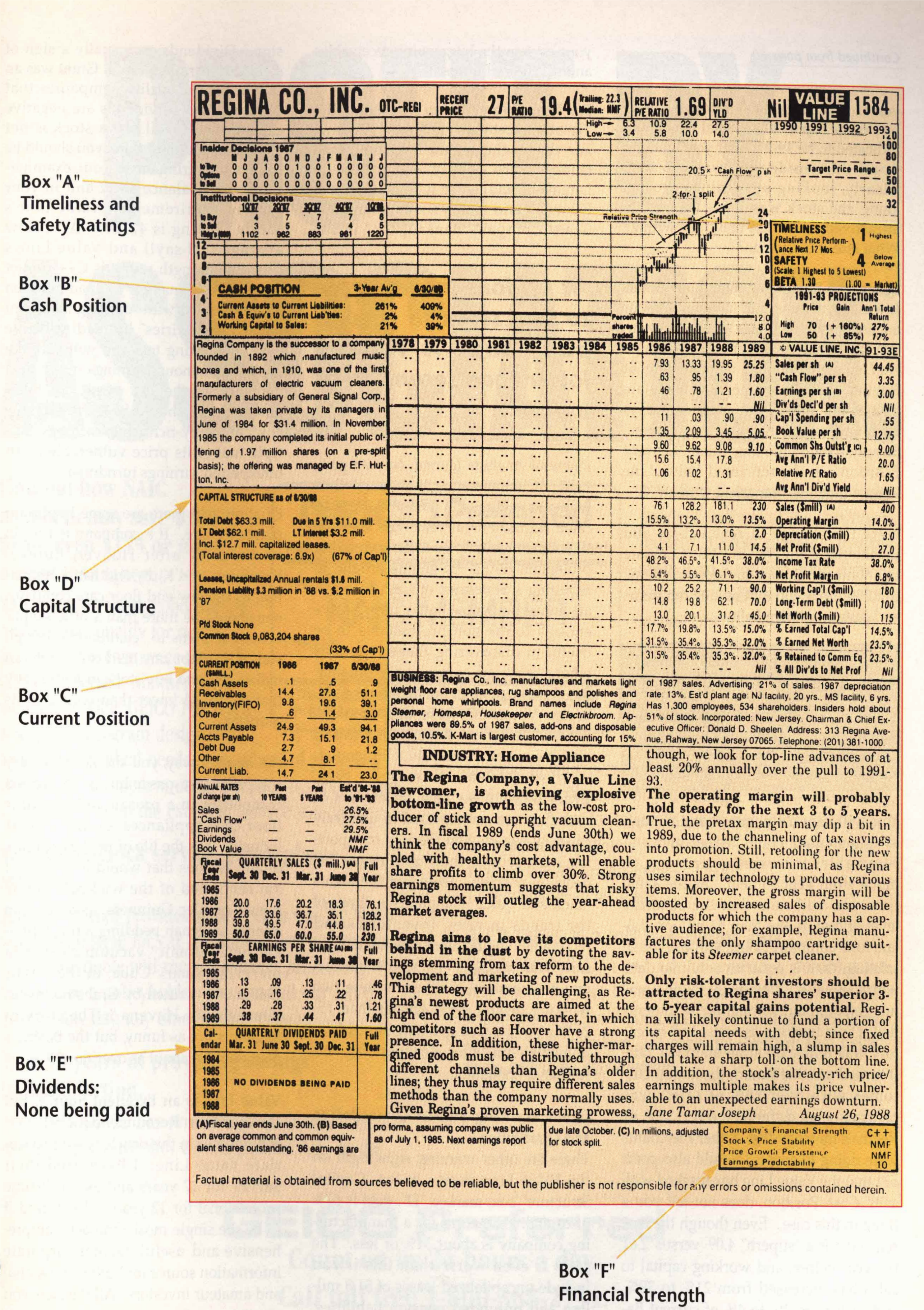
How a quick glance at the balance sheet can keep investors from being left behind in the dust!

"Many times I have seen novice NAIC investors blithely select the stock with the highest earnings per share growth record while naively ignoring other factors such as the quality of earnings and of the balance sheet. The recent example of Regina Co., Inc. illustrates the perils of such a careless approach like perhaps no other corporate example since W. T. Grant more than a decade ago. Fortunately I know of no NAIC investors who were 'bagged' by this 'growth' company, but as the story illustrates, many others including professionals were blown away."

Getting "Bagged"-
The Bait: "Sugar Plum Fairies"

The original Regina Vacuum Cleaner Company was founded in 1892, taken private in June of 1984 in a management-led leveraged buyout, and, brought public again in November, 1985. Over the next three years, reported earnings grew more than 150 percent and the stock price went from 3.50 to 27.00. On August 26, 1988, in its full-page report, (following page) Value Line gave Regina its top #1 rating for timeliness (see Box "A") at 27 per share. This is a rating given to only the top 100 stocks of the 1700 stocks covered by the Value Line Survey. Value Line accurately showed the company's current ratio, the traditional measure of liquidity, as a well above-average 4.09 to 1 (Box "B").

Value Line projected Regina's earnings to grow 29.5 percent per year to $3.00 per share in five years and waxed poetic about "explosive bottom line growth," being "the low cost producer of stick and upright vacuum cleaners," and "leaving its competitors in the dust by devoting the savings stemming from tax reform to the development and marketing of new products." Much of the rest of the text gave the impression that new investors



REGINA CO., INC. OTC-REGI

RECENT PRICE	27	P/E RATIO	19.4 (Trailing: 22.3 Median: NMF)	RELATIVE P/E RATIO	1.69	DIV'D YLD	Nil	VALUE LINE	1584

	1986	1987	1988	1989
High	6.3	10.9	22.4	27.5
Low	3.4	5.8	10.0	14.0

20.5 × "Cash Flow" p sh

2-for-1 split

Relative Price Strength

Target Price Range

Percent shares traded

Insider Decisions 1987

	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J
to Buy	0	0	0	1	0	0	1	0	0	1	0	0	0	0	0
Options	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
to Sell	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Institutional Decisions

	1Q'87	2Q'87	3Q'87	4Q'87	1Q'88
to Buy	4	7	7	7	8
to Sell	3	5	5	4	5
Hld's(000)	1102	962	883	961	1220

TIMELINESS (Relative Price Performance Next 12 Mos.) **1** Highest

SAFETY (Scale: 1 Highest to 5 Lowest) **4** Below Average

BETA 1.30 (1.00 = Market)

1991-93 PROJECTIONS

	Price	Gain	Ann'l Total Return
High	70	(+ 160%)	27%
Low	50	(+ 85%)	17%

CASH POSITION

	3-Year Av'g	6/30/88
Current Assets to Current Liabilities:	261%	409%
Cash & Equiv's to Current Liab'ties:	2%	4%
Working Capital to Sales:	21%	39%

Regina Company is the successor to a company founded in 1892 which manufactured music boxes and which, in 1910, was one of the first manufacturers of electric vacuum cleaners. Formerly a subsidiary of General Signal Corp., Regina was taken private by its managers in June of 1984 for $31.4 million. In November 1985 the company completed its initial public offering of 1.97 million shares (on a pre-split basis); the offering was managed by E.F. Hutton, Inc.

1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	© VALUE LINE, INC.	91-93E
..	..	..	..	..	..	..	..	7.93	13.33	19.95	25.25	Sales per sh (A)	44.45
..	..	..	..	..	..	..	..	.63	.95	1.39	1.80	"Cash Flow" per sh	3.35
..	..	..	..	..	..	..	..	.46	.78	1.21	1.60	Earnings per sh (B)	3.00
..	..	..	..	..	..	..	..	..	..	--	Nil	Div'ds Decl'd per sh	Nil
..	..	..	..	..	..	..	..	.11	.03	.90	.90	Cap'l Spending per sh	.55
..	..	..	..	..	..	..	..	1.35	2.09	3.45	5.05	Book Value per sh	12.75
..	..	..	..	..	..	..	..	9.60	9.62	9.08	9.10	Common Shs Outst'g (C)	9.00
..	..	..	..	..	..	..	..	15.6	15.4	17.8		Avg Ann'l P/E Ratio	20.0
..	..	..	..	..	..	..	..	1.06	1.02	1.31		Relative P/E Ratio	1.65
..	..	..	..	..	..	..	..	..	..	--		Avg Ann'l Div'd Yield	Nil
..	..	..	..	..	..	..	..	76.1	128.2	181.1	230	Sales ($mill) (A)	400
..	..	..	..	..	..	..	..	15.5%	13.2%	13.0%	13.5%	Operating Margin	14.0%
..	..	..	..	..	..	..	..	2.0	2.0	1.6	2.0	Depreciation ($mill)	3.0
..	..	..	..	..	..	..	..	4.1	7.1	11.0	14.5	Net Profit ($mill)	27.0
..	..	..	..	..	..	..	..	48.2%	46.5%	41.5%	38.0%	Income Tax Rate	38.0%
..	..	..	..	..	..	..	..	5.4%	5.5%	6.1%	6.3%	Net Profit Margin	6.8%
..	..	..	..	..	..	..	..	10.2	25.2	71.1	90.0	Working Cap'l ($mill)	180
..	..	..	..	..	..	..	..	14.8	19.8	62.1	70.0	Long-Term Debt ($mill)	100
..	..	..	..	..	..	..	..	13.0	20.1	31.2	45.0	Net Worth ($mill)	115
..	..	..	..	..	..	..	..	17.7%	19.8%	13.5%	15.0%	% Earned Total Cap'l	14.5%
..	..	..	..	..	..	..	..	31.5%	35.4%	35.3%	32.0%	% Earned Net Worth	23.5%
..	..	..	..	..	..	..	..	31.5%	35.4%	35.3%	32.0%	% Retained to Comm Eq	23.5%
..	..	..	..	..	..	..	..	..	..	--	Nil	% All Div'ds to Net Prof	Nil

CAPITAL STRUCTURE as of 6/30/88

Total Debt $63.3 mill. Due in 5 Yrs $11.0 mill.
LT Debt $62.1 mill. LT Interest $3.2 mill.
Incl. $12.7 mill. capitalized leases.
(Total interest coverage: 6.9x) (67% of Cap'l)

Leases, Uncapitalized Annual rentals $1.6 mill.
Pension Liability $.3 million in '88 vs. $.2 million in '87

Pfd Stock None
Common Stock 9,083,204 shares (33% of Cap'l)

CURRENT POSITION ($MILL.)	1986	1987	6/30/88
Cash Assets	.1	.5	.9
Receivables	14.4	27.8	51.1
Inventory(FIFO)	9.8	19.6	39.1
Other	.6	1.4	3.0
Current Assets	24.9	49.3	94.1
Accts Payable	7.3	15.1	21.8
Debt Due	2.7	.9	1.2
Other	4.7	8.1	--
Current Liab.	14.7	24.1	23.0

ANNUAL RATES of change (per sh)	Past 10 YEARS	Past 5 YEARS	Est'd '86-'88 to '91-'93
Sales	—	—	26.5%
"Cash Flow"	—	—	27.5%
Earnings	—	—	29.5%
Dividends	—	—	NMF
Book Value	—	—	NMF

Fiscal Year Ends	QUARTERLY SALES ($ mill.) (A) Sept. 30	Dec. 31	Mar. 31	June 30	Full Year
1985					
1986	20.0	17.6	20.2	18.3	76.1
1987	22.8	33.6	36.7	35.1	128.2
1988	39.8	49.5	47.0	44.8	181.1
1989	50.0	65.0	60.0	55.0	230

Fiscal Year Ends	EARNINGS PER SHARE (A) (B) Sept. 30	Dec. 31	Mar. 31	June 30	Full Year
1985					
1986	.13	.09	.13	.11	.46
1987	.15	.16	.25	.22	.78
1988	.29	.28	.33	.31	1.21
1989	.38	.37	.44	.41	1.60

Calendar	QUARTERLY DIVIDENDS PAID Mar. 31	June 30	Sept. 30	Dec. 31	Full Year
1984					
1985					
1986	NO DIVIDENDS BEING PAID				
1987					
1988					

BUSINESS: Regina Co., Inc. manufactures and markets light weight floor care appliances, rug shampoos and polishes and personal home whirlpools. Brand names include *Regina Steemer, Homespa, Housekeeper* and *Electrikbroom.* Appliances were 89.5% of 1987 sales, add-ons and disposable goods, 10.5%. K-Mart is largest customer, accounting for 15% of 1987 sales. Advertising: 21% of sales. 1987 depreciation rate: 13%. Est'd plant age: NJ facility, 20 yrs., MS facility, 6 yrs. Has 1,300 employees, 534 shareholders. Insiders hold about 51% of stock. Incorporated: New Jersey. Chairman & Chief Executive Officer: Donald D. Sheelen. Address: 313 Regina Avenue, Rahway, New Jersey 07065. Telephone: (201) 381-1000.

INDUSTRY: Home Appliance

The Regina Company, a Value Line newcomer, is achieving explosive bottom-line growth as the low-cost producer of stick and upright vacuum cleaners. In fiscal 1989 (ends June 30th) we think the company's cost advantage, coupled with healthy markets, will enable share profits to climb over 30%. Strong earnings momentum suggests that risky Regina stock will outleg the year-ahead market averages.

Regina aims to leave its competitors behind in the dust by devoting the savings stemming from tax reform to the development and marketing of new products. This strategy will be challenging, as Regina's newest products are aimed at the high end of the floor care market, in which competitors such as Hoover have a strong presence. In addition, these higher-margined goods must be distributed through different channels than Regina's older lines; they thus may require different sales methods than the company normally uses. Given Regina's proven marketing prowess, though, we look for top-line advances of at least 20% annually over the pull to 1991-93.

The operating margin will probably hold steady for the next 3 to 5 years. True, the pretax margin may dip a bit in 1989, due to the channeling of tax savings into promotion. Still, retooling for the new products should be minimal, as Regina uses similar technology to produce various items. Moreover, the gross margin will be boosted by increased sales of disposable products for which the company has a captive audience; for example, Regina manufactures the only shampoo cartridge suitable for its *Steemer* carpet cleaner.

Only risk-tolerant investors should be attracted to Regina shares' superior 3- to 5-year capital gains potential. Regina will likely continue to fund a portion of its capital needs with debt; since fixed charges will remain high, a slump in sales could take a sharp toll on the bottom line. In addition, the stock's already-rich price/earnings multiple makes its price vulnerable to an unexpected earnings downturn.

Jane Tamar Joseph *August 26, 1988*

(A) Fiscal year ends June 30th. (B) Based on average common and common equivalent shares outstanding. '86 earnings are pro forma, assuming company was public as of July 1, 1985. Next earnings report due late October. (C) In millions, adjusted for stock split.

Company's Financial Strength	C++
Stock's Price Stability	NMF
Price Growth Persistence	NMF
Earnings Predictability	10

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would be getting in on the ground floor as Regina attacked the high end floor care market, dominated by Hoover.

Taking a Ride on the Titanic

Unfortunately the "ground floor" was quickly attacked by the stock's price over the next two weeks as it collapsed to 7 in seven days and then fell as low as 3.50 in the next week, an 87 percent decline in two weeks. Regina's auditors withdrew their opinion regarding the financial statements for the just-completed fiscal year of June 30, 1988, commenting that there were serious questions about reported earnings and other matters and that actual earnings for the preceding year could not be readily determined! Within a few weeks the company's Chairman and CEO resigned and faced indictment for fraud. In the Spring of 1989, with the stock trading around 3.50, the company declared bankruptcy.

Shortly after the stock first crashed in September 1988, I was discussing Regina with a broker friend, who like me, was a long-term subscriber to Value Line. She had called me on the phone and I can still hear her lament as she said, "But Phil, how could we have known? It was right in Value Line, ranked at #1! Even an NAIC Stock Selection Guide would have shown the stock to be a buy. What could we have done?" My reply was, "The answer is right there on the Value Line sheet in the balance sheet items!"

Sales and Earnings -- Growth Looked Good on an EvalForm

However, out of curiosity I prepared an EvalForm Stock Selection Guide to see how Regina would have looked at the time Value Line was recommending it, i.e., on August 26, 1988 at 27 per share, .50 below its all-time high. To get six years of data on which to base projections (full data were available on the Value Line sheet from only 1986 on) I used 1986 earnings as the base for 1983, 1984 and 1985 as well. This assumption likely understates both earnings growth and P/E multiples. Even so, this procedure showed a sales growth rate of 21.34 percent which I used to project 1993 earnings of $3.18, very close to Value Line's projections. Using average high and low P/E multiples of 20.5 and 10.4 gave a projected high price of 65.28 and a projected low price of 12.54 for the next five years. The stock was definitely in the buy range (up to 30.12), total return was indicated to be 19-21 percent per year, and the

Phil Keating (seated) is president of NAIC's Southeast Florida Council and vice president and director of the NAIC Computer Group. Also pictured are Hans Steinke, Delaware Valley Council, and Ellen White, Tampa Council.

upside/downside ratio was 2.5 to 1. Clearly, looking at earnings growth alone, the stock was above average in attractiveness. What could go wrong? What else could we do?

Ignore the Balance Sheet at Your Peril!

It was not necessary to have an MBA or a CFA or even a college course in financial ratio analysis to quickly determine that something was very wrong at Regina. You didn't need to calculate any "fancy" ratios such as average days receivables or inventory turnover. Simply look at the box titled "Current Position: on the reprinted Value Line sheet which I have marked with a "C."

Note the change in receiv-

Regina Co., Inc.	1987 (Mill.)	1988 (Mill.)	Percent Change
Sales	$128.2	$181.1	41.3%
Receivables	27.8	51.1	83.8
Inventories	19.6	39.1	99.5
Cash	0.5	0.9	80.0

ables and inventories from 1987 to 1988. Compare this with the change in sales from 1987 to 1988. For clarity these three items and cash are shown below. You will quickly notice that although sales increased 41.3 percent, inventories and receivables increased over twice as much from year to year. At the same time you will note that the absolute level of cash is less than $1 million dollars for a company doing $181 million in sales, i.e., cash is equal to only two days worth of sales. Obviously Regina was not getting paid in cash for shipments that it was booking as sales, and inventory was piling up at an alarming rate! It turned out that Kmart, the largest customer with over 15 percent of sales, was returning as defective over 30 percent of Regina's merchandise. Other merchants were doing likewise. I would also point out that the Value Line box marked with a "B" Cash Position, does not tell you a thing in this case. Even though the current ratio is a "superb" 4.09 versus 2.61 the year before, and working capital to sales has increased from 21 percent to 39 percent, and cash from 2 percent to 4 percent of current liabilities, this company is clearly heading for bankruptcy! It is right there before your eyes in the burgeoning receivables and inventory figures.

For Those Who Want to Go Beyond the Tip of the Iceberg

For those who would like to go into things more deeply, see James A. Largay, III and Clyde P. Stickney, "Cash Flows, Ratio Analysis and the W.T. Grant Company Bankruptcy," in the *Financial Analysts Journal,* July / August, 1980. It is interesting that "only" thirteen years (July 15, 1988, too late to catch Regina's fiscal year end) after the W.T. Grant bankruptcy is the accounting profession (FASB 95) getting around to requiring a Statement of Cash Flows in all annual reports that is informative enough to the non-professional to be useful in discovering these situations where reported earnings are illusory. See Ashwinpaul C. Sondhi, George H. Sorter, Vincent C. Ross, and Gerald I. White, "Cash Flow Redefined: FASB 95 and Security Analysis," Financial Analysts Journal, Nov. / Dec., 1988. Unfortunately the new statements of cash flow are not required in quarterly financial reports and the lags in reporting may reduce their usefulness for decision making. However the above "slick and quick" comparative check of the trends in sales, inventories and receivables should always be used as an early warning sign. I would think that any non-seasonal buildup in these two working capital items greater than 15-20 percent above sales growth should be immediate cause for a caution flag and further investigation.

Other Warning Signs: Quantitative and Qualitative

There are other warning signs right on the Value Line sheet. In the "Capital Structure" box, marked "D," debt is 67 percent of capital. The norm for a manufacturing company is about 34 percent or less. The ratio is even worse than this if you include uncapitalized leases of $1.8 million and unfunded pension liabilities. In the dividend box ("E") you will note, "no dividends paid." This is not a good sign. Dividends are usually a sign of solid cash earnings. (W.T. Grant was an exception and utility companies that borrow to pay dividends are negative exceptions as well.) If a stock is not paying a dividend I think you should be even more stringent in your examination of the balance sheet and in your quality requirements! Value Line's Safety ranking is 4, (Box "A") below average (I'll say!) and Value Line's financial strength rating is C++ (forget the pluses!). Finally if you had not been totally dazzled with "dancing images of sugar plum fairies" by reading Value Line's preceding text: "Only risk-tolerant investors should be attracted . . . the stock's already-rich price / earnings multiple makes its price vulnerable to an unexpected earnings turndown."

Qualitatively there are some important points to note. If a company is fifth in its industry after Hoover, Eureka, Electrolux, and Kirby and has a reputation as the low-end floor care company, one should be more than a little skeptical about plans to "challenge the high end of the floor care market." It seldom makes sense to buy stock in a company that is ranked lower than second in its industry.

Put another way, you should have very compelling reasons to buy a fifth ranked competitor in a prosaic industry like floor care appliances, or any similar industry. For the life of me I can't think of any reasons that would justify it. I am reminded of the wickedly comic scenes of Alec Guiness, as a vacuum cleaner salesman peddling a revolutionary new "atomic" vacuum cleaner in prerevolutionary Cuba, in the classic 1960 movie written by Graham Greene, "Our Man in Havana." The story of Regina is not as funny, but the business plan was just about as overblown.

Value Line is an Excellent Source, But Do Your Own Recommendations!

My purpose in this article is not to excoriate Value Line. I have used their Survey for 17 years and as a full-time professional for 12 years. I still find it to be the single most compact, comprehensive and useful, factual corporate information source for both professional and amateur investors. All the facts you needed to know that Regina was really a "short sale" and not a "buy" were right in the tables. Unlike Value Line, many technically-oriented "investment" services and market letters do not give you the relevant information about fundamentals to make independent judgments. They suffer even more from the potential for taking investors (daily or otherwise) on a ride on an investment Titanic.

Dangers in Black Box Rating Systems

I have always been bemused by Value Line's ranking system even though statistically it has outperformed the market almost every year! It is reportedly a computerized "black box" and focuses on those factors related to "beating" the market over the next twelve months. The two most emphasized factors are the last six months' earnings and price momentum, the one mostly fundamental and the other entirely technical. It is my understanding that the rankings are done mechanically by computer with no human judgment. In fact in order to be successful this is how any "system" must work.

In the past if you could buy all 52 weekly recommendations, aside from commissions and taxes, you would beat the market most years. Obviously it is impossible for most individuals to buy that many stocks, and most institutions would substantially move the market prices up if they tried to buy many of the small capitalization stocks recommended.

Ironically, if you read the full text of the analysts' comments they are usually skeptical about "1" rated stocks, especially with regard to their 3-5 year appreciation potential. You should be even more skeptical especially if the company's financial position looks anything like Regina's did! Finally you need to determine whether your goal is to "beat the market" for the next twelve months, like Value Line's Timeliness ranking attempts to do, or rather to invest regularly for the long-term (3-5 year total return) like NAIC's investment principles stress. I hope I don't need to tell you which approach ultimately "buys more cups of coffee."

The Moral of the Story

Your judgement is very important. Use it! Don't focus only on earnings momentum, earnings growth, or technical market action. Don't just mechanically calculate a Stock Selection Guide or EvalForm. This is especially relevant for those of you like myself who download the excellent EvalForm data files put up on CompuServe's NAIC Forum library by Dick Kenfield.

Look at the underlying facts. As a minimum look at the whole picture, and do as I have learned to do on all my stock studies; calculate the comparative changes in sales, inventories and receivables, year over year and quarter to quarter. This "quick and dirty," simple-to-apply test can help keep you from being "bagged" whether by vacuum cleaner companies or other "full blown" investment fairy tales.

You would be surprised at how many famous professionals don't look at the balance sheet and thus come up short in their investment results.

Perhaps, ultimately, the story of Regina can help us all to better "clean up" in our investing activities.