

A Lesson in Recession

A look at which industries are well-positioned and which are vulnerable for a slowdown in the economy.

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With talk that a recession will soon befall the U.S., I thought that it would be pertinent to do a research study on the 216 industries covered by StockDiagnostics.com with the goal of comparing well-positioned industries with those that may be at risk should a recession come to pass.

In order to best paint this picture, I decided to first use annualized cash flow From operations (CFFO) growth because CFFO increases and decreases are generally a good leading indicator or predictor of future earnings for companies and industries. I then singled out those industries that have had accelerating annualized CFFO growth rates for their last three consecutive reporting periods. I also identified those industries that have had decelerating annualized CFFO growth rates over the same three periods.

The goal of the study was to find those industries that have enough positive momentum to easily propel them through a recession, and compare them with the industries that are on the verge of collapse. By focusing on those industries that have or don't have accelerating or decelerating CFFO momentum, one can more easily find the ones that have less risk, and avoid those that are more risky.

The annualized CFFO for 65 industries has been accelerating over the last three consecutive quarters, and 54 industries had decelerating annualized CFFO over the last three consecutive quarters. The No. 1 industry among the top 20 that have been experiencing accelerating

annualized CFFO growth is the wholesale electronics industry, which, for the most recent 12 months, increased its CFFO by 699%. I found three companies in the industry that are worthy of recommending—each are trading at market caps that are approximately five times their annualized CFFO and growing their annualized sales in excess of 10%. The companies are Arrow Electronics (NYSE: ARW), WESCO International (NYSE: WCC),

and Avnet (NYSE: AVT).

The second-place industry among the top 20 that have accelerating CFFO was engineering services. Its annualized CFFO growth rate accelerated from 55% three months ago to a recent 319%. A company that looks interesting in the engineering services industry is Michael Backer Corporation (AMEX: BKR).

In examining the top 20 industries that had accelerating CFFO growth, I found

Top 20 Industries (according to accelerating positive CFFO growth rates)				
Rank	Industry	CFFO% Recent	CFFO% Three Months Ago	CFFO% Six Months Ago
1	Wholesale Electronics	699.76%	216.99%	-23.40%
2	Engineering Services	319.62%	55.25%	-3.34%
3	Home Builders	255.58%	205.53%	109.29%
4	Wholesale Groceries	154.25%	31.56%	-4.71%
5	Metal Processors and Fabrication	146.40%	130.20%	75.72%
6	Athletic Equipment	115.83%	95.15%	44.92%
7	Retail—Specialty	104.47%	91.12%	56.05%
8	Agrochemicals	99.16%	55.41%	-5.02%
9	Wire and Cable Products	95.36%	27.99%	18.35%
10	Recreational—Racetracks	77.18%	73.80%	66.77%
11	Printing Services	70.63%	32.22%	14.83%
12	Electronic Test and Measurement Instruments	63.55%	45.73%	45.02%
13	Chemicals	56.59%	49.40%	8.24%
14	Retail Computers	54.90%	28.78%	9.53%
15	Wholesale Industrial Equipment	49.54%	27.95%	15.69%
16	Construction Materials	46.55%	20.44%	-20.47%
17	Patient Monitoring Equipment	44.55%	10.88%	-148.59%
18	Computer Graphics	44.25%	43.02%	30.96%
19	Retail Electronics	38.38%	23.29%	19.46%
20	Electronic Components and Parts	37.15%	5.82%	-9.32%

that only two of them—homebuilders and athletic equipment—had declining annualized sales. I also discovered that 11 of the top 20 industries are in the business of providing industrial goods and services and will all likely continue to benefit from a lower dollar and global economic growth. The agrochemicals industry is the most interesting. Its CFFO grew at approximately 100% over its latest 12 months, and every company in the agrochemical industry with a market cap above \$1 billion had increased both its CFFO and sales over the latest 12 months. It's a rare occurrence to find every company in the same industry firing on all cylinders. I'm picking the agrochemical industry and several companies in it, including Terra Industries (NYSE: TRA) and CF Industries Holdings (NYSE: CF), to outperform the stock market in 2008.

The biggest surprise that I found in my search for the top 20 industries was the patient-monitoring equipment industry. Only six months ago, the industry had a negative annualized growth rate of negative 148.59%. Its growth rate subsequently rocketed to 10.88% three months ago, and most recently increased to 44.55%. Most notable is Somanetics Corporation (NASDAQ: SMTS), which appears to be an excellent small-cap growth stock that is emerging as a leader in the industry. Additionally, Somanetics has gross margins in excess of 80% and has a well-established track record of generating consistent quarterly revenue growth.

Surprisingly, the worst industry for negative or decelerating CFFO growth is agriculture, simply because its annualized negative CFFO increased by 236% in its latest period (compared with a 156% increase in negative annualized CFFO only three months earlier). For CFFO growth rates, the agriculture industry currently ranks 212 out of 216 industries. It has not always been bad for the agriculture industry. Its 10-year highest ranking was No. 2 out of 216 industries in July of 2005.

This industry has since hit a wall and is deteriorating rapidly. Every company in the agriculture industry generated declining cash flow over its most recent 12 months. Fresh Del Monte Produce (NYSE: FDP) looks especially risky and is one to avoid. Its annualized CFFO has been declining since it peaked in 2002, and it has gotten progressively negative. Even worse, its annualized sales have declined for its last

three consecutive quarters, and its gross margins have also declined considerably.

Fresh Del Monte and the agriculture industry are in serious trouble. The entire industry is being negatively impacted by foreign producers who have a much lower cost in producing and distributing agriculture products. How can it be that two supposedly similar industries—agrochemical and agriculture—are at opposite ends of the spectrum? Because foreigners are buying agrochemicals from U.S. agrochemical companies so they can produce agriculture products that can better compete against U.S. agriculture companies.

Another industry among the 20 worst (which soon might become a dinosaur) is the entertainment software industry. It came in at No. 7 among the 20 worst, with a 52% annualized increase in negative cash flow over its most recent 12 months, and a industry ranking of 198 out of 216 (compared to a previous ranking of 180 and a 26% increase in negative CFFO for its prior period). The entertainment software industry has fallen hard and fast. For the period prior to the past two, the industry's CFFO grew at a 22.7% clip and

ranked at 58 out of 216 industries. The last time the industry was ranked so low for CFFO growth was in April 2000, when it came in at 210 out of 216.

Will the industry recover? It will be difficult, because a lot of the players of these games are spending more and more time playing games in online communities instead of purchasing software. How do I know this? After my 12-year-old son joined World of Warcraft, an online community estimated to have 6 million players, his interest in games that must be played on video game consoles has completely disappeared, and my wallet has fattened.

Needless to say, the entertainment software industry has generated declines in annualized CFFO in seven out of its last eight quarters; in the 12 quarters prior to the last eight it only had one quarter of declining CFFO. A company that looks particularly vulnerable to eventually going out of business is Take Two Interactive Software (NASDAQ: TTWO). Take Two has generated over \$100 million of negative CFFO over its latest 12 months, and it has generated annualized sales increases in only one out of its last six quarters. **E**

Bottom 20 Industries (according to accelerating negative CFFO growth rates)

Rank	Industry	CFFO% Recent	CFFO% Three Months Ago	CFFO% Six Months Ago
1	Agriculture	-236.67	-156.41	-150.44
2	Medical Laser Systems	-99.43	-43.17	108.31
3	Travel Services	-71.27	-65.05	-38.16
4	Retail Gasoline and Automobile Dealers	-65.56	-60.49	-49.93
5	Heavy Construction	-64.64	-52.32	-11.73
6	Plastic and Rubber Products	-53.77	-40.56	-35.27
7	Entertainment Software	-52.23	-26.21	22.71
8	Cleaning Products	-47.12	-42.86	3.75
9	Building Maintenance and Related Services	-46.95	-10	17.77
10	Pollution and Treatment Control Products	-41.18	-19.63	-13.53
11	Medical-Optical Supplies	-38.93	-19.06	7.73
12	Shipping	-32.36	-32.33	-23.34
13	Auto Parts and Accessories	-26.49	-6.52	0.11
14	Wireless Communications Equipment	-21.93	-17.7	-10.81
15	Pharmacy Services	-21.55	-18.32	-5.44
16	Recreational Activities	-20.49	-18.05	-11.18
17	Retail Apparel	-19.1	-16.21	-3.62
18	Retail Department Stores	-17.13	-11.91	7.47
19	Data Processing	-17.02	-13.43	-10.33
20	Semiconductors	-13.47	-11.3	-3.1