

OPS WINNERS & SINNERS

Storm clouds on the horizon



BY MICHAEL MARKOWSKI

In May, the Dow Jones came within 100 points of its all time high, but the storm clouds appeared on the horizon, bringing a chill wind. My 2006 financial forecast has been dampened by steadily deteriorating cash flow conditions, which are indicating a slowdown or downturn in earnings momentum during the second half.

Cash Flow From Operations (CFFO), not to be confused with EBITDA, is a reliable indicator or predictor because it monitors a company's balance sheet components including receivables. Receivables tend to peak or grow faster at the top or near the end of a business cycle as companies maturing product lines get closer to the end of their life cycles.

Businesses grant more favorable credit terms to their customers (better terms on receivable financing) in order to clear their shelves of aging products, and the result is that a company's Sales or Revenue grows at a faster rate than its Cash Flow From Operations (CFFO). The growth in receivables or the increase in the ratio of receivables to revenue increases the volatility and unpredictability of a company's future earnings because a portion of those increasing receivables are inevitably written off for non-payment in future quarters.

For the twelve months ending January 31, 2006, the aggregated revenue for non-financial companies in the Dow Jones Industrials increased by 7.1% while the cash flow (CFFO) decreased by 2.3%. Revenue for the Nasdaq 100 improved by 8.0% compared to a modest increase in its cash flow (CFFO) of 0.9%. The revenue for the S&P 500 increased by 6.4% but its cash flow (CFFO) increased only slightly by 0.1%. This negative trend where revenue growth has been significantly higher than cash flow growth began in July of 2005 for both the Dow and the S&P and in October of 2005 for Nasdaq.

If this trend continues, there will be a significant increase in negative earnings surprises beginning in the second half of 2006. Given my stormy weather scenario, I would focus on today's winners; energy stocks that have CFFO growing faster than revenue. They are international oil companies, Harvest Natural Resources, Inc., (NYSE:HNR-13.65) which has generated a 27.3% increase in revenue and a 54.07%

increase in CFFO over its latest 12 months and Valco Energy (AMEX:EGY-8.18) with an increase in revenue of 50.9% and an increase in CFFO of 57.6% over its latest 12 months. Other winners could be drillers Grey Wolf (AMEX:GW-7.50) with annualized revenue increases of 64% and increasing CFFO of 390% and Parker Drilling (NYSE:PKD-7.10) which generated revenue increases of 43% and CFFO increases of 325% over its latest 12 months.

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Other possible winners in the second half are stocks positioned for positive surprises. They include those companies that have generated positive CFFO for the first time ever in their most recent quarters. These include Sirna Therapeutics, Inc. (Nasdaq:RNAI-5.56), BioSphere Medical, Inc. (Nasdaq:BSMD-5.78), Specialized Health Products International, Inc (OTCBB:SHPI-0.46) and Identix Incorporated (Nasdaq:IDNX-6.41). Two turnaround candidates based on accelerating CFFO momentum are Centillum Communications, Inc. (Nasdaq:CTLM-3.09) and Russ Berrie & Co, Inc. (NYSE:RUS-12.51)

Finally come our sinners that have been reporting positive earnings growth but have been generating decelerating and negative CFFO. These stocks should be completely avoided or shorted. They are SigmaTron International, Inc. (Nasdaq:SGMA-8.54), Espey Manufacturing & Electronics Corp (AMEX:ESP-17.80), SBS Technologies, Inc. (Nasdaq:SBSE-16.43) and Exactech, Inc. (Nasdaq:EXAC-13.76).

MICHAEL MARKOWSKI is founder of *StockDiagnostics.com* and utilized its CFFO (Cash Flow from Operations) and OPS (Operational cash flow Per Share) metrics to predict the bankruptcies of several large companies and in *EQUITIES* in early 2005 General Motors' looming serious credit problems. *StockDiagnostics.com* publishes current and historical cash flow metrics on over 8,000 companies.