Forbes.com

Money & Investing

Scandal Stocks

Erika Brown 01.08.07

Want a cheap growth stock? Get one tainted by an investigation into options backdating.

A stock damaged by scandal can be a great buy. Consider Tyco International, laid low by the larcenous behavior of its boss, Dennis Kozlowski. If you had bought Tyco shares in 2002, just after Kozlowski resigned under pressure related to a criminal investigation, you'd be up threefold.

Options backdating is the latest scandal to roil Wall Street. Over the past year dozens of companies, among them Brocade, Home Depot and Apple Computer, have confessed that executives backdated options grants to days when shares were cheap, giving the options an artificially low strike price. Fear that earnings might have to be restated or that executives could get ousted or arrested sent stocks tumbling.

In some cases the selling was overdone. Shares of software maker Mercury Interactive declined 43% to $25.60 in five months after word hit Wall Street in June 2005 that the company had "misdated" options. A year later computer maker Hewlett-Packard agreed to buy Mercury for $4.5 billion, or $52 a share.

Alexander Slusky, a managing partner of Vector Capital, a technology-focused private equity firm in San Francisco, thinks fears of options-related repercussions are exaggerated and that some companies with strong businesses are selling at low prices. Slusky's group recently compiled a list for us of 85 companies under backdating scrutiny. His argument for looking at this list for buying opportunities: Restatements for backdating, as opposed to earnings fraud of the WorldCom variety, don't have a significant financial impact.

We refined Slusky's list by kicking out companies with per-share declines in either sales or operating cash flow over the past three years. (Cash flow from ops, shown in an annual report following the profit-and-loss statement, is roughly equal to net income plus depreciation.) In addition, we tossed out any stock that is not trading at least 15% lower than its 52-week high.

One more hurdle: To get on this list a company had to be cheap in relation to its growth rate. More precisely, we wanted to see an annualized growth in sales over the past three years that was higher, in percentage points, than the enterprise multiple. The latter is a sort of all-inclusive price/earnings ratio. You get it by dividing enterprise value (common market capitalization plus debt net of loose cash) by operating earnings (net before interest, taxes and depreciation).

In October Asyst Technologies admitted to backdating options prior to February 2004. As a result, it would take a $19 million charge, including taxes, or 4% of annual sales. At $6.30, its stock is trading at a 44% discount to its 52-week high; at that price, Asyst has an enterprise multiple of seven, the lowest in our table. The company, which makes automation systems that keep semiconductor wafers clean during processing, has increased sales per share at a 16.8% annual clip the past three years.

Molex makes electrical components for the communications, consumer and automotive markets. In August its board found 12 years' worth of options irregularities and the board then told some executives to return $685,000 of realized gains to the company. The stock's enterprise multiple is 40% lower than its sales growth rate. More bad news may yet surface: The U.S. Attorney for Northern Illinois has subpoenaed its financial documents.

Under Scrutiny, Undervalued

These cheap, scandal-hobbled stocks are for companies with strong sales growth—and they should recover nicely.

COMPANY/BUSINESS	PRICE RECENT	PRICE 52-WEEK HIGH	ENTERPRISE MULTIPLE[1]/ SALES GROWTH	ENTERPRISE MULTIPLE[2]	3-YEAR SALES/ SHARE GROWTH	MARKET VALUE ($BIL)
APOLLO GROUP/colleges for working adults	$38.75	$71.59	0.4	8	22.3%	$6.7
ASYST TECHNOLOGIES/electronics manufacturing equipment	6.30	11.20	0.4	7	16.8	0.3
CAREMARK RX/pharmaceutical services	49.51	59.89	0.3	11	40.2	21.1
MAXIM INTEGRATED PRODUCTS/integrated circuits	31.40	42.99	0.7	11	17.0	10.1
MOLEX/electronic connectors	33.16	40.10	0.6	10	16.8	6.1
NEWPARK RESOURCES/environmental and oilfield services	6.17	9.65	0.6	9	13.3	0.6
UNITEDHEALTH GROUP/managed health care	49.66	64.61	0.4	9	20.3	66.9
WITNESS SYSTEMS/software	18.02	25.48	0.8	25	30.4	0.6

Prices as of Dec. 7, 2006. [1]Enterprise multiple divided by three-year annual sales-per-share growth rate. [2]Enterprise value (market value plus net debt) divided by operating income (earnings before interest, taxes, depreciation and amortization). *Sources: Vector Capital; Reuters Fundamentals via FactSet Research Systems.*