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Bad Hare Day

By ALAN ABELSON

Magicians are a tough act to follow. Don't take our word for it -- ask Samuel Palmisano. Mr. Palmisano succeeded Louis Gerstner as the main man at IBM. And when it comes to pulling rabbits out of the hat, Mr. Gerstner has no peers. Poor Mr. Palmisano; he takes over and -- just like that! -- it's a bad hare day.

Obviously, we're speaking metaphorically. Mr. Gerstner doesn't go about in a top hat, tails and patent-leather shoes, armed with a wand. But somehow, quarter after quarter, year after year, he performed the impossible: conjuring up profits out of the blue.

Of course, if you knew the tricks of the trade, it wasn't all that difficult to make out the source of Mr. Gerstner's sorcery. But, a master of suspense, he liked to vary his shtick. Sometimes he'd fiddle with pension assumptions. Or transform an everyday expense into an extraordinary one. Or tap a rock and produce a windfall to buoy the bottom line.

This is not to say he relied solely on one-off stuff. He had a long-running routine as well. Which consisted, right before your eyes, of shrinking the number of shares IBM had outstanding, while -- presto! -- simultaneously enlarging earnings per share. And no matter how many times he worked that old chestnut, the crowd went wild (and, more often than not, so did the stock).

The gig, it's no secret, involved buying up shares to shrink your capitalization. And that takes real money. Mr. Gerstner's bag of marvels regrettably did not include an incantation that would make money grow on trees, so he had to turn to friendly bankers or willing bond buyers for the dough. That's what you do when you want to "enhance shareholder value" -- that is, goose the price of your stock -- when your business isn't earning enough hard, cold cash to let you practice your legerdemain.

While the trick worked wonders for the stock, it did increasingly sully a once-pristine balance sheet. But until this year's rash of blockbuster bankruptcies changed perceptions, the prevailing view on the Street was that to borrow big was to think big and thinking big deserved a big multiple. Only wimps worried about balance sheets.

For all his skill as a prestidigitator, Mr. Gerstner wasn't able to summon even the illusion of growth: In his nine years at the helm, IBM's revenues gained an average of 4.01% compounded annually, which does not quite equate with any reasonable definition of a growth company. But, hey, even Houdini wasn't perfect.

Mr. Gerstner's magical touch was sorely missed last Monday, when Mr. Palmisano took center stage and confided to the world that the first quarter would not be as good as advertised. More specifically, he mournfully cautioned that earnings would run between 66 cents and 70 cents a share, woefully short of Street estimates of 85 cents, to say nothing of the 98 cents a share posted at the same time last year. Mr. Gerstner, alas, in bowing out, apparently took his rabbits with him.

No doubt adding to Mr. Palmisano's discomfort was the fact that it was the first such warning issued by IBM in over a decade (perennially upbeat and solicitous of investor feelings, Mr. Gerstner saw no need for such rebarbative announcements when they could be avoided by simply mellowing the numbers). The reaction of the market was both predictable and nasty: IBM's shares got whacked a full 10%.

Shocked by the naked truth, some analysts were unable to come to terms with the idea that just conceivably IBM was now in the hands of an anti-illusionist. Thus, with the characteristic ingenuity of the breed, one analyst suggested that Mr. Palmisano might be pulling a kind of reverse Gerstner by deliberately understating earnings, so as to make future comparisons look better. Maybe we lack sufficient cynicism (a chronic fault, incidentally), but we suspect that even the most Machiavellian corporate chieftain might feel $17 billion in lost market value in a single session was too rich a price to pay for looking better.

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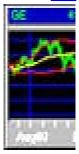

The collapse of IBM's stock -- it started the year around 125 and, last we looked, was some 40 points lower -- and the rupture of the skein of bullish revelations issuing from Armonk -- are confirmation that the magical Lou Gerstner era is over. And we must confess, we'll miss it. What it proved is that you can fool all of the people some of the time and some of the people all of the time, and, as someone once said, that's enough.

GE is still no. 1. It demonstrated that convincingly last week when, four days after IBM's bombshell blew up its stock, the company reported its very own disappointing results: flat sales and lower earnings for this year's opening quarter. And the reaction of its stock to the unpleasant surprise was to lose twice as much in a single session as had IBM's shares -- $35 billion, to be more precise.

Which probably made Jack Welch proud. Not the fact his old company's stock tanked. But, rather, that even on the downside, GE was not going to be outshone by IBM, or anyone else on the face of the earth, for that matter. (Jack, rumor has it, still wakes up in a cold sweat in the middle of the night remembering that brief but awful moment when Cisco boasted a higher stock-market value than GE.)

Mr. Welch was no slouch, of course, at working minor miracles to keep GE's fantastic (in every sense of the word) winning streak alive when he was running the show. If you needed a digit to make those double-digit earnings gains that GE was famous for, why he'd pluck one out faster than you could say "lower pension contribution."

But Jack Welch is gone and, eerily like Mr. Gerstner, he obviously took the magic with him. Mr. Welch's successor, Jeffrey Immelt, sports the hash marks -- he has two decades under his belt at GE -- but, off last week's rueful disclosures and stock performance, has yet to master the fine art of creating profits on demand, an art of which, as intimated, Jack was a true master.

Unlike Mr. Gerstner, who surrendered his post a few years ahead of compulsory retirement, Mr. Welch had no choice (although he managed to put off the inevitable by trying to lasso Honeywell, a game effort that was stymied by fusspot European regulators). The investment moral, though, is the same: When an extraordinary corporate shaman, who has guilefully guided the company to vast riches and huge reputation, departs, it's time to sell.

The fall of the stocks of the two great financial icons in a single week also speaks eloquently to the new and meaner post-Enron environment. Even the most sacrosanct no longer are above suspicion. Fun and games are out. Probity and prudence are in. Awful, isn't it?

How long those bleak imperatives hold sway is anybody's guess. But, at the very least, investors should be aware of their dominating presence, and should be especially wary of new dogs performing old tricks.

Any current compendium of "How the Mighty have Fallen" would be incomplete without the inclusion of AOL Time Warner. We're not suggesting that this issue of the somewhat benighted union of the leading Internet provider with the magazine-cum-entertainment conglomerate is quite in the same league as IBM or GE. But it's undeniably a biggie; at the time of the merger, two very long years ago, the combo was valued at north of $100 billion.

Nor is there much argument that in terms of investment stature, these days AOL Time Warner doesn't rank very high, let alone mighty. Last week, in fact, the shares, which in the past year sold over 58, broke 20, depressed by an ugly host of concerns, ranging from high-profile management changes to financial burdens. Its latest plunge carried the stock to a new low in its present incarnation and light years away from the 95 reached by AOL in 1998, when dot.com fever was in full rage.

Among other things, AOL is one of the prime casualties of the more stringent Wall Street climate. As a Web wunderkind, it embodied all the sins of the bubble market of the late 'Nineties. Management's projections often were laced with hope and hype, and its approach to earnings and that sort of stuff seemed engagingly casual. It was far more serious about its stock and rightly so, since the stock was easily its most valuable asset and one that it used freely to expand its horizons both here and abroad.

AOL must be credited with a sharp marketing edge and it has doggedly held on to its leading position as an Internet provider against some stiff competition, from outfits that gave away the service for nothing (most of which, it grieves us to note, have gone away) as well more substantial jousters, including Microsoft.

Not the least of the things that AOL had going for it in stock-market allure was its appeal to the Street's young guns, who could fully connect with the company's hip-hop qualities, and who, lest we forget, from their perches in both mutual and hedge funds, were a powerful force in the blazing markets of '95 through early 2000.

Many a time and oft, we have given voice to our skepticism about AOL; the valuations granted the company seemed downright ridiculous and, in retrospect, they seem even more so. But, then, in all the thousands of words this column has wasted on Internet stocks, we only remember a very few that weren't querulous and those happen to be the only ones we regret.

As indicated, our reservations on AOL (both before and after it linked up with Time Warner) have been of the "emperor has no clothes" variety. For more analytical critique, we turned to Doug Kass, who runs a hedge fund dubbed Seabreeze Partners and whose name and sentiments have popped up more than once in this space. On AOL, Doug boasts what we consider impeccable credentials: He was unwaveringly bearish from the autumn of '99 through late last year.

That doesn't mean he has been short every day of that stretch.

But throughout, he has traded the stock, always on the short side, and made a fistful of dough doing it. Doug refused to swallow either management's frothy calculations of future growth of cash flow (20-25% a year) and its insistence that it was immune to the normal tugs and pulls of the business cycle or Wall Street's dreamy confections that were supposed to justify paying looney prices for the stock.

It was Doug, too, who brought to light here the fact that AOL was going to have to fork over $7 billion to buy out its German partner in AOL Europe because of an agreement forged at the peak of the Internet mania.

So why is he suddenly bullish on AOL?

Good question and our first thought was, well, he suffered a temporary (we hoped) loss of bearings. However, Doug assures us that he's still sound of wind, limb and mind. It's just that the market in its own inimitable fashion has taken full measure of the negatives he found so egregious in AOL, with this result: The stock has been beaten down so much and its price reduced so sharply, that AOL's valuation is now powerfully attractive.

He foresees cash flow growing a moderate but plausible 5-10% a year. AOL's "enterprise value" (a phrase that trips lightly off everyone's lips, so it must be important) as a multiple of cash flow is selling at a discount to Viacom, a major competitor, for the first time in years. And he's confident that, in the fullness of time, an improving economy will revive ad revenue at the company's magazines and online. He also sees Microsoft's recent hint that it may raise its Internet fees as possibly sparking a surge in subscriptions for AOL.

Frankly, we're willing to grant Doug points here, but we don't find the arguments overwhelming. We're far more impressed by his observation that the stock has made the painful transition from "investment darling" to "pariah," which, in our askew view, means it can't be all bad.

And we find virtually incontestable his reasoning that when cable-mogul and shrewd-operator John Malone expresses interest in expanding his stake in AOL, as he has, and the bruised mutual fund, Janus, cleans out its monster position in AOL acquired at ghastly higher prices, as it reportedly has, the stock has got to be a Buy.

He thinks the shares, now 20, have a good shot at 35. And, as usual, Doug's put his money where his mouth is.

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Return to top of page | Format for printing