

Taking Stock: Circuit City needs a rewiring

by Malcolm Berko

Dear Mr. Berko: In 1999 I bought 75 shares of Circuit City Stores at \$31 (split adjusted) and sold them at \$58 less than a year later. I watched the stock fall to \$5 in 2003 but didn't have the guts to buy 1,000 shares. The stock is down to \$19 from \$31 last year and I am thinking of buying 300 shares. Please give me your thoughts on this stock. Goldman Sachs has a "buy" recommendation on the stock. Do you think it can move back up to \$25 in the next 12 months?

W.P.

Fort Walton Beach, Fla.

Dear W.P.: Circuit City Stores Inc. (CC-\$19) retails elaborate video and audio equipment, sophisticated consumer electronics, complicated computers, complex software and accessories and other moderate to high tech products that only an engineer from Georgia Tech or MIT can operate. Because CC had a disastrous third quarter, management decided to fire 3,400 of its highest-earning salespeople (about five salespeople per store) and replace each of them with dorks who will work for less.

Top salespeople at CC's 665 stores earn between \$38,000 and \$51,000 and management reckons it can save about \$15,000 per salesperson, or \$60 million, by substituting idiots who will work for less. Certainly an eloquent example of the dumbing down of America.

Circuit City is a great place to shop, the stores are bright, big and roomy, they have inventory up the wazoo and their revenues have grown steadily, doubling too nearly \$14 billion since 1996. However, in the last 10 years, CC's earnings seem to flutter up, move sideways, crash down, fall lower, skid sideways again then tumble out of control like a kite in a heavy wind. Something is grossly out of whack with this company and the next couple of years are a concern.

The crashing home market is certain to dampen sales of TVs, appliances and audio systems. Discounters (Wal-Mart, Target, Costco, BJ's Warehouse, etc.) are targeting CC's customer base with much lower prices and some believe the consumer has maxed out his credit and that his wallet is notably thinner.

Meanwhile, Best Buy Co. Inc. (BBY-\$47), CC's nemesis, has twice the operating and profit margins of Circuit City; its stores sell twice as much merchandise. BBY has predictably increasing earnings and superb customer service that makes use of a bright and well-compensated staff called "The Geek Squad." These lads and lasses assist customers with their purchases of satellite systems, appliances, home theaters, audio systems, flat-screen TVs, DVD players, mobile electronics, digital cameras, camcorders, make alternative

recommendations, advise on product quality, demonstrate competitive equipment and provide installation assistance. These Geeks earn, on average, about \$45,000 a year. However many of the same economic reasons affecting CC's future revenues will also dampen BBY's revenue and earnings growth over the coming few years.

So what's CC's problem? In just one word: "management" or should I say "lack of management." The proof is in the pudding because in the past 10 years, BBY's revenues have grown fivefold, earnings have increased every year and the company has over \$2 billion in cash flow. CC's management and board of directors is a bunch of lost souls. Best Buy and Circuit City sell the same products at relatively the same price. BBY expects \$40 billion in 2007 revenues from 771 stores and expects to make \$1.5 billion this year. CC may book \$14 billion in revenues from 655 stores and believes it will net \$165 million in 2007.

CC needs an entire makeover in the boardroom, in the executive suite and in the field. Failing that, I wouldn't go near the stock with a flamethrower. Unless CC has a thorough housecleaning, the company could experience a brutal corporate metathesis. And right now, I think the vultures are beginning to circle the corpse. Don't buy the stock.

Yes, Goldman Sachs does have a "buy" recommendation on CC and Goldman also owns 22 million shares of the stock. Goldman had a "buy" on CC when it owned the stock at \$31 in June of last year. While the stock plummeted to \$18, Goldman steadfastly maintained its "buy" recommendation. But you must know that Goldman has been hired by Circuit City to explore the sale of some of its subsidiaries. Apparently the New York Stock Exchange and Chief Executive Officer John Thain fail to see this as a conflict of interest.

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