How to Pick Winning Retail Stocks, Pt. 2

Shopping for names in this sector starts with your own habits.

BY WAYNE BURRITT
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I really enjoy the process of picking retail stocks, and I wanted to give you a behind-the-scenes look at how I look for winners in the sector. In part 1 , I led you through the first steps of retail-stock selection:

- Select retailers you know something about.
- Make sure the retailer's stock is public.
- Check for sufficient market capitalization, share size and liquidity.
- Look for an attractive technical uptrend.
- Focus on stocks with attractive valuations.

Now I'll drill even deeper into the key fundamentals that I consider before I take the plunge on a promising retail stock.

Peer Standing

At the end of the first part of this stock-picking journey, the universe of retail stocks had come down to a handful that looked attractive. But there's more work to do.

The next thing to figure out is where each retailer stands in its marketplace. Is it a gorilla, a medium player or an up-and-comer? Figuring that out requires key financial data on each of the prospective winners and its competitors.

Not so long ago, this would have been a monumental task that would have required scouring each company's filings with the **Securities and Exchange Commission**, such as 10-Ks and 10-Qs, and crunching a bunch of numbers.

Now sites such as Yahoo! Finance Industry Center or *Reuters* make this information easy to get. Typing in a ticker symbol yields a table of key data points on the retailer in question and its competitors. I sort this table by market cap from the biggest company to the smallest. Where does my retailer fit into the mix? Is it a smaller player or does it dominate its peers? Note the result on the list of potential stock picks and move on to the next one.

Two Key Points

Then compare the retailer with industry averages on two data points:

1. net profit margin (net profits divided by sales)

2. long-term debt-to-equity ratio (long-term debt divided by equity)

In both cases, the target stock needs to be in line with industry averages or better. For profit margin, that means my retailer must meet or exceed the industry average. For the long-term debt-to-equity ratio, my retailer must meet or be less than the industry average.

These two data points give me a quick, convenient look at the company's profitability and debt structure. I only want companies that are performing in line or better with competitors and have similar or better debt structures. Those retailers that don't meet the grade get crossed off my list.

I repeat this process for every retailer on my list. That may sound daunting, but after you get the hang of it, things move along quickly.

Three Fundamental Factors

At this point, I'm usually down to two or three solid candidates, but I'm not quite done. I now need to check out long-term growth rate, margins and recent financial performance. *Reuters* is a good, free source for this information.

For long-term growth rates, I'm looking for rates of growth in sales and in profits that meet or exceed industry averages for a significant time period, which I define as five years. That shows that a retailer can deliver over a significant period and can weather the ups and downs in the retail business, a huge plus because there are many. This is not a stable sector.

Then I look at how my retailer's key margins -- gross margin, operating margin and net profit margin -- stack up. Again, I'm looking for them to meet or exceed industry averages. I want to make sure my retailer is keeping its operations lean and mean. That's especially important in retail, where a basis point or two of margin improvement can be huge.

Now, if my target retailer doesn't shape up on all counts, I don't necessarily eliminate it. It's subjective, but I weigh the factors, with a bias toward growth; if the margins are off, long-term growth could make up for it.

I also want a view of how the company has done recently, so I dig up its latest quarterly financial statements. This gives me a good idea of what's happening near-term. I'm looking for solid top- and bottom-line growth, same-store sales growth in line with historical norms and with competitors' growth, and any new catalysts and changes going forward.

I may even listen to the company's latest conference call. If it's not earnings season, I can often find a podcast on the company's investor relations Web site. Listening to the quarterly conference call is a good way not only to review and get new information but also to get a feeling for the key managers and their style. Sometimes transcripts are also available, which is nice if you like to make notes.

Check SEC Filings

By now you know your retail stock candidates pretty well. There's still one more level of research to dig into: SEC filings. You can find these on the SEC's Web site, often on the company's Investor Relations Web site or even through Yahoo! Finance.

Start with the 10-K, an annual filing loaded with excellent information that can include the company's history, retail platform and growth, as well as its outlook for the coming year, strategy, competitors and management. Because of its depth, the 10-K is usually better than the company's Annual Report and quarterly filings.

Here's what I'm looking for:

A company with a solid history that's weathered a number of cycles in the retail business. That proves it can react to changing retail demand environments over a significant stretch. As with long-term growth rates, a good rule of thumb is five years or more.

A good retail platform that shows consistent growth. You're looking for consistent store growth and solid same-store sales over the long term.

New store concepts. Retail concepts are cyclical: They grow, mature and decline. Sure, it can take a long time for that to happen, but you want to see retailers try new store concepts. That way they can leverage their existing retail prowess and find a new niche that could deliver faster, newer growth down the road. On the other hand, some concepts are going to be duds. Don't freak out. Just make sure management isn't expanding the new concept until it has the kinks worked out.

Upper management with seasoned backgrounds. Even better is a long-term track record with the current company in various positions. That shows that upper management knows the company from the inside out.

Strong catalysts for strong growth next year and beyond. Find out what your retailer plans to do differently this year and next. Sure, if a company has gotten this far in your research process, it has a solid fundamental track record. But what's going to keep that furnace stoked? Look for something new and exciting that will get shoppers fired up.

If you haven't already done so, check out the company's Web site. A solid Web presence is essential to any retailer these days. Look for an easy-to-use, user-friendly Web site that makes shopping a snap. If the retailer's Web site doesn't blow me away, I'd still move forward with the trade, but I'd look for some Web site improvement in the future.

At this point, you probably already have picked which retail stock will be your next purchase. But before you send your order, scan the latest news on the company to make sure nothing significant has popped up recently.

Then pull the trigger, and you should be able to sit back and enjoy the ride.

At the time of publication, Burritt had no positions in the stocks mentioned, although positions may change at any time. Wayne Burritt is president and director of equity research for Burritt Research, which operates BurrittResearch.com. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Burritt appreciates your feedback; **click here** to send him an email.

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