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Stupid Investment of the Week

Commentary: Finish Line shares deserve no trophy

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- If you're an athlete in search of appropriate footwear or something hard to find, a Finish Line store with as many as 1,000 choices of sneakers and casual shoes is a shopper's dream.

That said, the Indianapolis-based company could be an investor's nightmare. Its shares are priced near the high end of their valuation, with some muddy off-balance sheet issues that could make buyers feel like they've just stepped into the Stupid Investment of the Week.

Stupid Investment of the Week showcases the concerns and conditions that make a security less than ideal for the average investor. It is written in the hope that highlighting danger in one issue will make trouble easier to avoid elsewhere. While obviously not a purchase recommendation, neither is this column intended as a mandatory sell signal, as there may be times when unloading a worrisome investment simply compounds the problem.

Stock market volatility suggests higher prices

Key measures of stock market volatility, such as the Vix and VStoxx, indicate that stocks are likely to climb. But a consensus view of a 10% rise could be wrong.

Gain-ending play

For investors in Finish Line Inc. (NASDAQ:FINL) , the real concern in selling might be capital gains, as the stock is coming off consecutive triple-digit years. While the average stock fell about 40% in 2008, Finish Line shares were up 134%. They barely slowed when the market rebounded in 2009, jumping another 125%-plus. Those gains seem enormous, but they followed three straight years of losses, and the 83% drop in 2007 was so big that an investor who had the stock in January of that year is still waiting to break even, despite the huge runs of the last two years.

Clearly, this is a stock where the volatility runs in both directions; and the question for investors now is whether the tide may be rolling out.

Finish Line was started by guys who were running franchises for one of its competitors, The Athlete's Foot, when they broke away on their own in the mid-1970s. Today, the chain has more than 700 stores in 47 states.

There have been some missteps along the way. The company started the Man Alive chain -- urban-inspired fashions -- but sold that unit last year. A proposed 2007 acquisition of Genesco (NYSE:GCO) , which operates several popular fashion retailing brands, fell apart and dissolved into a mess of lawsuits and settlements. Some of the effects of those deals linger on, in the form of asset write-offs and more.

While the stock was busy running up over the past two years, Finish Line's operating margins were getting squeezed, going negative in 2008 and just barely into the black a year ago. Not surprisingly, return on equity went the same way. While Finish Line pulled a bit of a surprise when it delivered a profit for the third quarter of its current fiscal year, those results were boosted by one-time gains stemming from the Genesco mess. Sales were roughly flat.

Flat-footed

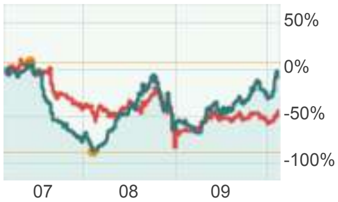
Finish Line's business is hardly in an enviable competitive position, as the domestic market for athletic shoe retailing is saturated, and primary competitor Foot Locker (NYSE:FL) is the dominant player. Because the bigger retailers -- including companies like Dick's Sporting Goods (NYSE:DKS) -- have more bargaining power, it's hard for Finish Line to negotiate the great deals with major suppliers. As such, every promotional battle and special with those other operators is more damaging to Finish Line's already-squeezed margins.

FINL **11.99**, +0.23, +1.96%

FL **12.25**, -0.18, -1.45%

Moreover, some industry watchers believe that with a reputation for selling high-end performance footwear, Finish Line is more sensitive to the economy than some of its competitors. That could mean customers will continue migrating to the discounters if the economic recovery doesn't gather steam.

One big worry for the stock right now is that two years of triple-digit gains has lifted its valuation dangerously high.



Said Mark Coffelt, manager of the Empiric Core Equity fund (FUND:EMCAX) : "If they exceed expectations [when earnings are reported in late March], investors might get a short-term bump in price. If they miss, investors could get pretty good downside, perhaps 10% to 15% over a couple of days. Insiders have also been net sellers. ... Also, inventory turns have fallen from 3.5 turns the previous quarter to 2.9 turns in the latest quarter, suggesting that they may get some markdowns."

David Trainer, president of New Constructs, a Nashville-based research firm, suggests that things are more perilous than they appear. Finish Line is on his company's list of the "most dangerous stocks" for January.

"The company shows positive net income when we show negative economic profits," Trainer said, noting the main reason for the dangerous label is "$384 million in off-balance sheet debt and nearly $50 million in [after-tax] asset write-offs which, when added back to the balance sheet, nearly doubles their reported net assets."

Trainer suggests that the current stock price of roughly $11.80 per share "implies the company has to grow its top line by 10% compounded annually for 36 years straight, while also boosting profit margins by 240 basis points over the same time frame."

With a fair-market value that stands somewhere between $6 and $9 per share, by most estimates, there's no denying that Finish Line is past the flag on the time when it should be purchased as some kind of bargain. Given the current economic and retail climate, investors should be betting that this race is over, and that Finish Line shares will head back to fair value -- or worse -- before toeing the starting line for another run.