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SIZING UP SMALL CAPS

Jim's Gems

BY RHONDA BRAMMER • Our conversation last week with a soft-spoken money manager from Georgia was going along just swimmingly. Or so it seemed. Here we were, talking about (of course) a small-cap company – Liqui-Box, of Worthington, Ohio – a mildly reclusive firm we'd long admired from a distance and one that he owns, likes immensely and, as it happens, finds compellingly cheap.

Both of us cheerfully agreed the stock is particularly enticing because not a single analyst follows the 36-year-old enterprise.

Mutual agreement was readily forthcoming, too, that the company's track record was just splendid: earnings up in nine of the past 10 years; per-share profits up 10% a year for a decade; return on equity of 20%-plus and more than nine cents out of every dollar of sales dropping down to the bottom line.

And we both happily agreed that the stock, at under 15 times trailing earnings, looks like a tantalizing bargain, in a market in which bargains are few and far between.

But then our casual remark that Liqui-Box is not exactly in what you'd call a sexy business met with a rather sharp reply.

We cannot tell a lie: Plastic packaging simply doesn't set our pulse racing.

"I actually think it's a *very* sexy business," insisted Jim Barksdale, who since 1986 has been running his own Atlanta-based investment firm, Equity Investment. "I've always been absolutely intrigued by the economics."

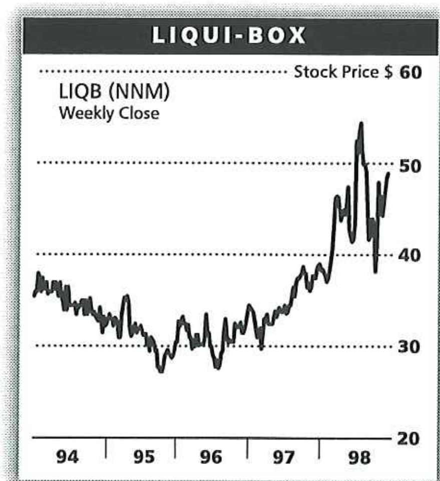
A disposable plastic bag, shipped in a cardboard box, he contends, is far superior to virtually any other delivery vehicle – a can, a bottle, a pail. And compared with a conventional five-gallon plastic pail, Liqui-Box's five-gallon bag-in-a-box reduces total plastic use by 90%.

All well and good – but sexy?

Back in the 'Sixties, when the concept was first unveiled, shipping milk in plastic bags instead of metal cans was revolutionary. Today, that type of packaging is used to ship everything from syrup for soft drinks to edible oils to wine.

Over the years, Liqui-Box has been a steady source of new products: medical pouches for pharmaceutical companies; stand-up and squeeze pouches to replace cans and bottles; 2.5-gallon Handi-Tap polyethylene containers that are top sellers for bottled water.

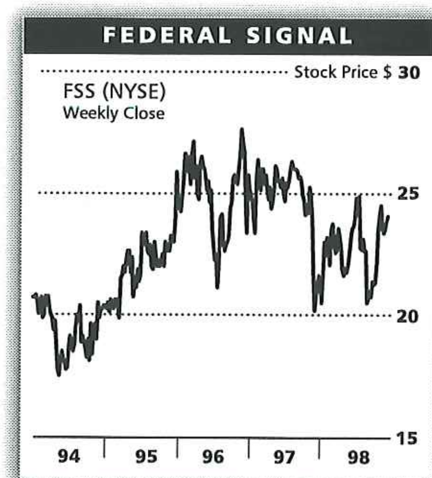
Though Liqui-Box boasts sales of nearly $160 million, and a stock-market value of over $200 million, management admits



without evident regret to discouraging analysts and even shareholders from attempting to pry very deeply into the company's products or strategies. As one exec bluntly put it: "We don't disclose much to anybody."

But the company's results speak volumes. As noted, only once in the past decade did Liqui-Box's earnings decline – a modest 8% in 1995, a year that the price of resin, Liqui-Box's most important raw material, skyrocketed. A lapse, in other words, that's pretty easy to forgive.

Indeed, even when revenues declined slightly – as they did in 1996, after Coca-Cola, once a pretty big customer, reportedly began doing its syrup packaging in-house – earnings continued their brisk upward march. A bold local reporter buttonholed CEO Samuel Davis to ask how he managed the feat and Davis replied: "It was done by getting more product out of the same number of people and the same equipment."



Despite the 3% dip in revenues in 1996, operating income increased 20% and, because Davis also ratcheted up the company's stock-buyback program, earnings per share advanced an even healthier 25%, to $2.41 from $1.92 in 1995.

"They don't tell you much," Barksdale reports, "but they are really driven at that company, really focused."

One reason, he believes, is that employees own stock – and not just the top execs and directors, who account for about 40% of the shares outstanding.

Barksdale recalls a couple of years ago talking with a junior-level employee, a

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financial type, "making maybe $50,000 a year." The employee was offered a loan through the company's good offices and encouraged, strenuously, to buy a rather large number of shares. "I remember this guy telling me that the monthly payment on his stock loan was higher than his mortgage."

The stock was a good investment, management believed – and not just for employees. Once Davis geared up the buyback program in 1996, it never slowed. Indeed, since December 1995 through the third quarter of 1998, Liqui-Box has shrunk the number of its shares outstanding by almost 25%. Which, as intimated, has been providing a nice boost to per-share earnings.

Thus, from 1995 to 1997, net income increased a very respectable 30%, from $12.1 million to $15.7 million. But profits per share over those two years jumped a sparkling 42%, from $1.92 to $2.72.

And the momentum, spurred by still more stock repurchases, has continued. While net rose 10% in the first nine months, earnings per share soared over 30%, to $2.92 from $2.23. What's more, those already fat net margins widened further: Liqui-Box earned almost 12 cents on every dollar of sales.

Current top-line growth, though, leaves something to be desired. After climbing about 8% a year for the better part of a decade, sales seem to have stalled out in the $155-$160 million range.

That's because Liqui-Box has shed some commodity operations, Barksdale points out. Moreover, shifts in resin prices can mask underlying improvement. Though revenues grew less than 1% in the first nine months, unit volume was actually up 6%-7%.

The thing he loves most about Liqui-Box is that "it just gushes up cash." Even after its large stock buybacks, the company is debt-free. For a decade, return on assets has averaged a stellar 15%-plus.

Barksdale is looking for earnings on the order of $3.50 a share this year, up from $2.72, and, conservatively, $3.80-$3.85 next year. So at 49¾, shares are going for about 1.5 times sales, 14 times this year's number and 13 times next.

IN SPITE OF HEAVY EXPOSURE TO small-caps, Barksdale's portfolio was up almost 12% through November – way behind the 21%-plus gain of the S&P 500, to be sure, but handily ahead of the Russell 2000, which was down more than 8%. Though clearly worried about the market – he's holding over 20% cash – Barksdale still finds what he believes are first-rate firms at bargain prices.

Another case in point: **Federal Signal**, with a stock-market value of $1.1 billion.

This 97-year-old company makes an awesome array of keen stuff like fire trucks, street sweepers, police sirens, explosion-proof lighting, die components, carbide drills, advertising displays and illuminated awnings. But its four divisions – vehicles, tools, safety products and signs – have one thing in common: They supply niche markets where Federal Signal strives to be the dominant player.

Which partly explains why, eight years running, return on equity has topped 20%. Last year, sales exceeded $900 million, the 32nd year in a row of record revenues. But operating earnings, alas, after rising for 13 years, were flat, and net declined to $1.29 a share from $1.35.

"Their suppliers, Freightliner and Navistar, put them on allocation," Barksdale explains. "They couldn't get chassis." But the situation has improved, he reports, noting that Federal Signal is beginning to work off a record backlog.

This year, earnings will be at best a few pennies ahead of last year's $1.29 a share. But Barksdale is looking for $1.55 a share in 1999. Which means the stock, at 24 and change, is going for about 15 times that estimate.

"I really don't see how you can lose," he asserts. "You've got all the orders in hand. The company has very little Asian exposure and few Asian competitors. It basically sells to municipalities. You've got a strong management, rising sales momentum – and the stock's cheap." ■