

A Case Study of Firm Valuation Measures and the Reversal of Fortune Among 7 Rivers Equity Index Firms

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Abstract

This article represents an attempt to provide readers with insight regarding common valuation metrics and how these can be applied to real companies. The same analysis could be applied in alternative settings and results compared to those presented here.

I. Introduction

The 7 Rivers Region of Eastern Minnesota and Western Wisconsin runs from just south of Minneapolis, Minnesota to just north of Madison Wisconsin. Within this region, The 7 Rivers Alliance is a regional leadership group that boosts economic growth by fostering collaboration in western Wisconsin, southeast Minnesota, and northeast Iowa. The 7 Rivers Alliance brings together public and private resources to forge entrepreneurial growth, and serves as a clearinghouse of vital information to enhance quality of life in the region. One of the pieces shared with regional leaders is insight to the performance of publicly held local companies, known as the 7 Rivers Equity Index.

Over the seven years from 2000 to 2007, publicly held firms in the 7 Rivers area earned an annualized rate of return of 8.1%. By contrast, the Dow Jones Industrial Average rose at an annualized rate of only 1.4%, and the Standard & Poor's 500 fell at by about 0.6% yearly. However, much of the performance difference can be tied to the fact that local companies were a bit more insulated from the dot.com bust, 9/11 terrorist attack, and beginning of the Iraqi War which took place early in this century. Over the December 2003 - July 2006 period, all three measures of stock market activity had similar rates of return; the 7 Rivers Index rose by sixty-three percent, the Dow Jones Industrial Average rose by forty-nine percent, and the Standard & Poor 500 rose by sixty-one percent.

However, there appears to have been a reversal of fortune in 2007! The 7 Rivers Equity Index dropped by 8.5 percent. By comparison, during our most recent year with complete data, the Dow Jones Industrial Average and Standard & Poor's 500 rose by 6.5% and 3.5%, respectively. However, the local stock performance was similar to that of the Russell 2000.

Could the relatively poor difference among 7 Rivers firms be the result of woes in the subprime market, questionable political leadership, \$3 oil prices, limited industry representation in the 7 Rivers region, or specific company events? The remainder of this report will examine the investment prospects of firms in the 7 Rivers Index. The next section of this report presents the 7 Rivers Equity Index and its performance in comparison to national stock market performance. Those companies which have contributed the most to the success of the 7 Rivers index will be identified. The remainder of this report focuses on the investment merits of local companies. Research tools used in this investigation include Value Line, Morninstar.com, and my.zacks.com. This article lays out a presentation that could be adopted to any reader's vicinity.

II. The 7 Rivers Equity Index

Two criteria must be met for inclusion in the 7 Rivers Equity Index. One, the firm must be publicly held with share price data available from the financial press or Internet sources. Two, the company's headquarters must be within 100 miles of La Crosse, which includes the 7 Rivers Region. A listing of such companies is generated with the assistance of *ReferenceUSA*, a data service allowing one to screen public corporations by state. The thirteen companies currently in the 7 Rivers Equity Index set are identified in Table 1.

Performance of the 7 Rivers Index, an equally-weighted index of regional companies, is presented in the first column of Table 2. The index is based on share prices, which are obtained from Yahoo!Finance. Index values are based on the assumption that investors reinvest their funds equally in public 7 Rivers companies on a monthly basis, earning the average rate of return on firms in the 7 Rivers Index over the ensuing period. The 7 Rivers Equity Index, like the comparison benchmarks described below, excludes dividends.

The values listed in Table 2 represent the value of \$100 invested in local shares on 12/31/1999. For instance, in 2000 the value of the 7 Rivers Index dropped 9.3% to 90.7, meaning a \$100 investment would have lost \$9.30. Over the first eight years of this century, through December 2007, the 7 Rivers Index rose 47.0%, to 147.0. Meanwhile, \$100 invested in the Dow Jones Industrial Average would have been worth only \$115.4, a \$15.40 increase over eight years! Worse yet, investors in the Standard and Poor's 500 companies would have experienced a dime loss per \$100 invested. However, all indexes were outdone by the Russell 2000, which gained \$51.80 per \$100 invested.

Correlation statistics are presented in the bottom half of Table 2. The 7 Rivers Index' correlation with the Russell 2000 is 0.90. This is only second highest, behind the 0.95 correlation of the Dow Jones Industrial Average and S&P 500. The lowest correlation is that of the 7 Rivers Index and S&P 500. Figure 1 illustrates the index similarity described in Table 1.

III. Local Common Stock Characteristics

Risk and Return Insights from Value Line

As shown above, although local shares and the Russell 2000 have performed markedly better than the other two aggregate measures of stock market performance, local and Russell 2000 share prices dipped in 2007. Investors may be wondering whether this atypical performance is going to continue. In order to gain insight to this issue, information from Value Line Incorporated, Morningstar, and Zacks Investment Research was obtained. These firms are in the business of selling information. Hence, their focus is on producing accurate reports that are not necessarily biased towards the purchase of certain stocks. All information presented here is freely available at their web sites or most local libraries. Therefore, this analysis can be completed by all readers and shared with students, business leaders, or the public in general.

Value Line publishes more than a dozen print and electronic products, but is best known for *The Value Line Investment Survey*. Several measures of stock price performance are provided. Table 3 exhibits individual firm rankings and measures for the 7 Rivers firms covered by Value Line. The following paragraphs describe each measure and how some of the 7 Rivers firms size up on that metric.

Timeliness Ranking is Value Line's rating of a stock's probable performance over the next 6 to 12 months. Stocks ranked 1 (the highest) and 2 (above average) are likely to

outperform the market, while those ranked 4 (below average) and 5 (the lowest) are expected to underperform the market. As shown in the first row of Table 3, none of the 7 Rivers firms are in the extreme categories. The 2007 average Timeliness ranking is the better than it was, on average, over the prior three years.

Safety Ranking is Value Line's measure of the potential risk associated with an individual stock's financial strength (e.g., financial leverage) and price stability (e.g., stock price variance). As shown on the second row of Table 3, Hormel and HMN Financial are considered the most secure, while none of the 7 Rivers firms have a safety rating below 3. The Safety Rankings have been very stable and better than the overall average of 3.0, for all firms in the Value Line universe, over the 2004 to 2007 period.

Technical Ranking is Value Line's predictor of a stock's short-term (three to six months) relative price change. As shown in the third row of Table 3, none of the 7 Rivers companies are in the extreme technical rating levels. However, the current average technical rating is better than it was during the prior three years.

Institution Buy/Sale Ratios allow one to compare the performance and implied sentiment of professional money managers. The 1.6 values for Heartland Financial and Rochester Medical indicate that institutional investor purchases exceed sales by sixty percent. Overall, the number of institutional purchases versus sales is up slightly from the 2004-2006 average.

Price Stability, given in fifth row of Table 3, is based on a ranking of the standard deviation of weekly price changes over the past five years. Value Line reports price stability on a scale from 100 (highest) to 5 (lowest) in increments of 5. While HMN Financial has the highest possible price stability rating, Renaissance Learning and Rochester Medical's price stability rating is quite low. These values are approximately the same as they were in prior years, which is not a surprise because four of the five years used in creating the measure are identical.

Price Growth Persistence, exhibited in the sixth row of Table 3, is Value Line's proprietary measure of the tendency of share prices to rise when compared to other stocks. With ratings of 95 and 90, respectively, Fastenal and Hormel have had the most persistent stock price growth. A Price Growth Persistence rating of 15 makes sense for Wausau-Mosinee Paper, which experienced a share price rise of \$7.62, followed by a loss \$6.47 over the past five years. Price Growth Persistence is perhaps the best trend among local firms, with values rising from 37, to 42, to 46, and now to 57 over the past four years.

Beta measures, exhibited in the seventh row of Table 3, are reported by Value Line with a regression towards the mean using a proprietary model. Not surprisingly, industrial concerns Fastenal and Wausau-Mosinee Paper are the most sensitive to market conditions. Meanwhile, the maker of upholstered furniture for use in homes, businesses, and recreational vehicles, Flexsteel, has the lowest sensitivity to market conditions. With an average beta of 0.8, local firm beta values have consistently been defensive. However, as witnessed in 2007, the 7 Rivers Index and some stock market benchmarks can go in opposite directions.

Dividend yield, which is exhibited in the eighth row of Table 3, is the ratio of the dividend payments over the next twelve months, as estimated by Value Line, divided by the current price. Several 7 Rivers companies pay dividends at a rate exceeding what local investors would receive on savings accounts, with National Presto leading the way at 6.5%. Overall, there has been a slight rise in dividend payments per dollar invested.

Price projections, given in the last two rows of Table 3, are Value Line's estimate of the annual, compound total rate of return for the largest firms in the 7 Rivers Index. Yields are

based on appreciation from the current price to both the high and low ends of the anticipated price range in three to five years. Unfortunately, Value Line makes these predictions only for a select group of typically larger firms. While share prices for Wausau-Mosinee common might grow at a twenty-nine percent annual rate, Hormel's best, projected annual performance is only sixteen percent. Value Line thinks that, at worst, Wausau-Mosinee Paper will provide a capital gain of nineteen percent, while Fastenal's price, at worst, might rise at a ten percent rate. The current average maximum growth rate is lower than it was in the 2004-2006 period. However, the current estimated minimum growth rate is higher than before.

Valuation Insights from Morningstar

Morningstar is an investment research firm providing commentary, portfolio management tools, and detailed reports on stocks and mutual funds accessible at www.morningstar.com. After signing up for a free membership, one can access a great deal of free information. This report studies the pricing of securities, relative to earnings, sales, and cash flow, which is presented in Table 4. One advantage of Morningstar's investigation is that all public firms have a share price and are likely to have earnings, sales, and cash flows. The lone exception to this comprehensive coverage assumption is Baraboo Bancorporation, which is not covered by Morningstar. Citizens Community Bank, Flexsteel, National Presto, Rochester Medical, and TenderCare International did not have positive earnings, TenderCare had a negative cash flow, but all had sales.

Price/Earnings ratios divide a stock's current price by the company's trailing 12-month earnings per share. Generally, the higher the price/earnings ratio the more confident the investor is that the firm will provide earnings growth in the future. As shown in the first column of Table 4, approximately half of the firms with positive earnings had price/earnings ratios exceeding their industry average, which is exhibited in the second column. Investors appear to be very confident about the future prospects of Fastenal, where twenty-five years of current earnings (i.e., without earnings growth) would be necessary to pay for the stock. Since few would wait that long to be reimbursed, investors must be expecting significant earnings growth at Fastenal. The 2007 average price/earnings ratio is much lower than the 2005-2006 average. However, it exceeds the 2007 relevant industry ratio and the 2007 S&P 500 companies' price/earnings ratio, both of which declined from earlier levels.

Price/Sales ratios, exhibited in the center columns of Table 4, divide a company's current price by sales per share over the past twelve months. Price/sales ratios are commonly considered in conjunction with price/earnings ratios, because even companies with negative earnings produce sales. Generally, confident investors pay more for shares, which implies that they will pay more per dollar of sales. As with the price/earnings ratio, some of the 7 Rivers Index companies appear to be richly valued when it comes to earnings. Reviewing the center two columns of Table 4, only five of twelve local firms had price/sales ratios exceeding their industry average. Confident investors are paying almost six dollars per dollar of sales at Rochester Medical. By comparison, investors in Flexsteel are only paying twenty cents per dollar of sales.

Overall, there has been a reversal in what investors are willing to pay the most per dollar of sales. During the 2005-2006 period, buyers of 7 Rivers shares were paying a lower price per dollar of sales. In 2007, 7 Rivers Region company investors are paying more than those investors would in other firms in the same industries. However, the average price/sales ratio of the five hundred firms in the Standard & Poor 500 is higher yet.

Price/cash flow ratios, presented in the right columns of Table 4, divide a company's current price by cash flow per share over the trailing 12 months. Price/cash flow ratios show the ability of a business to generate cash and can be an effective gauge of liquidity and solvency. The greatest valuation difference was that at Citizen's Community Bank, where investors are paying almost five times the industry average per dollar of cash flow. At the other extreme investors in Marten Transportation are only paying about forty percent of its industry average. The 2007 7 Rivers' price/cash flow values exceed the industry benchmark, both the 2005-2006 7 Rivers' firm and industry average, and the average of the Standard & Poor's 500.

Average Broker Recommendations from Zacks Investment Research

The paragraphs above present a significant amount of information regarding anticipated return, risk, and current valuations. Nonetheless, one still has to decide whether or not to buy a specific company. In order to gain insight to this process, average broker recommendations (ABRs) were obtained from Zacks Investment Research. ABRs, the number of analysts giving a recommendation, perceived pricing errors, industry rank, and company rank within their primary industry are exhibited in Table 5. Among those with at least four recommendations, Fastenal (2.29) has the highest average rating and Marten Transportation (3.00) the lowest average rating. On average, local companies have a rating of 2.4, which is between "Outperformance Expected" and "Hold (current position)." Although the average ABR is only down slightly from 2006, the number of raters has fallen by over fifty percent.

An important insight provided by Zacks is a ratio of the firm's estimated value relative to its current value. The estimated value of Wausau Paper is ninety-one percent higher than the current value. At the other extreme, Fastenal is only considered to be worth four percent more than its current price—which would be absorbed by transaction costs and taxes.

Zacks also ranks industries and firms within industries on the basis of expected price performance over the coming year. The larger the values in columns four and five of Table 5, the better the anticipated performance of the industry (in column 4) and firm (column 5). The fourth column of Table 5 shows that National Presto and Hormel are considered to be in two of the better industries. In six of the eleven instances with data, the 7 Rivers company comes from an industry that is considered to be above average.

Of course, the 7 Rivers firms may be stars in otherwise lackluster industries. For instance, Marten Transportation and Wausau Paper are in the top quarter of industries that fall into the bottom third in the industry ranking. By contrast, Flexsteel is in the bottom third within an industry that is in the bottom third of 207 industries. While the 2007 industry percentile is 15 (53 – 38) points higher than it was in 2006, the firm ranking within the industry has dropped by 6 (58-52) percentage points.

IV. Summary

This report covers the 7 Rivers Equity Index, a measure of the share price performance of firms located in the local area. Local firms have outperformed large-cap stock market benchmarks during this decade, though the difference eroded significantly during 2007. Only one of the firms currently in the 7 Rivers Index have experienced a decline since 2000. By contrast, the share prices of only four of thirteen local companies rose during 2007.

Three web sites available to readers at no charge were used to examine the investment value of local companies. Virtually all of the common stock characteristic measures bode well for 7 Rivers firms, including currently having a higher Timeliness ranking, technical rating,

institutional buy/sell ratio, price stability, price growth persistence rating, and dividend yield, versus average value from the 2004 - 2006 period. Firm valuation measures, including higher average prices per dollar of earnings, sales, and cash flow, when compared to industry benchmarks, suggest that investors are confident about the continued success of local companies. Investors appear not to have been shedding 7 Rivers companies as quickly as earnings, sales, and cash flow have fallen, resulting in high valuation measures. Although broker ratings of local firms within their respective industries may have declined slightly, the forecast performance of the industries has increased dramatically. All in all, this analysis paints an optimistic picture of local firms and the 7 Rivers economy and the potential for another reversal of fortune.

Table 1. 7 Rivers Equity Index

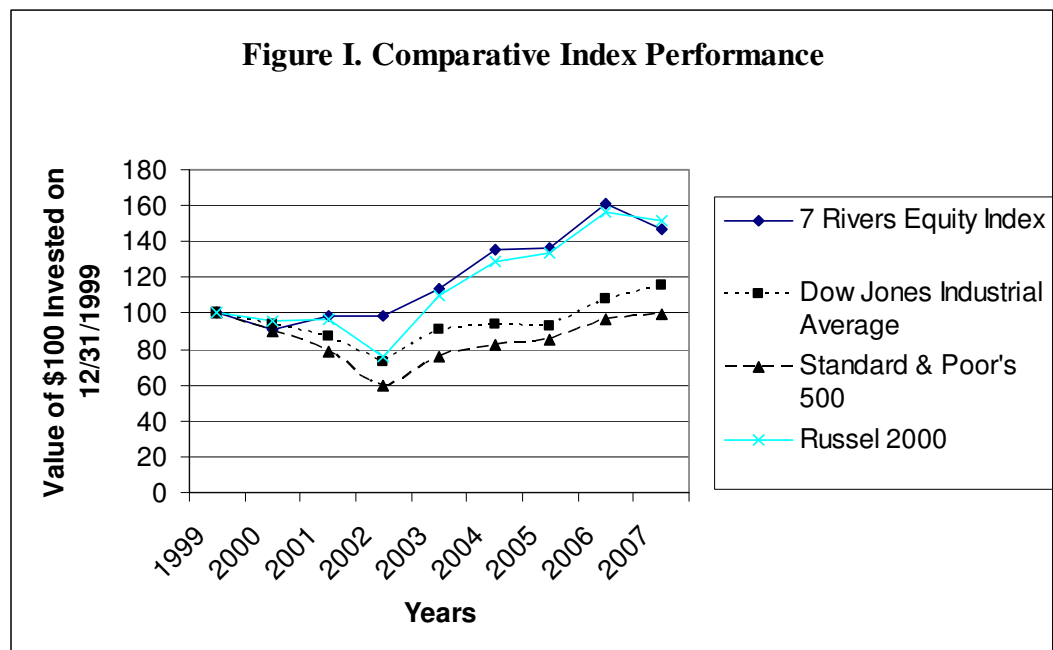
The headquarters of each of these public firms is within 100 miles of La Crosse

<u>Firm</u>	<u>Market Capitalization (\$millions)</u>	<u>Line of Business</u>
Wisconsin firms		
Baraboo Bancorporation (BAOB)	\$ 80	Retail banking
Citizens Community Bank (CZWI)	\$ 57	Retail banking
Marten Transportation (MRTN)	\$ 363	Trucking
National Presto (NPK)	\$ 430	Cookware
Renaissance Learning (RLRN)	\$ 408	Educational software
TenderCare International (TCAR)	\$ 3	Paper products distribution
Wausau-Mosinee Paper (WPP)	\$ 423	Paper products
Minnesota firms		
Fastenal (FAST)	\$ 6784	Threaded fasteners
HMN Financial (HMNF)	\$ 75	Savings & loan
Hormel (HRL)	\$ 5222	Pork and turkey processing
Rochester Medical (ROCM)	\$ 139	Urinary treatment products
Iowa firms		
Flexsteel Industries (FLXS)	\$ 73	Home furnishings
Heartland Financial USA (HTLF)	\$ 362	Retail banking
Firms included in the La Crosse Equity Index that are no longer publicly held:		
Ag Services of America	Bone Care International	Featherlite
First Federal Capital Corporation	La Crosse Footwear	Land's End
Northland Cranberries	Pemstar	Sheldahl
State Bank La Crosse		

Table 2. Comparative Index Performance

Index Values				
Year-end	7 Rivers Equity Index	Dow Jones Industrial Average	Standard & Poor's 500	Russell 2000
1999	100.0	100.0	100.0	100.0
2000	90.7	93.8	89.9	95.8
2001	98.6	87.2	78.2	96.8
2002	98.1	72.6	59.9	75.9
2003	114.0	91.0	75.7	110.3
2004	135.8	93.8	82.5	129.1
2005	136.5	93.2	85.0	133.4
2006	159.5	108.4	96.5	156.0
2007	147.0	115.4	99.9	151.8

Index Correlation				
7 Rivers Equity Index		0.78	0.66	0.93
Dow Jones Industrial Average			0.95	0.90
Standard & Poor's 500				0.82



3. Common Stock Characteristics for 7 Rivers Equity Index Members

Data Provided by Value Line Investment Survey^a

	Fastenal	Flexsteel	Heartland Financial	HMN Financial	Hormel	Marten Transportation	National Presto	Renaissance Learning	Rochester Medical	Wausau-Mosinee Paper	2007 Average	2004 – 2006
Timeliness Ranking	3	3	3	3	4	2	-	4	2	2	2.9	3.1
Safety Ranking	3	3	3	1	1	3	3	3	3	3	2.6	2.6
Technical Ranking	2	2	3	3	3	2	-	3	2	4	2.7	3.0
Institution Buy/Sale Ratio	1.1	1.4	1.6	1.4	1.1	0.8	1.4	0.7	1.6	1.1	1.2	1.1
Price Stability	60	85	75	100	95	30	85	25	25	65	64	62
Price Growth Persistence	95	40	-	75	90	90	50	30	30	15	57	42
Beta	1.2	0.4	0.6	0.6	0.8	0.6	0.8	1.1	0.7	1.2	0.8	0.8
Dividend Yield (%)	1.0	3.5	1.5	2.9	1.6	0.0	6.5	1.7	0.0	2.5	2.1	1.6

3- to 5-Year Projected Returns

Maximum	20	na	na	na	16	na	na	27	na	29	23	25
Minimum	10	na	na	na	11	na	na	15	na	19	14	10

^a Value Line does not cover the other firms in the 7 Rivers Index. Specific 3- to 5-year projected returns are only provided for the 1700 largest firms.

Table 4. Current Share Valuation using data provided by Morningstar.com^a

	Price/Earnings		Price/Sales		Price/Cash Flow	
	<u>Firm</u>	<u>Industry</u>	<u>Firm</u>	<u>Industry</u>	<u>Firm</u>	<u>Industry</u>
Citizens Bank	NMF	14.2	3.2	3.4	44.8	9.6
Fastenal	25.0	19.2	3.8	0.4	58.8	23.7
Flexsteel	NMF	15.1	0.2	0.6	5.8	10.5
Heartland	11.8	14.2	2.5	3.4	15.7	9.6
HMN Finance	11.2	11.3	3.0	2.8	4.1	---
Hormel	15.3	18.2	0.8	1.0	16.1	17.0
Marten Trans	11.4	16.8	0.6	1.7	4.0	9.7
National Presto	NMF	15.1	2.2	0.6	21.3	10.5
Renaissance	31.5	19.9	3.4	3.5	17.0	18.2
Rochester Med	NMF	21.6	5.8	3.5	4.4	26.2
TenderCare	NMF	17.1	1.1	0.8	---	12.5
Wausau Paper	15.3	17.1	0.5	0.8	14.6	12.5
2007 Average ^b	17.4	16.7	2.3	1.9	20.2	14.8
2005-06 Average ^b	25.1	21.1	1.9	2.4	20.0	15.0
2007 S&P 500:		15.8		2.9		15.0
2005 - 2006 Average S&P 500:		21.0		2.8		14.2

^aBaraboo Bancorporation (WI) is too new to be included in Morningstar.

^bData was gathered on approximately August 1 of each year

NMF = Not a meaningful figure due to negative earnings, in NMF instances the industry value is excluded from calculation of the average.

--- = Not a meaningful value due to negative cash flow, in such instances the industry value is excluded from calculation of the average.

Table 5. Average Brokerage Recommendation (ABR) data provided by My.Zacks.com^a

	ABR	Number of Ratings	Estimated Value Current Value	Industry Percentile Rank	Percentile Rank in Industry
Fastenal	2.29	7	1.04	54	50
Flexsteel	NA	NA	NA	30	35
HMN Financial	3.00	1	na	30	55
Hormel	2.38	8	1.12	92	14
Heartland Financial	3.00	2	1.41	11	67
Marten Transport	3.00	4	1.33	31	88
National Presto	1.00	1	na	98	100
Rochester Medical	NA	NA	NA	68	40
Renaissance Learning	3.00	1	1.31	77	16
TenderCare	NA	NA	NA	71	33
Wausau Paper	1.50	2	1.91	19	77
2007 Average	2.4	3.2	1.35	53	52
2006 Average	2.2	6.7	1.30	38	58

^aMy.Zacks.com does not include analysis of Baraboo Bancorporation and Citizens Community Bank.