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Company Focus

7 out-of-favor stocks insiders are buying

The markets think higher rates spell trouble for housing, auto and specialty retail stocks. But top brass at these companies see a different story -- and plunk down their own money.

By Michael Brush

With the economy so strong, many market pundits believe the real risk for stocks is higher interest rates, courtesy of a Federal Reserve Board looking to kill inflation before it starts.

This dynamic threatens many stock sectors, but it especially clouds the outlook for shares of housing-related, specialty-retail and auto-related companies. Higher interest rates make it harder to borrow money for homes and cars, and if growth slows, consumer spending might cool off.

Top managers in these industries understand these risks, of course. And a great many of them have dumped shares in recent weeks. But intriguingly, some are snapping up shares in their companies, going against trends based on decades of market wisdom -- and creating a powerful buy signal for their stocks.

A buy signal for a home-furnishings company

Many top executives in the housing sector are dumping shares. And why not? They've made lots of money in their stocks, and now higher interest rates may cool demand for housing.

But for this very reason, you have to be impressed by an insider-buying binge at **Restoration Hardware** (RSTO, news, msgs), the small retailer that sells upscale, classic American home décor. Top execs -- including CEO Gary Friedman and CFO Patricia McKay -- picked up more than $1 million worth of shares in the Corte Madera, Calif., company at the end of March in the $5 range.

Since then, the stock has moved up about 36% to $6.80. But with such a powerful buy signal from the insiders, there's likely more upside, says Michael Painchaud of Market Profile Theorems. "Insiders were buying very consistently in March after being very correct buyers back in 2003," he says. "I would expect this stock to outperform the average stock for three months following the buy signal."

What makes insiders so bullish? The company is in the early stages of a turnaround. CEO Friedman, who managed the **Williams-Sonoma** (WSM, news, msgs) Pottery Barn brand for years, recently revamped Restoration Hardware's product lineup and stores in a bid to bring in more upscale spenders. These tactics should pay off, says Christopher Krueger, an analyst with Miller Johnson Steichen Kinnard in Minneapolis. "Its product offering is generally more sophisticated than other retailers, yet less expensive than interior designers," says Krueger.

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At **Decorize** (DCZ, news, msgs), a small furniture distributor that imports furniture and home décor accessories from Asia, insiders are placing big bets against the market pundits, as well. In February, directors John Michael Sandel and James Parsons bought over $620,000 worth of Decorize shares at 99 cents per share. The stock recently traded for 64 cents.

Another turnaround, Decorize, based in Springfield, Mo., got new management last January. Since then, says CEO Steve Crowder, Decorize has set up a furniture finishing company in Indonesia, put managers in Asian countries for better quality control and hired new sales reps.

Decorize also put in new systems that help it manage orders better, says interim CFO Brent Olson. This should help it take business from smaller competitors in a sector still dominated by mom-and-pop shops. "We are continuing to leverage our design talent and technology in an industry that is pretty technologically illiterate," says Olson.

Two big-picture trends help importers such as Decorize, as well. First, domestic furniture making is declining rapidly in favor of imports from Asia. Last year, Chinese imports represented 43% of the wood furniture market in the United States, up from just 13% in 1996, says Raymond James analyst Budd Bugatch. Second, there's a lot of pent-up demand after years of uncertainty among consumers, says E. Larry Ryder, the treasurer of **Hooker Furniture** (HOFT, news, msgs) of Martinsville, Va., which saw a tiny insider purchase by a new board member recently. Paul Fulton, chairman of **Bassett Furniture Industries** (BSET, news, msgs) in Bassett, Va., also bought $197,000 worth of his company's shares at the end of March.

Retail suppliers buck the trend

Conventional wisdom says that retailer stocks do poorly whenever economic growth begins to slow because the Fed is hiking rates. Just don't tell that to the insiders at **Tarrant Apparel Group** (TAGS, news, msgs) and **Innovo Group** (INNO, news, msgs), two tiny companies that produce and design clothes for retail chains and department stores.

Tarrant Chairman and CEO Gerald Guez bought $95,000 worth of his company's shares in April at per-share prices of $1.68 and $1.97. Insiders at Innovo -- including CEO Samuel Furrow Jr. and CFO Marc Crossman -- bought over $8.5 million worth of their stock since the start of the year. That includes purchases as recently as mid-April for around $1.70 per share.

What's going on at these two clothing producers?

Tarrant's Guez was taking advantage of the dramatic slide in his company's shares, which tumbled to well under $2 from $4.50 last October. Tarrant took a hit when it lost a big chunk of business last year as critics slammed it for unfair labor practices at a Mexican plant, which Tarrant eventually shut down. (The company denies any wrongdoing.)

With that episode behind it, Tarrant is now boosting margins by developing its own stable of brands it can sell to retailers; otherwise, the company simply produces their designs for them, a service that yields lower profit margins. "We were a sourcing company, and we've added some design capability to get up out of the fray of who can do it the cheapest," says Barry Aved, Tarrant's president. Tarrant, based in Los Angeles, recently bought the right to produce casual clothes under the American Rag label, a name taken from two popular stores in Los Angeles that sell edgy and vintage casual wear. It also signed popular woman's wear designer Cynthia Rowley, and it owns the No Jeans brand sold at Wet Seal.

Innovo Group of Commerce, Calif., produces youth-oriented casual wear sold by retailers such as **American Eagle Outfitters** (AEOS, news, msgs), **Target** (TGT, news, msgs) and the Bloomingdale's divisions of **Federated Department Stores** (FD, news, msgs). It posted a big loss, $4.9 million, in its most recent quarter. Sales were weak. And costs rose as the company spent a lot to build an infrastructure to support new brands like Fetish and Shago.

All good excuses, but the bad results sparked a minor shareholder revolt during Innovo's recent quarterly conference call. Investors demanded that heads roll. Innovo promised to cut costs and take steps to increase sales, but it offered scant details. Nonetheless, the purchase of $89,000 worth of stock by insiders in the days after the conference call -- plus an $8.4 million purchase in March -- suggest top managers think they have a good plan.

Slower growth at retailers should hit companies that take a piece of the action each time stores process credit-card payments. But insiders at **CAM Commerce Solutions** (CADA, news, msgs), one of these companies, clearly disagree. CEO Geoffrey Knapp kept buying the Fountain Valley, Calif., company's shares as the stock rose to $10 in March from $5 last summer.

Now, the stock trades for around $18, but there is likely more upside. Why? The company's X-Charge software helps retailers integrate their cash registers and credit-card-payment systems; this cuts down on mistakes. Knapp says there's a lot more room to sell software to more retailers and expand to other sectors like restaurants and health care. "We are only at the beginning," says Knapp. "We are leveraging our model to many other markets."

Naysayers have it all wrong

The world's largest supplier of car wheels and a big producer of components for suspension systems and brakes, **Hayes Lemmerz International** (HAYZ, news, msgs) *looks* like it's being hit by a double whammy.

Rising U.S. interest rates should cool off car demand. Meanwhile, a rebound in global demand for steel has jacked up the price of steel. So analysts such as Jackie Weiss at Merrill Lynch rate the stock "neutral." And investors are aggressively dumping the stock -- driving it under $14 at one point this month, from $20 earlier this year.

But insiders, who have stuck with the company through a Chapter 11 proceeding, apparently think the analysts and the sellers have it all wrong. And they should know, because they have the front-row seats. Since early March, CEO Curtis Clawson and CFO James Yost have bought $322,000 worth of their stock for $13.67 to $16.17. "It is very clustered, consistent and aggressive buying," says Painchaud.

Clawson dismisses higher steel costs as a concern. For one thing, Michigan-based Hayes Lemmerz has lots of long-term contracts that are not affected by the recent increases in the price of steel. Besides, Clawson thinks steel prices are coming down soon. As for car demand, Clawson concedes growth will be anemic this year. But demand for commercial vehicles will be strong. And new car models will boost demand beyond 2004.

"Starting in the second half of 2005 and into 2006, we're going to be bustling around here," he said in the company's April 6 conference call. "I'm optimistic about the business." A week later, Clawson and Yost backed up their bullish words with actions -- purchasing $147,000 worth of Hayes Lemmerz stock for around $13.70 per share.

At the time of publication, Michael Brush did not own or control shares in any of the companies listed in this column.

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