10 Simple Rules For Spotting Successful Turnaround Stocks
Turnaround investing can be very profitable. Year-in and year-out, many of the biggest winners on Wall Street are struggling companies that have turned themselves around and returned to favor with investors.

What produces the tremendous profit potential in turnaround stocks?

It’s that most investors, including many “sophisticated” institutions, avoid turnaround situations. They sell potential turnaround stocks too soon—often right when the worst of a company’s troubles become known—and they buy them back too late —only after they are certain that the company will recover. When these investors bail out, that is often the best time to buy in!

Not every struggling company will turn into a success story. Some will fail while others will languish with depressed stock prices for years.

The key to turnaround profits is separating those companies that will recover and return to favor from those that won’t. You can significantly improve your chances of spotting a successful turnaround by following these 10 rules:

1. **Look For Solid Core Business**

Cash flows are the lifeblood of a turnaround—and the most valuable source of cash flows usually is a strong core business. This core becomes the foundation for the company's immediate recovery and for its future growth opportunities. The core business may or may not be its biggest or best-known business. The company's chances for recovery can be further enhanced if it has ancillary businesses that can be sold to raise cash. Multi-business companies usually have at least one subsidiary that is in decent shape, providing a much better chance for overall recovery than a single-business company.

Companies often get into trouble because they expanded too quickly or entered new businesses that they did not adequately understand. The entire company is dragged down by these weak subsidiaries. But an exit from these operations allows management to refocus on their core business. Shutting down a weak subsidiary can eliminate a cash drain. Or, in many cases, while these operations may have negative value to the parent company, they may have real value to someone else. Selling the business then brings an added benefit over merely shutting down: It brings in fresh cash that can pay down debt or fund other growth opportunities.

2. **Look for Well-Known Products or Brands**

It is essential for a turnaround company to maintain a steady level of sales to provide the cash flow and time span needed to execute its recovery plan. If revenues remain stable, there is a high probability that the turnaround will eventually succeed.
Anything that keeps customers coming back carries tremendous value in a turnaround. Customer loyalty, backed by a widely recognized and strong brand, is a major source of revenue stability. Few customers will switch to a competing brand, even if a company is struggling, as long as the quality of the goods and services stays reasonably steady. When the purchasing decision involves servicing or other post-sale involvement by the troubled company, a strong brand will provide some reassurance (often correctly) that the company would not sacrifice its reputation. With its ability to produce stable revenues, the strong brand can serve as the core business upon which the company is rebuilt, or it can be sold to raise cash to support other core operations.

3. Compare Cash Flow to Obligations

The stronger a company’s cash flows are relative to its obligations, the greater its chances are for recovery. If cash flows exceed its obligations, the company has resources and time. If, however, cash flows barely match or fall short of its obligations, the company fights not only its operational challenges but also fights the clock. Missing an interest payment or other timely obligation can push a company into default. Increasing its cash flows may be just a matter of waiting for a recovery from a cyclical dip in sales.

It may involve selling or closing money-losing operations. Sometimes eliminating overspending on research and development or cutting frivolous expenses is enough. In other cases, a more rigorous overhaul of how the company runs its operations is necessary.

Selling businesses can produce one-time cash windfalls. These can fund one-time reductions in debt or other financial burdens. However, this must be balanced against the loss of cash flows from these sold operations. Selling a cash cow may reduce debt but can leave the remaining businesses starving. In cases where cash flows are currently inadequate, the company needs to convince investors that it will, at some foreseeable point, actually produce excess cash flows. This opens opportunities for raising urgently needed new financing. Yet because this new funding increases the financial burden on the company, it may extend the time needed for a recovery, and increases its risks of failure.

4. Look for Management Changes

Just as real estate experts say there are three keys to success in real estate—location, location, location—I believe there are three keys to success in turnarounds: Management, management, management. A change in senior management is generally a good sign.

First, it indicates that the board of directors recognizes that the company has serious problems. This is often one of the largest hurdles to a recovery. Second, it usually brings in a new skill set tailored to addressing the problems. If existing management did not have the skill to keep a company out of trouble, it is not likely to have the skill or the mindset necessary to get the company back on its feet.
Third, it sends a signal that “business as usual” inside the company will be replaced with a greater sense of urgency and frugality. This often is enough to redirect employees’ priorities and unleash new and productive ideas. Finally, it can free the company to meaningfully shift its strategic priorities, including how it allocates its capital, approaches its customers and how it operates its businesses.

The announcement of the hiring of a turnaround veteran is not, however, a sign that investors should immediately buy the company's stock. Even the best turnaround managers may take a long time to revive a company, best measured in years not quarters, and there may be more bad news still to come.

When looking for favorable signs of a potentially successful turnaround, new management is a great place to start.

5. Look at Who Owns the Company’s Stock

Stock ownership can provide important clues for spotting successful turnaround situations. Stock ownership by management, for example, gives them an extra incentive to get the company out of trouble. An executive who is there just for the salary is likely to quit and look for a more secure place to collect his or her paycheck. But the executive who owns a significant amount of stock will usually try a lot harder to turn the company around. Often, turnaround executives will be compensated partly with stock or options, and this can be a good sign for the stockholders.

Management knows it can maximize its own rewards by creating value for the other shareholders. Insider stock purchases can provide more clues. Corporate officers, directors and major stockholders are required to report their purchases and sales of stock to the Securities and Exchange Commission (SEC) every month. These “insider” trades can indicate that those with the best knowledge of a company believe it will do better in the future. Long before anything newsworthy happens, or before an upturn appears in a company’s financials, an insider may see positive changes and purchase the company's stock. This can be a sign that “outsiders” should consider buying it, too.

Second, the presence of a major non-management stockholder can be another valuable clue to a promising turnaround. If the company’s stock is widely dispersed, there may be no one to look out for the stockholder’s interests. But holders of 5% or more of a company’s stock are likely to take an active role in reshaping the company. If a credible activist investor takes a large position, this can be an even better signal of positive changes ahead—as activists focus on engaging managements to turn around their companies. As these big holders look out for their own interests, they are also protecting the interests of their fellow shareholders who may own only a few shares.

Just as with the arrival of new management, however, the purchase of a big block of stock by an investor is not necessarily cause for immediate rejoicing by other stockholders. There have been a number of cases where a big investor bought into a potential turnaround situation only to find that things were really a lot worse than they believed.
6. Look for Special Problems that Do Not Affect Core Operations

Sometimes a company will be in trouble because of an isolated issue that is not related to its future business prospects. Litigation is a common example of this type of problem. While some legal problems can put a company in serious danger, frequently the market will assume that the worst-case scenario is a certainty, even if the chances of that scenario actually occurring are remote.

If the company can resolve this problem and remove the cloud over its securities, its stock and bonds may move up sharply. There have been a number of well-known examples. In February 2013, S&P Global, Inc. (NYSE: SPGI)—previously called McGraw-Hill Financial—was sued by the US Department of Justice for allegedly defrauding investors by overrating mortgage securities during the financial crisis. The lawsuit, joined by 16 states, threatened a $5 billion federal penalty and potentially much more from other jurisdictions. The shares dropped over 25% in the following weeks to 42. The legal wrangling was formally settled for $1.5 billion in early 2015. The end of the legal issue, combined with strength in the underlying business, pushed the stock to 108 by March 2015.

Anadarko Petroleum (NYSE: APC), a global oil and gas exploration company, saw its shares drop by over 50%, to just over 36, in early 2010 when the Macondo oil well blow-out killed 11 workers and spilled millions of barrels of petroleum into the Gulf of Mexico. Anadarko was a partner in the well. Although it was not involved with the drilling operations, its mere association threatened a potentially calamitous legal liability. However, the company defended its position successfully and the shares rebounded to 84 by early 2011.

7. Pay Attention to Economic and Market Conditions

There are some conditions that are especially favorable for turnaround stocks and other conditions that are less favorable. Turnaround investors need to be aware of both. The best environment for turnaround stocks is when the economy is just beginning to improve after a slowdown. As broad economic conditions improve, the weakness of turnaround companies can become their strength as they benefit much more than healthier companies. Their sharper recovery can lead to outsized share price gains relative to other stocks.

A steady but sluggish economy and stock market can provide a great environment for turnaround stocks, as well. One of the major benefits of turnaround stocks is that they tend to move independently from the overall market. Successful turnarounds producing strong stock price gains can really stand out in a dull market. In these kinds of markets, the successes of turnaround stocks can attract buying interest of more traditional investors who would otherwise shun them.

Like many investing trends, once turnarounds become fashionable, the market conditions for them become unfavorable. Smart turnaround investors must become cautious, take advantage of the opportunity to sell at sizeable profits, and then wait for good turnaround situations to become

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unfashionable bargains again before buying. Conditions become unfavorable during a sharply weakening economy. Turnaround companies have enough difficulties in a stable economic environment. When sales are declining everywhere, turnaround companies’ struggles become magnified.

Conditions also become unfavorable when the company’s industry faces periods of heavy oversupply. Weakening demand means shrinking revenues and margins, sometimes for years. These produce heightened operating stress. Furthermore, the stock market has little patience for turnarounds in this environment, often resulting in protracted declines in their share prices. Turnaround investors may find that the best strategy is to wait for shares to reach significantly depressed levels, and for industry fundamentals to show some signs of stability, before buying.

8. Watch for Companies Emerging From Bankruptcy

Most investors think of bankruptcy as bad. As a result, they tend to avoid the stocks of companies that have been through Chapter 11. But Chapter 11 can be very beneficial to a company. The bankruptcy process provides the company with an opportunity to solve most of its financial problems and aggressively address its operational issues. The emerging company will most certainly be stronger than it was going into bankruptcy. It may also be stronger than many of its competitors. However, because investors have such a negative view of bankruptcy, the stocks of these newly emerged companies are often underfollowed and likely undervalued.

Wall Street analysts and commentators who recommended a stock before it went into Chapter 11 will have painful memories and won’t likely recommend it again. Similarly, the views of most investors will be tainted by their memories of the troubled company before it was transformed through the Chapter 11 process. As a result, they overlook the improvements in the company’s prospects and avoid the stock.

Post-bankruptcy stocks can be undervalued for another reason. Often when a company comes out of Chapter 11 it will give creditors new stock to pay off some or all of their old debts. While the creditors are grateful to get paid something most would much rather have cash than stock, and will sell their shares as soon as they can. This short-term selling pressure may depress the price of the stock for some time after the company emerges from Chapter 11.

Eventually, the selling by creditors will stop and investors will begin to realize that the company is much stronger than before. When that happens, the stock can appreciate dramatically.

For example, US Concrete (Nasdaq: USCR), a maker of concrete and related building products, was forced into bankruptcy in early 2010 following the 2008 financial crisis. It emerged from Chapter 11 later in 2010 at around 9, then traded to below 3 the following year as investors unloaded their positions. The shares then began a rebound that took the price to 71 by early 2017.

Similarly, AMR Corp (Nasdaq: AAL), the parent of American Airlines, was pushed into bankruptcy in late 2011 by high operating costs and a heavy debt load. While in Chapter 11, the company restructured its
labor contracts, reduced other operating costs and exchanged its old debt for new equity. AMR emerged from Chapter 11 in late 2013 through a merger with US Airways. The stock of the new company began trading at around 24 in December 2013, and by early 2015 it had risen to 55.

9. Watch Media Headlines for Opportunities

Negative media headlines can be a great source of turnaround ideas. Stories about struggling companies, management turmoil, failed strategies, large financial losses, industrial accidents, lawsuits and the like can drive a stock to well-below reasonable levels and may provide a buying opportunity. But like all Wall Street axioms, “buy on bad news” must be accompanied by careful analysis to evaluate the potential for turnaround success.

Another Wall Street axiom says that “there is no such thing as only one cockroach.” Translated into regular English, this means that one bad headline is usually followed by a long stream of bad news. So when an appropriate negative news story appears, put the company on your list of possible turnarounds, but wait for more signs before rating it a probable turnaround investment.

10. Compare Common Stocks, Preferred Stocks & Bonds

While the common stock of a turnaround candidate usually has the greatest upside potential, other classes of securities, such as preferred stock or bonds, may offer attractive profit possibilities with less risk. Common stock carries the greatest risk, as it can only receive cash after all debt and other obligations are paid in full. If there is inadequate cash, the equity holder could receive nothing. But once all the other obligations are taken care of, the equity holder has rights to all remaining cash flows. In a successful turnaround, these remaining cash flows can be enormous.

Preferred stocks have a higher priority claim on cash flows than common stocks, so their risks are generally lower. However, their claims are capped at the stated dividend amount, and their price generally doesn’t increase much above par. The most interesting preferreds have “cumulative” dividends that are unpaid, or “in arrears.” Cumulative preferreds require companies to pay all unpaid preferred dividends before common shareholders get any dividends. For companies that have skipped preferred dividends for an extended period, the accumulated in-arrears dividends can be substantial. As the company begins to recover, investors realize that preferred stockholders might soon receive a large payment of accumulated dividends, and they bid up the price of the preferred stock accordingly. Bonds share some traits with preferred stocks yet have some important differences. Bonds are senior to preferred stocks so they are paid first.

Most importantly: Interest on bonds must be paid, on time, so companies will do everything in their power to meet that obligation. When investors aggressively sell bonds, it is usually because they fear that the interest and possibly the principal can’t be repaid. This selling pushes down the bond price, which boosts the yield and the attractiveness to the turnaround investor.
For example, a 4% coupon pays $4 interest per $100 bond. Yet if the bond price falls to $40, the company still must pay the $4 coupon, increasing its yield to 10% ($4 coupon/$40 price). If the bond price recovers to $80, the investor gets a 100% return on the bond plus all the interim $4 coupons.

Occasionally a turnaround company will issue bonds or preferred shares that are convertible into common stock. If the conversion price is not too far above the current stock price, these securities can provide many of the protections of bonds and preferred stock yet offer the upside potential of common stock. Legacy convertibles (those issued well in advance of the company’s current troubles) usually offer little improvement in value over straight bonds or preferred stock as the conversion price is too far above the current stock price.

Another time that convertible securities can be attractive is soon after a company emerges from bankruptcy. Companies frequently issue convertibles as part of their reorganization or in a follow-on financing round. With the “taint” of the bankruptcy restraining demand, the interest or dividend rate on these convertibles tends to be high and the premium for convertibility tends to be low. Investors can get almost all of the upside potential of the common stock with a bonus of substantial interest or dividend payments. Where there are different types of securities to choose from, it can pay to do a little extra analysis of the various options.
About the Expert

Bruce Kaser has more than 25 years of value investing experience in managing institutional portfolios, mutual funds and private client accounts. He has led two successful investment platform turnarounds, co-founded an investment management firm, and was principal of a $3 billion (AUM) employee-owned investment management company.

Previously, he led the event-driven small/midcap strategy for Ironwood Investment Management and was Senior Portfolio Manager with RBC Global Asset Management where he co-managed the $1 billion value/core equity platform for over a decade. He earned his MBA degree in finance and international business from the University of Chicago and earned a Bachelor of Science in finance, with honors, from Miami University (Ohio).