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Corporate makeovers investors shouldn't overlook

By KATHLEEN GALLAGHER, kgallagher@journalsentinel.com

Market volatility is on the rise, the economy is in transition, the dollar is strong, the price of oil has plummeted, the Federal Reserve is hinting at a rate hike — and clarity is in short supply.

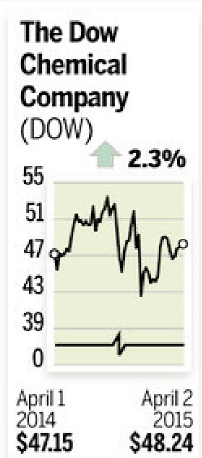
Ignatius L. Smetek

In such an environment, the stock market is no sure bet, said Ignatius L. Smetek, president and chief investment officer at Arcataur Capital Management LLC in Milwaukee.

"It's probably not overvalued, but definitely not as cheap as two to three years ago," Smetek said. "Investing is not going to be an easy opportunity."

Amid the crosscurrents, Smetek said he looks for mispriced values, some among industrial companies that are transforming themselves.

These next two companies "both need to have the world economy doing better for the stocks to perform well, but right now they're a low-risk bet because they're being priced based on history rather than how they're changing," Smetek said.



Graphic/Journal Sentinel

Dow Chemical Co. (DOW, $48.24) Midland, Mich., makes and supplies raw materials and end-market products.

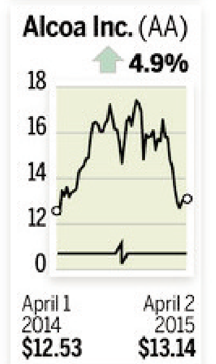
While Dow's stock got hit by the oil price decline, it is not as sensitive to energy prices as it was a decade or two ago, Smetek said. Over the last 10 years, the company has focused more on value-added products, he said. Dow's plans to sell a portion of its century-old chlorine business to Olin Corp. for $5 billion will bring noncommodity sales and revenue close to 75% of the company's total, Smetek said.

"This move is a watershed statement that, going into the next economic cycle, their earnings should be more stable than they've ever been in company history," he said.

The biggest risk is the possibility Dow could fail to execute the transformation and not achieve the desired earnings stability, Smetek said.

Dow shares are trading in a 52-week range of $41.45 to $54.97. Smetek said he would buy them in the mid- to low 40s. The stock could trade above $60 in the next 12 months if the economy continues to do well and the market recognizes the company's transformation and quality of earnings, he said.

Alcoa Inc. (AA, $13.14) New York City, produces aluminum-related raw materials and finished products to a range of industries, including transportation, construction, oil and gas, aerospace and consumer electronics.



Graphic/Journal Sentinel

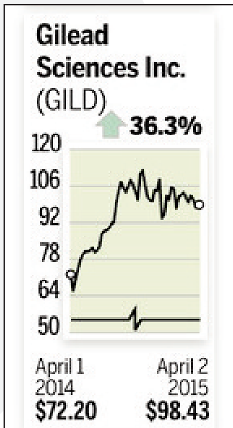
Alcoa's shares have taken a hit recently as the strong dollar dented international sales and profits. The company historically has been viewed as poorly managed, but current management is well respected and driving a transformation to more stability and higher profitability, Smetek said.

Alcoa's transformation isn't as pronounced as Dow's, but more of the company's earnings are coming from value-added products now, he said.

The biggest risk is the possibility that Europe might fall back into recession, Smetek said.

Alcoa shares are trading in a 52-week range of $12.34 to $17.75. Smetek said he would buy them below $13. They could reach $20 in the next 12 months with a favorable economy, he said.

For diversity, Smetek turns to health care, which has been one of the best-performing sectors of the last few years.



Graphic/Journal Sentinel

Gilead Sciences Inc. (GILD, $98.43), Foster City, Calif., is a biopharmaceutical company.

Gilead's shares have fallen as competition has emerged to its hepatitis C drug, but the company's product is still superior, although expensive, Smetek said. Gilead could be forced to lower the price for its drug, but its stock price likely reflects that, and the market "may be discounting some of its other products as well," he said.

Gilead is trading at a price-to-earnings ratio of about 11, a reasonable valuation that may not fully appreciate the company's potential, Smetek said.

Gilead shares are trading in a 52-week range of $63.50 to $116.83. Smetek said he would buy them below $95, and they could trade as high as $125 over the next 12 months.

About this

The Journal Sentinel focuses on one Wisconsin money manager or analyst in this weekly feature, looking at a trend that helps investment pros make their decisions.

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