Can Salton Swing?[1]

Sales growth and profitability are the two pillars of a high valuation. And, based on these two measures, Salton Inc.—the maker of the BreadMan bread machine, the Juiceman juice extractor, and the George Foreman electric grill—looks fabulous. As of fiscal 2000 (ending July 1, 2000), the average ROE for the past four years has been 50.5 percent, and the average annual sales growth has been 70.6 percent. Allowing *eVal* to extrapolate this past performance over the next ten years yields a valuation as of September 30, 2000 (approximately when the 10-K was filed), of over $1,400 per share. At the time, Salton's stock was trading at an all-time high, but this was still only $40 per share, and in the subsequent year it drifted back down to a $20 range. The purpose of this case is to figure out why the market expects so little out of Salton compared to its historical fundamentals, and to decide if this is an appropriate valuation or a severely undervalued stock.

To aid you in your analysis, there are online exhibits at www.lundholmandsloan.com. These exhibits include excerpts from the fiscal 2000 10-K filing and an Excel file with ratio analysis for the four competitor firms and Salton. Finally, case data can be imported by going to the Case Data sheet in *eVal* and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.)

In their 10-K, Salton states that they have the leading domestic market share in toasters, juice extractors, indoor grills, bread makers, griddles, waffle makers, and buffet hotplates, and a strong presence in a number of other related products. They either own or license a number of major brand names, including Toastmaster, Maxim, Breadman, Juiceman, George Foreman Grills, White-Westinghouse, Farberware, Melitta, Timex, and Kenmore. Three principal product lines—George Foreman Grills, Juiceman, and Breadman—accounted for 55.2 percent of sales in fiscal 2000 and 55.4 percent of sales in fiscal 1999. All small appliances combined account for 89 percent of total sales in fiscal 2000.

Salton predominately sells its products to mass merchandisers and department stores, with only a small Internet business selling directly to consumers through infomercials and the company Web site. Its largest two customers in fiscal 2000 were Wal-Mart and Kmart, representing 13 and 12 percent of its sales, respectively. The top five customers in fiscal 2000 represented 46 percent of total sales. With only minor exceptions, it has no long-term contracts with any of its customers.[2]

BACKGROUND

Salton manufactures its products in the Far East using over 45 unaffiliated suppliers, although the largest producer accounted for 38 percent of purchases in fiscal 2000. Its purchases are typically denominated in U.S. dollars, limiting exposure to foreign currency risk. Finally, Salton must place a firm purchase commitment with its suppliers approximately 6 to 12 months prior to receiving a firm commitment from its customer.

THE DEAL WITH GEORGE

Salton's hottest product line is the George Foreman Grill, an electric grill that comes in various sizes and colors, and in both indoor and outdoor versions. The original agreement with George Foreman (former heavy-weight boxing champion of the world) was that Mr. Foreman received in royalty fees 60 percent of the gross profit from this product line.[3] But midway through fiscal 2000, and effective as of the beginning of fiscal 2000, Salton negotiated a significant change in this agreement. Instead of annual royalty payments,

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[1] Professor Russell Lundholm prepared this case as the basis for class discussion.

[2] Salton has a contract with Kmart that technically runs through June 30, 2004, but Kmart can terminate the agreement without cause after June 30, 2002. Consequently, this contract by itself does not represent a sustainable competitive advantage.

[3] December 9, 1999, company press release.

Salton purchased the rights to the George Foreman trademark in perpetuity, paying with shares of Salton stock valued at $23.75 million and a note payable for $113.75 million, payable in five annual payments (one of which occurred in fiscal 2000). All together, the present value of consideration given for the trademark was $122 million, which is being amortized over 15 years.

QUESTIONS

1. Consider the competitive forces at work in the small-appliance industry. Do you think Salton can sustain its unusually high profits and return on equity in this industry?
2. For comparison purposes, the online exhibits for the case give a ratio analysis from *eVal* for four of Salton's competitors: Applica, Maytag, Sunbeam, and Whirlpool. Based on the Dupont analysis, how has Salton generated such a large return on equity relative to these other firms? Do you see any significant trends or changes in Salton's ratios over time?
3. For the past two years, Salton has stated in their Management Discussion and Analysis that a significant source of their sales growth has been from the George Foreman product line. Estimate what fraction of total sales is due to these products?
4. The deal with George Foreman has both real economic effects and cosmetic accounting effects that will bear upon your forecasts of Salton's future income. Discuss each. How will the deal with George Foreman change the relationship between sales and other income statement items?
5. Suppose you believe that the George Foreman trademark is grossly overvalued in Salton's books; in fact, rather than its book value of approximately $113.9 million ($122 million less $8.1 million in amortization), you believe it is worthless. Discuss the different ways you could express this belief in your forecast inputs to *eVal*.
6. Load the case data for Salton into *eVal*. Change the valuation date to be September 30, 2000, roughly the release date of the fiscal 2000 10-K. If you leave everything else at the default *eVal* levels, the resulting value estimate is over $1,000 per share. Modify the forecasting assumptions to represent a more realistic scenario. If you believe the Foreman trademark is over-valued, you may also want to modify the financial statements to correct for this distortion. Putting it all together, is Salton still an undervalued stock?