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Pull the Plug on Best Buy

By Teresa Rivas

EVEN AFTER TODAY'S SELLOFF in Best Buy (ticker: BBY) shares, better buys can be found elsewhere in the market.

This morning, the largest U.S. electronics retailer reported fiscal third-quarter earnings of 53 cents per share, beating the Street's estimate of 43 cents, boosted by charges in the year-ago period and increased sales.

However, the stock tumbled 8% on the news to a recent $41.74, as investors fretted over this quarter's margins, which Best Buy said would come in below expectations due to lower prices on items like netbooks and televisions.

Still, it wouldn't be wise to buy on today's weakness as the company continues to face strong headwinds in the current retail environment.

The stock, which established a 52-week high yesterday of $45.55, has risen 85% in the last 12 months. Looking at today's news, it's hard to see what might push shares higher.

Best Buy's results, which showed that consumers remain eager for bargains, are consistent with other retailers' holiday experiences who have seen increased sales but a lower total of dollars spent per shopper. Best Buy, along with other electronics retailers, has seen its margins pinched throughout the recession. The company's trailing profit margin is now below 2%, and its operating margin is just above 4%.

Likewise, while it shares macroeconomic woes with the rest of the sector, Best Buy must also contend with the fact that consumers often have lower-priced alternatives, especially in rivals like Wal-Mart Stores (WMT) and Amazon.com (AMZN) who have been turning up the heat in this holiday's price wars.

As Telsey Advisory Group analyst Joseph Feldman notes, this is even more problematic than in years' past, due to a lull in new product offerings and the commoditization of popular items like big-screen TVs. Without new specialty items, Best Buy loses its edge and consumers have less incentive to pay their slightly higher price points. Indeed, on Thursday, when Costco (COST) reported fiscal first-quarter earnings, the discounter noted it had seen an uptick in television sales.

Nor has the demise of onetime competitor, Circuit City, had as meaningful an impact for Best Buy as some had hoped, as the consumer pullback allowed some business to simply evaporate, rather than transfer to other retailers.

Trading around 14 times next year's earnings may make the shares seem relatively inexpensive, but Wedbush Morgan analyst Michael Pachter argued that a multiple in line with the market isn't warranted, given Best Buy's growth prospects. "Notwithstanding positive indications about the start to the holiday season, we believe the consumer electronics category will remain under pressure for some time," he wrote in a research note. "[W]e think that Best Buy's core business is exposed to flat or negative growth in the coming years."

Company insiders may agree. In late November, Best Buy's founder and chairman, Richard Schulze, sold $21.6 million of the company's shares. (See Inside Scoop, "Best Buy Founder's $21.6 Million Sale," Nov. 24, 2009.)

"[T]he fortunes of the company are so tied to the consumer that now is probably a good time to sell shares," Lon Juricic, president of StreetInsider.com noted at the time of Schulze's sale. "The gains in the stock are already discounted for the wariness of the consumer. More gains will be hard to come by until the consumer really opens up his wallet."

With margins under continued pressure and increased competition, Best Buy will have to overcome a number of headwinds before its stock can be considered a good purchase.