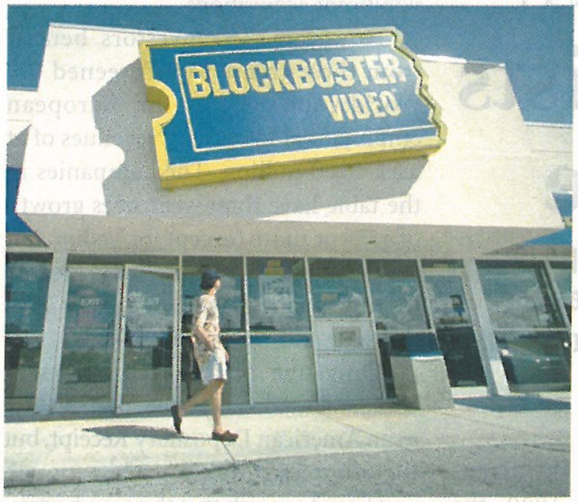
Blockbuster Idea

Viacom's public offering of an 18% stake in its Blockbuster video rental chain has been something of a dud. Shares fell 20% below the $15 offering price before recovering to a recent $14.56. Buy them, recommends Salvatore Muoio of SM Investors in New York City.

Bears say the video rental business will soon be overtaken by "video-on-demand" services over cable TV. Muoio counters that video-on-demand is still five years away in most of the country. In the meantime, Blockbuster (NYSE: BBI) will be taking a lot of business away from solo rental-store operators. Its 6,500 stores enjoy considerable economies of scale, including a nice deal with Hollywood, in which it gets tapes for a nominal $5 a copy in return for giving the movie studios 40% of its revenue. That beats the old system, in which it would pay $60 to $70 apiece for the tapes and risk having a lot of inventory that never left the shelf.



Blockbuster: Not a dinosaur—an 800-pound gorilla.

Don't be put off by the meager reported earnings; they reflect a noncash charge for goodwill amortization. Instead, Muoio focuses on the chain's operating income, in the sense of profits before depreciation, interest and taxes. For next year Muoio expects that figure to be $715 million. The chain's enterprise value—debt plus market value of common—is only $3.9 billion, or 5.4 times that operating income. Granted, some of Blockbuster's depreciation expense represents a true depletion in the value of hit movies. Even so, the enterprise multiple is very low.

The chain, which enjoyed a 13% gain in U.S. same-store revenue last year, plans to add 3,000 stores in the U.S. and overseas in the next three years, and is developing a system to allow customers to reserve tapes on-line. —JOHN GORHAM

Saks Alabama

Manhattan merchant Saks Fifth Avenue lost a bit of its cachet after it was taken over by Birmingham, Ala. department store chain Proffitt's, which then adopted its acquisition's name. Shares of Saks Inc. (NYSE: SKS) have fallen 55% from their February high, to a recent $17.88.

The problems are very visible. Chief Executive R. Brad Martin has lost credibility on The Street, having cut the earnings forecast for the Jan. 31, 2000 fiscal year from about $2.16 to $1.80 per share. When he first took over Saks, the snickers started about whether a Tennessee native could ever be hip to New York fashion. Then Martin and his executives misread demand for Saks' upscale mix, which includes items like $18,000 evening gowns.

Now comes Lawrence Sondike, a portfolio manager at Short Hills, N.J.-based Mutual Series Funds, to say that the disparagement of Martin's management is overdone. Martin must know something about retail, says Sondike, to have taken the predecessor to Saks from a five-store operation in 1984 to a $6.2 billion chain now. "Martin's one bad forecast is a rare blemish," says Sondike.

He predicts that Martin will back off from involvement in Saks' merchandising and will focus on the $65 million in "back office" efficiencies he originally promised at the time of the merger. At any rate, says Sondike, a 15% crimp in the earnings forecast does not justify a 55% collapse in the stock price. Peers like Federated Department Stores sell at earnings multiples that are double Saks'. —DOLLY SETTON

Tooth Fairy

Susan Schottenfeld, manager of TCW Galileo Value Opportunities Fund in New York, is buying Henry Schein Inc. (Nasdaq: HSIC) at $14, less than a third of the $46 it commanded back in January. The company is the world's largest distributor of supplies to dentists. In 1998 its sales were $1.9 billion and net profits were $16 million, or 42 cents a share.

What's not to like: Schein's acquisition binge of 13 small companies in the past 18 months has given it indigestion. Dozens of salespeople defected to rival Patterson Dental. That and $65 million in unanticipated merger costs hurt earnings.

The defections have been staunched. But what Schottenfeld especially likes about Schein is a small ($80 million sales), fast-growing division that sells software to manage customer lists and billings for dentists and doctors. She thinks the tiny unit is worth $500 million, 85% of Schein's current

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