Reprinted from BARRON'S

June 11, 2007 *Copyright © 2007, Dow Jones & Company, Inc.*

Hard Times Ahead at the Mall

BY SANDRA WARD

Interview With Shawn Kravetz

Founder and president, Esplanade Capital

By sticking to select sectors and to disciplined investing principles, the man in charge of Boston-based Esplanade Capital has consistently rewarded investors with good ideas and strong performance. This year, Kravetz has delivered 9.45%, after fees, through May, and his fund has gained 16.57% a year on average, after fees, for the past five years. For the first time we can remember, he's not finding much to like in retailing, a specialty of his. But he's warmed upto the hot solar sector.

Barron's: Let's talk about your views on the retail sector.

Kravetz: Retail has always figured quite prominently in our portfolios. But today we have our lowest retail exposure in over five years, because there is an unfortunate confluence of growing risk as the stocks are rising and rarely does this lead to good investment opportunities, at least the way we think about them. We are just not finding much.

Q: Aren't there a lot of turnarounds to get interested in?

A: The markets tend to get very excited about the next big turnaround like the Gap [ticker: GPS], which had a lot of excitement around it during the holidays. But the excitement was on Wall Street, not in the stores. Paying high multiples for the promise of a turnaround or dramatic growth becomes a riskier and riskier bet as the environment gets tougher. We are cautious. We are thinking in terms of consumer compression not consumer recession.

Q: Meaning?

A: Meaning we expect a slowdown, as opposed to a collapse. A lot of my concern boils down more broadly to rates. If interest rates remain in this ballpark, lots and lots of things will squeak by. But if we see a rate spike, the real-estate market will face even more risk, and that will have a substantial impact on consumption. People's discretionary income will fall dramatically as the cost of keeping a roof over their head rises. Lastly -- and this is very important -- the discount rate that we as investors use, and particularly what private-equity firms use to calculate their beloved terminal value -- the present value of future cash flows -- will go up, and the terminal value will fall. The private-equity put that has been so valuable of late across industries will start to wither. And the leverage that private-equity firms and hedge funds use to support some of these valuations will also go away. A lot hinges on what happens with rates, and we don't see any immediate spike in rates. But that's the one thing that most concerns us.

Q: What retailers do you like?

A: In our entire universe, we could find only one core retail holding, and that's Tween Brands [TWB].

Q: Go on.

A: Tween Brands was formerly known as Too. But they changed their corporate name to reflect the fact that they have two very different distinctive retail banners today: the Limited Too, which is a great business, and a relatively new concept by the name of Justice. Limited Too is the most unheralded specialty-retailer growth story out there. They sell fantastically well-merchandised apparel and lifestyle products to girls between the ages of 7 and 14. It's a very steady, very profitable business with 570 stores and modest growth potential. Until recently, people thought they had no growth potential. But we think they'll increase square footage by 5% in the next couple of years. That's not immaterial. Combine that with 20%-plus operating profits at the store level, and this is just a great cash cow.

Justice, on the other hand, is the strip-mall version of Limited Too: You get a similar feeling but lower prices and the strip-mall format, which doubles their opportunity for square footage and market penetration. They have opened 184 stores under the Justice concept, and same-store sales comparisons were up 22% in its most recent quarter.

Q: Why is the stock underappreciated?

A: Only recently has Justice started to contribute to profits, because it was very small and there was some overhead required to open 184 stores. They are building 100 stores this year. Management thinks profit margins at Justice can be at least as high if not higher than the Limited Too margins. We agree with that because even though the average selling price is lower and gross margins are lower, the real estate is so much cheaper the operating margins can be higher. This is a business that in, say, 2008 can contribute roughly half as much to corporate profitability as the Limited Too division does. That's a big number for a piece of the puzzle that people still aren't talking much about yet.

Q: What are you expecting for earnings?

A: They are extremely well set up for the second half and, more importantly, 2008, when Justice will really be firing on all cylinders. Tween earned $1.95 a share last year. The company is guiding to $2.15 to $2.25 a share this year. But the story for us is 2008, and it is not unthinkable that they could earn $3 a share next year, up from $2.15 to $2.25 a share. They are also starting to do a virtual leveraged buyout. In the first quarter, they bought back $59 million worth of stock, or almost 5% of the company. You could easily see an 18 to 20 multiple that, if not in '08 then by '09, gets you to a $54 to $60 stock.

Q: What other sectors appeal to you?

A: We have been active in solar power. About three years ago, we started to see just a dramatic growth in the sector outside the U.S., and we started to appreciate the economics of solar power in a world very concerned with energy prices, energy independence and all things green. The solar market grew roughly 50% last year, and we believe it will grow 50% again this year. Growth would be faster if not for the global shortage of a key raw material, polysilicon, which is keeping

THE PUBLISHER'S SALE OF THIS REPRINT DOES NOT CONSTITUTE OR IMPLY ANY ENDORSEMENT OR SPONSORSHIP OF ANY PRODUCT, SERVICE, COMPANY OR ORGANIZATION
JOURNALREPRINTS (609) 520-4331 P.O. BOX 300 PRINCETON, NJ 08543-0300. DO NOT EDIT OR ALTER REPRINTS, REPRODUCTIONS NOT PERMITTED
DOWJONES

prices higher and supply lower than normal. We see that situation easing in the coming couple of years. We see staggering growth. We see superb companies, and we see local and national governments around the world with a tremendous appetite for solar energy.

Q: How about a pick?

A: Evergreen Solar [ESLR]. It's in many ways the most interesting because it is the messiest story. They offer a very special technology called String Ribbon wafer technology that allows manufacturers of solar products to use less silicon, which is important given the shortage of silicon. Evergreen's technology uses about five grams of polysilicon to produce one watt of power and we think that will go to about three grams a watt by 2010. The industry average is closer to nine grams per watt.

Today, at a weighted average cost of $100 per kilogram of polysilicon, Evergreen spends about 50 cents a watt on silicon, and that's 30% of the total cost of the solar cell. A typical industry player would spend about a $1 per watt on silicon, representing almost 45% of the cost of goods sold. Evergreen has a 20% cost advantage. Even if silicon prices were cut in half, Evergreen would spend about 15 cents a watt on silicon, whereas an industry player would spend roughly twice that.

Q: What else does it have going for it?

A: Today versus last year at this time they have a terrific new CFO, their Ever Q joint venture with Q-Cells of Germany is humming, and they have a secured silicon supply.

They've raised a lot of money, and solar is on fire. And we see a company that is poised for tremendous growth over the next three to five years but whose stock, unlike many of its solar peers, has done nothing.

Q: How is that?

A: They do not make money today. They have had to raise a fair amount of capital to build plants. Historically, they have had poor Wall Street relations. Expectations, because of that, are quite low.

Q: Would they also be a takeover target at some point?

A: To us there are three potential outcomes to this story: One is what they are pursuing now, a go-it-alone strategy with some joint ventures where they can earn north of $1 a share by around 2010, and that gets you to a $15-$25 stock price. A second scenario, which I refer to as an "asset lite" strategy, is one where they become a technology-licensing company and instead of raising capital and building plants, license their technology for royalties.

That's not unlike what they've done with their joint venture in Germany, where they get a technology royalty, a marketing commission and also own a third of the equity. If they just went to a straight licensing fee, you could easily envision a business that generates a couple of hundred million in revenues at nearly 100% gross margins.

They could buy back stock. And you could see a stock that gets north of $20 a share based on $200 million or more in pure gross margin. The last scenario, which we think is incredibly viable, is the sale of the company.

Q: How about another idea?

A: Western Union [WU]. They are the leader in global money transfer, providing people around the world with easy and trustworthy ways to send money. They have 300,000 agent locations in 200 countries. It provides an absolutely vital service. We think it is underappreciated because Wall Street has an Internet view of the world, which is, why not use PayPal and credit cards to send money? But a lot of Western Union customers don't have access to e-mail or a computer or a bank, for that matter. When they were preparing to be spun out by First Data, we were astonished at their returns on capital, their cash-flow generation, their 30% profit margins. Historically, this has been a very solid and a low-double-digit-growth business. Nice and boring and immensely profitable. But because of the costs of becoming a public company and some short-term disruption in the Mexican market, an important market for them, and some headline risk on immigration reform, we think the stock now presents an opportunity.

Trading at just over 17 times 2008 earnings and just over 11 times 2008 Ebitda [earnings before interest, taxes, depreciation and amortization], it is just too cheap.

Q: Anything else?

A: We are short Amazon.com [AMZN].

Q: That's brave of you.

A: Amazon is a terrific company, no question. And oddly we once owned it. But we think the valuation here is excessive and their very solid recent quarter has led to dramatic expectations for earnings leverage. Those are expectations we do not believe can be delivered upon.

Q: Why not?

A: They are losing some customers such as Toys "R" Us and Borders Group [BGP]. Those weren't big profit drivers but they helped Amazon get to scale. Amazon is pursuing new categories for growth, which is a little bit like building more stores versus comp-store sales. Again, that's not necessarily bad but, it is a less profitable way to grow. Their competitive advantage of selling online is not growing, even while their business is growing.

Most importantly, there is a natural limit to their operating margin potential given the product categories they are in. Given the ease of online price-comparison shopping, Amazon is not going to have 20% operating margins selling books and music and general merchandise because, while they will have very loyal customers who are price insensitive, it is just too easy -- three mouse clicks -- to get to a cheaper way to buy the new bestseller. That will put a break on some of their margin expansion, even as they continue to grow their scale. Their ballpark 5% operating margins have room to grow, but we do not believe those margins can ever exceed 10%, and it will be a Herculean task moving them towards 10%.

To make this a cheap stock, margins would have to triple. Amazon is trading at a P/E of 72 times '07 estimates and 53 times '08 estimates. It is trading over 30 times Ebitda. Those multiples are higher than Google's [GOOG], and that is striking. As they raise prices to drive the incremental margin, they are going to lose some of their customers. We also believe their customer-service edge is not as sharp as it once was. As a result, it is going to take too many years of revenue growth to grow into this valuation.

Q: There's a lot of consolidation going on? Aren't you worried about a takeover?

A: At $30 billion in market value with the multiples it trades at, we think there are very few companies that could even begin to consider that, and so we are willing to take that risk.

Q: Thanks, Shawn.