TAYLOR
INVESTMENT SERVICES LLC

Independent Portfolio Management

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Dear Client,

I do not normally address the stock market situation in these quarterly reports, instead preferring to focus on stocks and their stories, but clearly the combined impact of earnings shortfalls, accounting irregularities, and external geopolitical events are wreaking havoc on the stock market, particularly the larger company indexes. When will it end?

I have no idea.

My views on this issue should not be surprising to those who have been with me for any length of time, as described by this Lynch quote mentioned in previous reports:

A decline in stocks is not a surprising event, it's a recurring event – as normal as frigid air in Minnesota. If you live in a cold climate, you expect freezing temperatures, so when your outdoor thermometer drops below zero, you don't think of this as the beginning of the next Ice Age. You put on your parka, throw salt on the walk, and remind yourself that by summertime it will be warm outside.

A successful stockpicker has the same relationship with a drop in the market as a Minnesotan has with freezing weather. You know it's coming, and you're ready to ride it out, and when your favorite stocks go down with the rest, you jump at the chance to buy more.

Of course, it is important to view your portfolios with an appropriate reference point. If, for example, you check your portfolios on a weekly basis or even more frequently, the tendency will be to measure everything from the highest point. As John Train says in **The Craft of Investing**:

In a decline, people measure down from the top. Thus, if over a year or two a stock rises from $20 to $60, then drops back to $40, its owners are depressed that it's down from $60, even though only a handful of shares may have traded at that level, rather than pleased that is has doubled from their original purchase price, which they now take for granted.

Of course, even a more appropriate long-term view does not eliminate the emotional pain of a short-term loss (particularly for those of you who have been with me only a short time), but everything should be placed in proper perspective. The last three years have been exceptional and as I write this most accounts that were with TIS at the beginning of the year achieved a solid return for the first half. A few smaller accounts are slightly negative for the year (largely due to the purchase of Alliance Capital discussed below).

Remember, the stock market is not like a CD. Periods of decline are common as investors price businesses based on a myriad of factors. Some may actually reflect the progress of the business itself but this is not assured in the short-run. Emotions will clearly play a large part in that pricing.

Investors should try to isolate themselves from the normal day to day chaos swirling in the market. This is easier to do when the market is surging forward instead of going down but detachment should work both ways. Look at your portfolio less frequently, and look at it objectively. If you are interested in how your portfolio is doing, try to focus on the individual company profiles in this report. Longer term, there is no reason to doubt that the progress of a business will be the ultimate factor that determines performance in the stock market. Besides, few people have any skills in market forecasting. What we can control is the type of companies selected and the underlying approach used. Very simply, we continue to invest in:

Understandable businesses.
The latest flood of annual reports profiled a dizzying array of clothes, stores, 99c items, and asset managers, among others. For the most part, these reports were relatively simplistic and brief in presentation, at least compared to many other companies you could review. The report for Christopher and Banks (CHBS) is a typical example. The company is a clothing retailer for 35 to 55 year old women and is expanding across the country. It is clear that growth is measured both by how sales are doing at existing stores ("same store sales") and from expansion. The report tells you that the company opened 82 new stores last year, ending with 351. Another 90 stores are planned next year. The growth path is simple and can be easily monitored. The business is understandable. This is typical of the companies we are buying.

Companies that do one thing.

We have generally avoided the multi-business operator, especially those that expand through acquisition of non-core companies (Berkshire Hathaway is a notable exception). Lynch used to call this "diworsefication". Acquisition activity is often fraught with risk, from paying too much to the difficulties of integrating new operations with an existing business. And if a company must look for acquisitions for growth, that is usually a pretty good indication that the core business has matured. Of course, one-business companies are also easier to evaluate.

Companies with solid balance sheets.
Investing is like tennis: you can win by simply not losing. One way to avoid losing is to stick with companies with conservative financing, those with strong balance sheets. Manageable debt can be useful in growing a business but excessive debt can lead to problems. You can see this on a personal level; mortgage debt is certainly appropriate in correct amounts, but if you add debt on a car or credit card then a temporary loss of income can have catastrophic effect on an individual's finances. TIS has simply chosen to avoid this problem entirely by focusing our attention almost exclusively on companies with strong balance sheets.

Companies in focused industry groups.
By concentrating my efforts in three core industry groups (retail, restaurants, and asset managers), I should be able to cover an unusually wide range of companies within these industries. Due to familiarity with the same business model, the critical factors for these industries should be obvious, the items that drive the stock should be apparent, and the potential pitfalls that could result in losses should be readily identifiable. In essence, we are trying to do one or two things very well, trying not to "diworseify" our investments.

RECENT SALES

We have sold a number of our asset management stocks and the portfolios carry a large amount of cash. Many asset managers have been liquidated entirely and our largest holding, Gabelli Asset Management (GBL), has been significantly reduced.

Asset managers, particularly those that manage large equity holdings, will be directly impacted by stock market conditions by varying degrees. The best time to hold an asset manager is when the valuation is reasonable and the asset under management (AUM) comparisons are improving. The worst time is when AUM is declining and the valuations are high.

Right now, most AUM comparisons are likely going to be negative going forward until the markets reverse. This probably means that earnings will be lower, and while that alone is not a reason to sell (comparisons could also improve if the market improves), most of the prices for these companies have not fallen enough to adjust to new realities.

As an example consider that at the time of our sale, Franklin Resources (BEN) and Neuberger and Berman (NEU) traded at a price to earnings (pe) ratio of 24 and 22x respectively, despite challenging AUM comparisons and lower recent earnings comparisons. Similarly, GBL's weak AUM comparisons (and pe of 20 or so, though GBL has a terrific balance sheet) no longer suggested the position should be over 10% of most portfolios.

Finally, I sold AC in some smaller accounts while simultaneously increasing it in some large accounts. While AC faces difficult AUM comparisons the price on that stock has fallen significantly. However, AC will also see a rise in expenses this year (partially related to a recent acquisition), which means that EPS comparisons should be weak and thus no obvious catalyst exists to drive the shares higher. I am comfortable with a 2% position in these shares but this size is impractical for smaller accounts.

Frankly, I would prefer all accounts reach at least $100,000 to allow for maximum flexibility, but the ultimate decision to place AC in smaller accounts had a detrimental impact on performance. In the future I will be more patient with smaller accounts because the number of positions we can buy there is not the same as my model account.

SELLING DECISIONS

TIS tries to be optimistic about our holdings, subject to verification, but also with the view that it is only what we own that can hurt us. This has often led to rapid portfolio turnover (with resulting tax consequences in taxable accounts), especially when our positions are undergoing substantial volatility. In part, as mentioned in past reports, this is a function of the type of stocks we follow. Retailers in particular undergo wide price swings, in part because their progress is usually updated monthly. You might think that having MORE information available would increase the patience and intelligence that investors possess who follow this area but the opposite is often true. In essence, it appears that more information on a short-term basis results in a short-term viewpoint. Since this results in substantial changes in valuation, we will buy and sell as circumstances dictate.

Actually making the decision to sell is a subjective process, but here are some basic questions that arise:

Am I willing to buy it in a brand new portfolio?
One of the advantages in managing separate accounts is that I am forced to evaluate my current portfolio's

suitability whenever new accounts are established – and no memory or reference point for each position is allowed. After all, this is new money, so past performance is irrelevant. My personal IRA portfolio stands as a model for all client accounts. If I am not willing to buy a stock in a new account that is in my existing account in the same percentage (as much as possible; portfolio sizes limit this flexibility) the next question should be, 'why do I own this stock?' In essence, by choosing to hold a stock, an investor is conceptually repurchasing the stocks in his portfolio anew.

Has the valuation or story changed?
A sell decision is ideally triggered by a radically altered stock price, hopefully in an upward direction. But even a lower price can cause a sell if the company's business has deteriorated further than the stock price of the company. I try to always evaluate a position without regard to a reference point, whether a buy price, a price at the beginning of the year, or a price three years ago. What is important is identifying the appreciation potential and possible risk involved from this point forward.

Have I made a mistake?
Stock picking is hardly an exact science and mistakes occur. An investor should carefully weigh the odds in an investment but nothing is assured. Sometimes an important piece of information can missed or circumstances can change. For example, if a company begins to issue significant option grants or makes an expensive acquisition. Not to belabor the point but a reference point like a buy or sell price should not cloud judgment. Holding a stock until it gets back to $35, your original buy price, is not a logical way to evaluate a stock.

Have I found something better?
TIS is rarely fully invested but there are times when better opportunities exist than what we hold. In this case we will sell, subject only to tax considerations. Among stock categories, we probably have the most turnover in our stalwarts, but I generally scale our stocks rather frequently.

COMMISSON CHANGE

TD Waterhouse has increased commission rates by $3 to $15 from a market order to $18 for a limit order. Any increase is repugnant, especially when the value received from the increase isn't readily apparent (though Waterhouse has said that the increase will help with technological improvements to their brokerage site).

That said, there is more to executing an order than just pricing. One of our former brokers failed to execute a market order in a timely fashion, ultimately causing the execution of a trade at prices as much as $2 higher than appropriate. While we saved money on commissions from this broker, this error alone cost several thousand dollars.

Overall, I have been pleased with our current broker, both in the resolution of normal daily issues and more importantly with order execution. While not oblivious to commission costs, they are inclusive in our return on investment totals and I would rather worry about whether an investment should be bought or sold verses how much this will cost in commissions. That said, TIS has a strong incentive to minimize commission costs: this fee goes entirely to TD Waterhouse.

I will allow the increase in commission size to have one noticeable impact. To ensure that commissions do not overwhelm a single purchase, orders will be limited to at least $2000 and normally $3000-$3500.

COMPANY PROFILES

This is a partial list of TIS companies; several smaller positions are not included, including Big Lots, Berkshire Hathaway, and Costco. Not all stocks will appear in your personal portfolio. To save time, these profiles were not re-written for client presentation. Many were written in April and May along with June as indicated on the specific item. **Thus, the numbers in these profiles are entirely dependent on the price at the time.** These opinions are subject to change on a moment's notice, and no profile should be construed as a recommendation for any listed security.

Abercrombie and Fitch - fast grower

ANF operates 507 stores under the ANF (college theme – 311 stores), abercrombie (7-14 year old - 153), and Hollister (younger teen – lower price point; 43) labels. ANF is a fast grower with store counts increasing from 250 three years ago to 354 two years ago and 491 last year. Plans are for 118 stores this year, a 20% square foot (sqft) growth rate. Like most apparel retailers, margins peaked in 1999, with net margins at 14.4% then to 12.4% last year. Margins were slightly lower in Q1, with gross margins down 0.5% and selling, general, and administrative (SGA) costs slightly improved, as cost controls continue to keep margins under control despite a same store sales decrease of 6%. Lower interest income led to a 13% EPS increase on a 19% increase in sales. The balance sheet is in great shape, with 239m in cash and 175m in total liabilities in Q4. Inventories were down 19% on a sqft basis as of the end of 1st quarter, though they expect inventory levels to rise to last year's level by Q2. The capital expenditure (CapEx) budget is now 95-105m verses about 210m so plenty of cash will be added this year. Hollister is the big growth vehicle now, with 60 stores planned for this year and likely even more than that next year. Hollister's gross margins have been approaching ANF margins despite 30% lower price points. They are not seeing any cannibalization with these stores. Hollister's growth potential is unlimited for now, though the 12 to 13% store growth for the ANF stores suggests that maybe that core concept is closer to saturation. The kids concept is clearly being de-emphasized in favor of Hollister. Option grants have been a problem with this company, though the 01 grant was significantly less than the previous two years (abt 648k granted compared to 1.4 and 5m the previous year when they were spun-off). Compensation is off the charts, though ANF's performance almost justifies it. Going forward, ANF has the following same store sales for May to Nov: (-2, -4, -14, -10, -18, -20, -5). ANF trades for 18.6x trailing earnings (19.5 option adjusted), 15.2x cash flow (14.8 adj; 15.2 option adj). The company has said they are comfortable with 26c in Q2 (vs. 24c last year). Value Line estimates $1.80 for 02 (17.3x) and the guess for 03 is $2.25 (13.8x) and a one year growth rate of 25% and a longer term growth rate of 14%. ANF is a superior company with great margins in a tough market. Hollister looks like a growth vehicle with big potential, and the balance sheet will likely only continue to get better. The big risk is that the still sky-margins come under pressure from decreasing same store sales, but eventually perhaps the men's business will turn around. If it does and women's business stays the same they could meet all estimates, maybe exceed them. I like this as a 3 to 5% position, mainly due to the strong balance sheet and the identifiable niche this company seems to have along with good growth in the Hollister brand, especially since the current sales problems might eventually resolve themselves if men's apparel turns.

5/19/02, 31.06

Alfac (AFL) – stalwart

Aflac sells supplemental insurance in Japan (75% of sales) and the U.S. (25%). Supplemental insurance helps to cover gaps in an individual's existing health plan, and often covers disease or body-specific areas (e.g., cancer insurance or supplement dental coverage). As a stalwart, even after the recent price rise (year to date) AFL sells for the lower end of its 5-year PE range of 27.8 to 16.1x earnings. Based on Value Line's 2002 estimate of $1.70, AFL trades for 18.2x earnings. The first quarter was optimistic, with premium growth of 4.4% in Japan and 16.4% (both figures annualized) in the United States. Last year Japanese premium growth was down 7.9% (on a yen basis) so the 1st quarter results lend credence to management's 5 to 10% premium targets in Japan this year. Next year could be even better as the Japanese Ministry of Health is likely to raise national health plan deductibles to 30%. In previous years when this was raised AFL's sales increased significantly. The US business continues to be strong, and with 200k payroll accounts (compared to 290k in Japan) targets of 15% appear achievable. The balance sheet appears in great shape (though frankly as an insurance company, especially with assets in Japan, you must assume that future policy benefits and unpaid claims are accurate) with 5.4b in equity. Last year total liabilities declined by 102m with assets – mostly cash and securities - increasing 629m. AFL continues with a buyback plan that purchases about 12 million shares a year. AFL had 624m shares in 1994 and the share count is about 525m now. The option plan is reasonable (though the grant last in 2000 was significantly higher than 2001) and compensation is also reasonable for a company of this size. Insiders own 19.4% of the company. AFL targets 15% operating income growth without impact of currency, though the yen weakness has really hurt them in Japan, and this target appears reasonable. Note that the pension plan does appear to be under funded by 60m, though compared to the equity of this company that total appears small, but this is an item to watch in future results. You now have generally about 2% in this stock and that percentage appears right considering the favorable trends offset by a higher price.

5/26/02, 31.12

Alliance Capital (AC) – asset play

As of the end of April, AC managed 437b in assets. They have 261b in equity assets (59.7%, with 35.2% in growth, 24.9% in value), 149 in fixed income (34.1%), and 27b in passive (6.2%) accounts. This compares to 465b in the 2nd quarter of last year. Assets have grown a good pace the last several years, as AUM was 219b just five years ago. Fund flows have been strong, with net flows of 5.1b in the first quarter and 29b for the past 12 months ending in March. Most areas have seen inflows though their retail growth side is having a difficult time (as expected). The balance sheet for the operating company is fine. The Dec balance sheet had 3.988b in equity, though AC does have 3.6b in goodwill, much of it from the Bernstein acquisition which added value oriented assets, an acquisition that looks terrific now that investment styles have changed. The second quarter was difficult, as average AUM was down modestly and due to shift of assets to fixed income the fee base has declined. Operating income was down to 60c from 69c last year, and the distribution was 59c. So far, it is reasonable to expect another down earnings quarter in the 2nd as AUM levels are lower than last year and the mix shift will hurt again. The option plan appears reasonable. My estimate (rough, considering the operating and holding structures complicates matters here) of the pe is 18x earnings and 14x cash flow and a dividend yield of 5.9% based on the latest 59c distribution (though it will also drop in the next quarter). AC spent 76m in buybacks in the first quarter. AC's asset mix is appealing – despite large declines in the large cap index, esp. the growth side, AUM has been stable. While next quarter will likely be down and the market environment is uncertain, AC is an attractive holding for the long term assuming 6% market appreciation. I think this should be a 2% position.

5/29/02, 39.89

American Eagle Outfitter – fast grower

AEOS operates 801 college themed late teen to early 20 mostly mall-based apparel stores targeting both men and women (54% women's apparel, 39% men's apparel). AEOS has been a fast grower, with store counts increasing from 332 five years ago to 466 three years ago and 790 at the end of fiscal 2001. Plans for 2002 include 70 new stores, 40 remodels for 14% sqft growth. Like most apparel retailers, margins peaked in 1998, with net margins falling to 7.7% last year. In the first half of this year ending in July, it looks like net margins will be lower again. First quarter results were disappointing, with same store sales down 6.1% and both gross and SGA margins worse, with depreciation also hurting earnings. The company says poor results were due to colder weather, restructuring in Bluenotes/Thrifty in Canada, and a fashion miss in not having the currently popular hippy/bohemian look. They expect the Canada stores to do better in the 2nd half as the company will have repositioned those stores, and the fashion miss should be corrected by summer. Weather is of course a wildcard, though cold weather has continued to this date (my note: weather is more normal now). The balance sheet is in good shape, with inventories only up 10% year over year and down 6% on a sqft basis, and cash levels are strong with the fiscal year ending with 225m with 170m in total liabilities. The CapEx budget is 107m this year verses about 140-145m in cash flow, so again they will generate excess cash this year (estimates are for 55m for depreciation/amortization). AEOS will likely add a new concept in 12 to 15 months, and with 1000 to 1200 store counts seen as saturation growth rates will become a bigger issue going forward (2-5 years currently with no new concepts). Option grants have been a problem with this company, though the 01 grant was significantly less than the previous two years (about 1m granted compared to 2.5 and 3m the previous year). Going forward, AEOS has the following same store sales for May to Nov: 0.2, 9, 3.7, 2.1, -1.5, 7.2, 9.6. AEOS trades for 18x trailing earnings, and 12.8x cash flow (12.4 adj). VL estimates $1.55 for earnings this year, reasonable with results expected to improve in the 2nd half which is per the company's guidance and a trailing pe of 16.2 and a yearly growth rate of 8%. The guess for 03 of $1.85 is a pe of 13.6 with a one year growth of 19%. I like this as a 4 to 5% position mainly due to the strong balance sheet and the identifiable niche this company seems to have, especially since the current issues – weather, fashion miss, and the BN/Thrifty conversion – all appear to be correctable issues. AEOS is a high quality company with fat return on equity (ROE) and return on assets (ROA) numbers and has generally managed its business well in a many sorts of environments. With 4 to 5% here, I think it makes sense to re-evaluate this company on a 6 month basis (to 11/19) and perhaps 12 months (5/19/03).

5/19/02, 25.08

Applebee's – Asset Play/Fast Grower

Latest evaluation: APPB operates 1404 company (314) and franchise (1090) owned restaurants. At the company estimate this year of $2.15, with a price of $40.46 the pe here would be 18.8. In 2002, they plan on 25 company units (base of 310, so this is an 8% growth rate) and 80 to 90 franchise units (base of 1082, so this is about an 8% growth rate too). Same store sales are difficult in the first half, easier in Q3, and then difficult again for the 4th quarter. Margins look to be higher this year, with an improvement in food and utility costs (food costs up in Q1; labor up 1%; direct and occupancy down). They will also have lower interest costs (see at 2.5m vs. 7.5m last year). CapEx is 60-65m, significantly under trailing cash flow of 100m. The longer term issue here continues to be saturation at 1800, though that number could of course move higher. April same store sales have gotten the quarter off to a great start. I see no reason to sell the shares I have (1% but range from 3-5% in smaller accounts).

5/3/02, 40.46 (please note that APPB has since split 2/1)

Buckle (fast grower/asset play)

BKE operates 298 apparel stores for 15 to 25 men and women. Buckle has been a modestly growing chain, with store counts 222 five years ago and 298 at the latest quarter. Stores counts generally increase 8 to 12% per year. Sales have slowed down the last couple years, with sales per sqft at $334 three years ago and $279 in the latest year. Stores do $1.3m a year in sales. Plans for 2002 include 12 new stores (4% unit count growth rate), 9-12 remodels. Growth has been slowed in part because BKE will introduce a new store prototype this year. The asset here is cash. The balance sheet is in great shape, with 143m in cash, only 31m in total liabilities. With 45m in cash flow last year and only 11m in CapEx, the balance sheet grew more cash heavy. Plans are for 19m in CapEx (7m for stores) in 02. The company does buy shares but only very modestly and at lower valuations. First quarter results were mixed, with same store sales down 1.3% and earnings basically flat with last year. Inventories are much lower than last year – 53.1m vs. 62.9m. Option grants are ugly, with my estimate that it cost them 3.3m in income last year. Going forward, BKE has the following same store sales for May to Nov (-

9.5, -12.3, -11.3, -3.3, -7.1, -1.1, -5.5). BKE trades for 14.5x trailing earnings, and 10.6x cash flow (8.1 adj, or 30m w/o interest income gets you to 8.6x). This stock is certainly cheap – even if cash flow stayed flat they would generate 135m in cash in three years, 225m in cash in five years. The question is whether management can be trusted to do the right thing. The underlying concept certainly appears managed well enough – despite a -6% same store sales last year operating margins were only down 1%. Compare that to the problems at GADZ or PSUN. Same store comparisons are certainly easier going forward. Growth has been notched down a level this year, though as noted the company suggests this has to do with the new store design. The insider position here is huge, but options are not attractive. I think you can justify this as a 3 to 5% position mainly due to the strong balance sheet, easy same store sales comparisons, and management's performance so far. However, this is likely going to take some time to do well, though one positive same store sales of any note would likely drive it higher.

5/19/02, 21.75

Bebe Stores (BEBE) – fast grower

April same store sales will be ugly and the next two months are tough. Same store sales get easier in Sep. Sales in the most recent quarter were actually decent considering the sharply reduced inventory levels caused by the move of their production team. The balance sheet remains in great shape and they do plan on another 25 stores next year (will end year at 167, so 25 is a 15% growth rate), so if margins improve you could get some nice earnings growth going forward with better SGA and better gross margins. At the very least this is worth keeping on eye on for price devaluation from here. The company did loose its chief operating officer, the second time this has happened in the past couple years.

4/24/02, 22.89

Cato (CTR) – asset play

Cato operates 949 stores selling moderate priced apparel for women in 24 states. Top line growth has been modest here, with sales up 4 to 6% in three of the past five years and up 11% and 12% in the other two years. Last year, sales were up 6%, though last year was 52 weeks vs. 53 weeks the previous year. Store counts have also grown at a modest pace, at 693 five years ago, 809 three years ago, and 937 at the end of last year. Plans are for 90 new stores this year, or a 9.6% growth rate. They expect to open 90 to 120 stores per year for the next several and their goal is to 'deliver annual earnings growth of 10% or more.' Margins have been expanding at a steady rate and last year finished at an all-time high of 6.3%. Operating margins also hit a peak. The improvements are occurring in both gross margins and SGA. In the first quarter, sales were up 2% with sales up 9% and EPS up 15%, though operating income was up 24%. Lower interest income and a higher tax rate reduced the gain. They only opened 12 new stores in the 1st quarter with 7 remodels. The balance sheet is cash heavy, with 85m in cash and 52m in receivables and only 97m in total liabilities. Stores appear to be all leased. Inventories were actually down 1% year over year and account receivables were up 11%, in line with sales. The CapEx budget is 29m vs. about 55m in trailing cash flow. They do pay a 54c dividend (14m), for a yield of 2%. Option grants are minimal, with the last two very low. Insiders own 78% of the shares, and salaries are ok considering the lack of option grants. Going forward, CACOA has the following same store sales for May to Nov (-5, +2, -4, -6, 0, +4, -5). Cato sees Q2 earnings at 46c vs. 42c last year, and full year earnings at 1.84 (a pe of 14.7x), an 11% increase. Cato continues to do well, with margins moving higher and the balance sheet in good shape. Store counts are growing at 10% so there might be a limit to EPS increases above that, but with a forward pe this year of 15x, a 2% yield, and a solid performance Cato remains an attractive 3% type position. (later note: TIS raised this to 5% or more when the price fell in June).

5/21/02, 27.74

Charlotte Russe (CHIC) - fast grower

CHIC operates 224 stores under the CHIC (171 stores), Rampage (43), and Charlotte Room (10) names. CHIC is a fast grower with only 107 stores two years ago. Plans are for 55 stores this year, a 29% unit increase, with 75 expected for next year (31% increase). Net margins were 6.6% last year (ending in Sep). Margins were much lower in the first half (ending in March, and this include Easter impact), down to 5.5% from 7.3% the period before and same store sales were down 12.1% in Q1 and 2.8% in Q2. EPS was down 6% despite a 26% sales increase. Using the Dec balance sheet, they have 21m in cash and 45m in liabilities with 110m in shareholder's equity, though 29m is goodwill. Inventories were down for much of the first half of this fiscal year but are now up 6% on a same store sales basis. The CapEx budget is now 30m verses about 33m in cash flow, suggesting the balance sheet should be ok this year. It is disappointing that their recent secondary offering only went to selling shareholders, not the company. Option grants are trending higher, with 120k at 7 3 years ago, then 270k at 11.19 and 443k at 15.23 most recently. Salaries are ok. Going forward, CHIC faces a -6.6 and -7.4 same store sales for the next six months. CHIC trades for 27.1 earnings (27.9x with options), 17.1x cash flow (19.4x with options). The company is comfortable with 24c next quarter with a low single digit same store sales (20c reported last year). CHIC has long-term appeal. They should end with 243 stores this year, 318 next, and with 80 stores a year another 5 years of growth to get to 700 stores, though likely they can open more than that or develop another concept. However, as the experience with Wet Seal shows, be careful with some of these numbers. At this price I am comfortable with 1 to 3% due to high growth rates and easier same store sales going forward, esp. since fashion trends appear to favor this company. You do need to wonder if store growth rates are too high but CHIC's management boasts much retail experience. Obviously this company could do much better if margins improve and earnings growth rates meet sales rates, though keep in mind they will get some minor gross margin pressure from the new distribution center (DC).

5/20/02, 23.93

Chico's (CHS) – fast grower

CHS operates 315 stores apparel stores for moderate to upper income women age 30 to 50. CHS is an explosive fast grower, with more than 40% top line sales increases the past several years as store counts have grown from 133 in 1996 to 304 company stores today. Another 65 stores are planned this year, with sqft growth even higher than unit count growth as the company opens larger stores than in the past. Another 65 to 70 stores are planned for 2003. Despite its rapid growth CHS has put up fantastic same store sales numbers and continually increasing margins. While gross margins were lower last year, in part due a new register roll-out, much lower SGA margins again led to a stellar operating margin of 17.9% and a net margin of 11.2%. The first quarter was incredible, with 40% sales growth, 13.2% increase in comps, and higher margins as both gross and SGA margins were improved. Earnings per share were up 55%. The balance sheet is in great shape. The year end cash level was 54m with 43m in total liabilities. Inventory in the first quarter was up at a lower year to year rate than sales. The CapEx budget is 60 to 65m this year, in part for a new DC purchased last year and a software system upgrade, and cash flow should be higher than CapEx by year end. CHS has only one growth vehicle but plans to open a new concept store next year for a younger age group and more moderate pricing. While this is a large market, there is far more competition in this age growth so any success is uncertain. Option grants are high in part due to the explosive rise in the stock price. Salaries are ok for all but the CEO but 66.6% of the option grants go to only five people. Going forward, CHS has very hard same store sales as usual from May to Nov (16.3, 15.6, 21.0, 16.5, 1.1, 6.5, 18.7) though with one week left the May same store sales was a strong 13%. The company expects SGA margin improvements with any same store sales over 7% and continued gross margin improvements, though not at the pace achieved in the first quarter. CHS trades for 33x earnings, 26x cash flow (38.6, 30.1 for options). Value Line estimates $1.55 for 03, though that looks low (the estimate for Q1 was 35c and CHS reported 46c). At $1.70, CHS trades for 22x earnings for 03. The risks with this company involve the very high margins (which could be hurt with any major sales pressure) and the end of rapid expansion going forward. The company previously predicted 500 stores as saturation and while that would likely be revised higher saturation would occur in four to five years. The new concept is entirely unproven, especially considering that CHS success in this demographic has clearly been due to a general lack of competition, something that the younger age group has plenty. CHS's current stores do an astounding $800 in sales per sqft and a $1000 AVERAGE is achievable going forward – those sorts of numbers will not happen in the new target market. For now, look for price declines in this stock to buy new positions. Most current client accounts have this as a 2% position.

6/3/02, 38.5

Christopher & Banks (CHBS) – fast grower

CHBS's 364 northeastern-based clothing stores target the 35 to 55 year old woman with moderate to high discretionary income. A newer division (CJ Banks) targets plus sizes with 56 stores. For the year, sales were up 32%, operating income up 30% and net income up 29%. EPS was up 25%. Gross margins were slightly lower than last year, but operating margins are an astounding 19.5%, higher than anybody I follow. Plans are for 90 stores which is a 25.6% unit growth rate to be funded from 23m in CapEx. Inventories appear well under control. Same store sales comparisons are hard going forward (next six months: 12, flat, 4, 7, 13, 5) as they have always been hard in recent years. The valuation reflects CHBS's premium valuation. At 30x trailing earnings and using a 20 to 25% EPS growth rate (1.51 to 1.58) next year's price to earnings ratio would be 24.7x to 23.6x. This all assumes that margins will remain the same. Any misstep considering how high these margins are would be deadly, but the company does say that newer stores are opening significantly above plan so they seem to be handling expansion well. CHS shows how high these things can go if everything goes right, and there does not appear to be any competitive threats to this situation, but the valuation does concern me.

4/13/02 37.25

Claire's (CLE) - Turnaround

CLE operates 2876 stores under the CLE and Icing by Claire's label in both the United States and overseas. CLE has been inconsistent. Stores counts were about 1000 a decade ago and reached 2067 at the end of 1999 before CLE acquired the Afterthoughts chain (now renamed to Icing by Claire). This expanded the store count above 3000 even with numerous closures. A male teen apparel chain was acquired a couple years ago and has now been sold off at a loss. Plans are for 180 new stores this year, most overseas, and 50 closures (about a 4 to 5% growth rate). Last year the international operating income was down even with much higher sales totals, something to monitor, though weakness in the dollar could benefit this division. Margins hit a multi-year low last year with SGA costs particularly high. This continued into the first quarter, with sales down 1%, operating income down 19%, and earnings down 10% as interest expense and the tax rates were lower. Like other mall retailers, CLE has reduced inventory to 85.3m from 100.2m at the same time last year. Despite the problems last year the inventory draw-down enabled the company to pay down long term debt, which has been reduced to 204m (total liabilities) from 310m two years ago. The CapEx budget this year is 50m, suggesting that with more than 100m in cash flow more debt will be paid down. As noted, most of the expansion is occurring overseas, and last year North American sales were 711m with 85m in operating income with Europe at 207m in sales with 29m in operating income. However, forays into the male teen apparel business and a catalog and other ventures have been quickly terminated, so the underlying core concept will mostly be a modest growth vehicle going forward. Like other companies the option grant was much lower this year and has never been ridiculous. Insiders had 65% of the company as of the last proxy. The salaries are reasonable enough even though the CEO (84 years old) got 1.5m last year and everyone earned bonuses even in a rotten year in 2000. Going forward, CLE has the following same store sales for May to Nov (-3, -7, -5, -3, -6, -6, -6). CLE trades for 23.6x earnings and 11.7x cash flow (26.1, 12.9 adj; 24.7/12.9 options). The full estimate for this year is 1.10, or a pe of 18.5x. A 10% margin last reached in 2000 would get them to 92m in income (1.89), and foreign expansion appears to be paying off, though once again they lost another key management person (the head of CLE UK). Eventually this company could be sold considering the CEO's age, though management positions are all from the family. I have 3% in this stock and think that is about right.

5/26/02, 20.13

DEB Stores (DEBS) – fast grower

DEBS operates 314 girl moderate priced apparel stores in strip centers and enclosed regional malls. Top line growth has been modest, ranging from 14% in 1998 to 6% two years ago and 7% last year, as store counts have been increased at only a very small pace. Plans this year are for 15 to 25 new stores, 11 remodels, and 2 closures. The company expects this to result in 12% sales growth, assuming a 3% comp. Unlike other apparel chains, DEBS operating margins hit an all-time high last year at an impressive 13.3%. Gross margins were significantly improved with almost flat SGA expenses. This continued in Q1, with sales up 10% and operating income up 35%, though lower interest income led to only a 9% EPS change. The same store sales were up strongly in Q1, and they opened 9 new stores, remodeled 7, and closed 2. The balance sheet is cash-heavy, with 139m in cash and only 33m in liabilities. All stores are leased. Inventories are up 13% year over year, below last quarter's level and in line with sales growth (the current inventory number listed is misleading because last year has not been adjusted for the sale of the book chain). The CapEx budget is not listed, but in the past three years they have averaged 6.2m, so it will likely be slightly higher this year. DEBS recently sold the money losing book chain and plans to expand its store base by 30% in the next three years. Option grants have been minimal, with nothing the last three years. Insiders own 68.6% of shares, 100% of the preferred shares. The management team ranges in age from 58 to 60s. The salaries are exceptionally reasonable with no bonus payments lately despite terrific numbers. Going forward, DEBS has the following same store sales for May to Nov (2.9, 9.1, 6.7, 12.7, 4.7, 0.2, 0.1). DEBS sees Q2 earnings at 44-46c (vs. 42-43c actual) and \$2.25 to \$2.30 for the year (13.5x). DEBS has done an incredible job operationally. While I might not like the fact that they keep so much cash, you can not fault them for anything else, including a refreshing lack of option grants and reasonable salaries. Of longer term concern is how long this momentum can be sustained (this is year 5 that business has turned), but the valuation is not expensive and if results can be maintained this is worth buying at 1 to 3%.

5/21/02, 30.75

Dress Barn (DBRN) – slow grower/asset play

DBRN operates 760 moderate priced woman's apparel stores, primarily in strip and outlet centers. DBRN has been an asset play/slow grower. The asset here is cash – as of the end of Jan, 217m with only 102m in total liabilities. Top growth has been modest, with 6% sqft growth this year and predicted mid-single digit growth next year. For the year to date period ending in late April (for 3 quarters), margins have been modestly lower, as efficiencies gained from closing down a catalog operation have been offset by lower gross margins from -3% ytd same store sales and lower interest income (entirely due to lower interest balances). Other than cash, the balance sheet is in good shape, with same store sale inventories down 2% year over year and flat on a direct dollar basis. The CapEx budget for this year is only 25m; with 52m in cash flow (approximate), there is excess cash flow for share buybacks. The company has purchased more than 6m shares for \$100m in the past three years. The option plan is fairly moderate, with only an estimated $2m annual cost based on the most recent grant. In the most recent quarter DB's same store sales was up 3% which led to gross margins gains, but earnings were powered by a huge improvement in SGA as the catalog was discontinued in the spring. The 3Q margin was higher than two years ago (last year's levels were depressed). Going forward, Dress Barn has relatively easy comparisons (-6, -7, -5, -8, -11, -5). May is off to a sluggish start, as cooler weather across the country has hurt sales. When weather has been warm, the company reported good sales. At the very least, lower costs from the catalog shutdown will help. DB trades for 18x earnings, and 11.5x cash flow, though the balance sheet has excess cash (adj p/cf ratio is 9.3x). Full year earnings should be $1.80 to $1.85, for a pe of 17.5x. With a modest 7% increase next year to 1.95, the pe would be 16.4. This is a modest grower with better comparisons. On a p/cf basis it is not expensive, and a better use of that cash – a modest acquisition – could accelerate the growth rate. At this point, I think DB makes sense from 3 to 5%.

5/17/02, 31.97

Dollar Tree (DLTR) – fast grower

The 1st quarter was better than expected and April is trending well. They will be hurt by the Easter shift and remain cautious, but there are reasons to be optimistic in the short term. While the valuation is pretty steep, I see no reason to sell these shares.

4/30/02, 37.96

Dollar Tree operates 2031 stores in more than 37 states where every item sells for a dollar. Earnings were flat last year as margin erosion offset sales growth. Problems with a closure of a DC acquired (now closed) in an acquisition exacerbated the problems. Stores opened now tend to be located in strip centers in a 7,000 sqft format. About 55% of the merchandise is sourced domestically with the rest overseas. Only about 15% of the merchandise is obtained from closeouts.

Here is why I like the stock:

- high sqft growth rates. DLTR will expand sqft by 25% this year. This should result in about 2275 new stores.
- Growth is self-funded. DLTR had 177m in cash flow in 2001 and expects 135-145 in CapEx this year (which includes initial inventory)

- Same store sales comparisons are not as challenging. DLTR reported flat same store sales for 1Q, and then -2.7 in 2Q, -0.1 in 3Q, and up 1.5% in Q4.

- Near term results have exceeded expectations. Due to the shift in Easter, Same store sales were up 6.5% in the first quarter, and the company estimates this was 2% without the calendar shift. As a result, 1st quarter results will likely be better than expected. DLTR also says that business strengthened during the quarter. Of course, this means the 2nd quarter will have negative same store sales most likely. Also, 1st quarter is the company's smallest earnings quarter.

- Store Payback. These dollar stores are incredibly profitable. DLTR claims the store payback is 12 to 15 months. New stores, including initial inventory cost 360k. At $217 sales per sqft and 5130 of selling sqft the stores do 1.113m in business. With a 6 to 7% net margin that means bottom line profit per store is 67k.

- Better Control of Inventory. DLTR will have point of sale registers in more than 600 stores this year (167 in 01). This should lead to better general inventory management.

Negatives include

- Valuation. DLTR trades for 30x trailing earnings, 20x cash flow. Based on Value Line's $1.35 02 estimate, the future pe would be 24x. If EPS increases by 20% for the next three years to $1.88, the pe would be 17.6x.

- Operating leases. DLTR's balance sheet is more leveraged than it appears, as all stores are leased and 3 DCs have synthetic leases (most likely requiring purchase of the property in 2006 for $113m)

- Lack of margin leverage. Net margins have fallen in the past 2 years, though clearly much is due to the economic slowdown. DLTR carries less consumable merchandise which clearly hurt them as consumers became more discriminating in their purchases. Plus, a gradual increase in consumables is going to hurt gross margins.

- Law of Big Numbers. DLTR currently estimates domestic saturation at 6000 stores, though this is simply an estimate. Based on company guidance sqft growth rates for the next 3 to 5 years still look like between 20 and 25%.

Brinker International (EAT) – fast grower

EAT trades for 17.9x their 03 $1.86 estimate, which is in line with a 15% growth rate. If the price traded for 20x this would equal $37.4, or 12% higher than here. So far, sales are up 20% with earnings up 13%, though a buyback plan is leading to higher EPS gains. There are now 806 Chili's units, with 618 company and 188 and joint ventures/franchise units. Macaroni Grill has 178, with 172 company units. OTD has 126, with 108 company units and the rest franchise. Maggiano's, a family high end Italian concept, has 18 units, all company. Overall, they have 1012 company units with 228 other. Long term debt, from the 2nd quarter since the press release does not have a balance sheet, is pretty high at 375m from acquisitions. Same store sales have been moderately higher though April and May will give them a better read. They see 119 units in 03, for capacity growth of mid teens. They are up against tough same store sales (Q201 at 6.0 for Chili, 3.4 for MG). This is not an unattractive price, but the debt on the balance sheet suggests a bigger margin. After all, at 20x the 03 estimate the price is only 12% higher. You have 1% in this in most accounts.

4/27/02, 33.51

Eaton Vance (EV) – fast grower

As of the end of the 2nd quarter (April), EV managed 59.2b in assets. They have 27.5 in equity assets (46.5%), 10.4 in fixed income (17.6%), 8.8 in bank loans (14.9%), 11.4 in separate accounts (likely mostly stocks – 19.3%), and 1b in money market accounts. The company said that 60% of assets are in equities. This compares to 49.3 for the previous year, though 7.9 of that was added by acquisition. Assets have grown at a good pace the last several years, as AUM was 18b just five years ago. Fund flows have also been strong. Net flows were 1.6b in the first six months (about 0.5b in the quarter), 6.1b for all of last year. In the past six months, only bank loans saw net outflows as they have for several quarters. The company thinks this is due to good performance in their managed investments. They do say the rate in bank loan redemptions is moderating, and due to good performance they think that institutional interest in bank loan funds is increasing but a real turn would take place when interest rates move up. Plans are for 2 private placements in the 3rd quarter (only 1 in 2nd quarter; they have done 5 of these since July of last year). The balance sheet is fine. They have more than 200m in cash and a 203m convertible than can be put to them later this year but have the facilities to handle it. Plus there is 258m in deferred sales commissions. Overall, total liabilities equal to 328m. In the second quarter sales were up 11% in sales and 12% in operating income. Over 12 month period SP500 was down 14% and the Nasdaq was down 20% and Dow off 7%. The option plan was made more generous last year and will cost about $15m this year, or 11.5% of income (though the K only lists 6m and they do compute based on a 10 year life). The trailing pe and pcf ratios are 19.6 and 18.1 respectively. EV uses its cash for buybacks, and they purchased 770k shares in the first half. EV also suggests that new hires (14 people now which added 3.5m in compensation) will help managed accounts to grow (200m vs. 100m last year; on pace for 100m month in Q3), esp. since Fox and Atlanta Capital have experienced very good performance. EV has done well in a tough environment and continues with positive fund flows. The historical AUM growth is impressive and the mix of assets is appealing. Plus, consider that they maintained margins even with the buildup of their separate accounts team. Obviously a more positive market would really help them going forward.

5/24/02, 35.15

Gabelli Asset Management (GBL) – asset play

GBL had a dull 1st quarter, as AUM growth led to a 6% increase in operating income but interest expense held back share gains, especially from additional shares added from the convertibles. AUM is roughly flat with Q2 though Q3's comparison is better. Other than the Growth fund and the telecom funds, performance continues to be good. Six funds containing 50% of rated assets are rated Morningstar 5 stars. The balance sheet continues to grow cash balances. The valuation has been stuck and looks to continue that way – at least until the market move modestly higher – but GBL continues to do a great job. I also trust management in this one, as the option plan is highly reasonable.

4/27/02, 38.1

Johnson and Johnson (JNJ) – stalwart

JNJ's PE is 25.1x the 03 estimate verses a range of 34.3 to 23.6 and a median pe based on Value Line data of 22. Business in the first quarter was better than expected with the higher margin pharma group driving earnings (Procrit, a cancer drug, was 991m of the 4.2b in pharma sales; Risperdal, an anti-psychotic was 547m), though due to wholesaler stock positions growth should slow in Q2 and then speed up in the 2nd half per a Merrill Lynch report. There is concern that Amgen's challenger to Procrit will hurt sales and ML is using what they call a conservative growth rate of 10%. There is no way to know what will happen here. The longer term picture of this company is exceedingly bright, with sales growth for 69 years! The balance sheet is also impeccable, and they generate plenty of free cash flow and spend a lot in RD (4b this year).

I decided to liquidate my position. JNJ is a great company but I purchased the bulk of shares when the projected pe was 18, not 25, and while the earnings estimate clearly appears more than within reach, I am not knowledgeable enough about the finer details on this company to purchase shares right here at this price for new accounts. I did hold onto two taxable accounts which currently have limits set on 69.99. Even if JNJ traded for 30x the 2.55 estimate the price would be 76.5, which is not more than 20% away.

4/21/02, 64.49

Kohl's (KSS) – fast grower

KSS operates 420 moderately priced department stores. KSS is a WMT-like fast grower story. Since the IPO about a decade ago, selling sqft has grown by 22%, net income growth by over 30%, and same store sales by 8% annually. The stock price has risen even faster. Plans for 02 include 70 stores (18.3% growth) with 03 at 80 stores (18%). In the first quarter KSS opened 38 stores, including 12 in Houston, 13 in Boston, and 4 in Nashville. This clustering of stores in one region is a hallmark of their expansion strategy, with stores being both built outright and acquired. KSS's net margins have expanded at a steady rate (sales per sqft have also marched modestly higher) with net margins at 6.6% in 2001. The trend continued in the first quarter, with gross up slightly but SGA much improved as sales were up 26% and EPS was up 41%. Inventory was up 25% year over year, in line with sales growth. The balance sheet is otherwise reflective of a high-CapEx aggressively expanding retailer. Almost 100 stores are owned though the majority is leased. The CapEx budget is 740m, almost covered by cash flow for 2002. Option grants are an issue, with more than 10% of the income going to grants. This is a longer term issue. Otherwise, salaries are modest for a company this successful, and the management team is relatively young. Insiders own 13.3% of the company. As always, KSS had difficult same store sales going forward but this has never seemed to matter as KSS's brand focus (75-80% of merchandise) and convenient locations continue to take market share from competitors. KSS is expensive at 50x earnings, 40x cash flow (options 56.2/45.6), though the growth path for this company is unusually well-defined which partially justifies the current valuation. There have been periodic opportunities to buy this stock. I own a small position just to monitor the stock.

5/24/02, 76.24

99c Store (NDN) – Fast Grower

NDN operates 133 retail stores in California, Nevada, and Arizona and also runs a wholesale division called Bargain Wholesale (generally around 10% of revenue). NDN is a model fast grower: plenty of growth potential with only 132 stores (25% store unit growth is the target), a good balance sheet and store return on investment of over 100% enabling growth to be entirely self-funded (37 million in capital expenditures this year and next balanced by 57 million in trailing cash flow). Inventory levels have only grown very modestly and are actually down from Q2. Other expenses continue to increase but this is due to additional hires to fund future expansion, a new point of sale system expected to be in the stores by March 02, higher minimum wage increases in California, and other items. None of this detracts from the underlying story. Gross margins, reflecting the additional markup on inventory, actually improved during the past 2 quarters. Sales have been blistering, with same store sales up an incredible 9.3% in Q3, 5.9% for Q4, and 8.0% in Q1 (though Easter comparisons helped) driven by increased transaction counts. NDN says this is due in part to the new deli (refrigerated) and frozen food sections, which encourages more repeat purchases. The only issue (but a big one) here is valuation – now at 49.3x trailing earnings, 37x cash flow it is not cheap. However, with 25% unit growth in 5 years the company would have 360 stores and 20% earnings growth EPS of $1.69. With a 25% EPS growth rate, the 5 year earnings number would be $2.08. With a PE of 35-25 NDN could trade at $73 to $42, though this valuation leaves no room for error. That said, because NDN is in inning 2 of their eventual nationwide expansion, I am more inclined to hold these shares despite the valuation.

Position Assigned 3-4%

Lincare Holdings (LNCR) – fast grower

LNCR trades for 18.6x cash flow (though if you exclude 30m from options it would be 21x). Sales were 19% in Q1, and without amortization changes and a one time charge in the previous quarter EPS was up 25%. Margins were better as expected as lower margin business divestitures are anniversaried this year. The balance sheet continues to look fine, as debt levels were reduced despite large CapEx and acquisition costs. Legal issues are a problem, and the government can always alter reimbursement rates. The company shows no sign of slowing down.

4/23/02, 32.41

Outback Steakhouse (OSI) – fast grower/asset play

Update: The first quarter was modest with same store sales down and margins still under pressure. A higher share count from options dilution also hurt them. Comparisons for the next four months are not easy (1.1,2.3, flat, 1.4) but not terribly hard. New advertising might help, but there are reasons to be cautious, though lower dairy and beef prices could help margins

OSI is a steady growth story. With 883 stores, 688 company owned, store counts are usually added at a 10 to 12% rate, funded internally. The main driver of growth is still the OSI chain, though with 746 total stores and another 60 plus planned for next year other concepts must start picking up the growth rate. Carrabbas, an Italian concept, is a modest grower (30-40 per year at most, though next year they are only planning 10-15 company units, another 5 to 10 joint venture), and while the company is experimenting with other concepts, there is no clear choice for the next phase of growth beyond the two core chains. The cost side is more favorable with margins apparently set to improve (food and utility costs in particular) in 2002. But expansion will only tail down from here and the buybacks have been modest at best. Thus, OSI is the type of stock I will trade based on valuation. After the recent run up, OSI trades for 21.3x trailing earnings and 15x cash flow. Based on Value Line's $2.35 estimate for 03, the PE would be 15.9x, more in line with what the valuation should be right now. At 20x the 2.35 estimate, OSI would be a $47 stock, or 21% higher from here in a 20 month span. I plan to liquidate most of my position and will re-evaluate the next quarter report.

4/15/02, 37.31

Pfizer (PFE) - stalwart

PFE is a pharmaceutical firm with additional operations in animal health and consumer products. PFE had 32.3b in sales last year. Liptor was 6.4b, Norvasc was 3.6b, Zoloft was 2.4b, Neurontin 1.8b, Zithromax was 1.5b, Diflucan was 1.1b, Viagra was 1.5b, Zytec was 990m, animal health was 1b, and consumer products were 2.4b. So that is about 23b I can identify, or 71% of the total. Here is why I own the stock

- The company estimates a 1.56 to 1.60 range for earnings this year.
- Targeted growth in 03 is 15%
- The pe based on VL's 2003 earning is less than 20x; the median pe is 28
- The balance sheet is rated A++ for financial strength
- Long term sales projected at 11%, earnings at 1.85
- The stock is at a low point in its 4 year range, with a high of $43 back in 1998
- Plenty of potential new drugs in pipeline; 5b in RD spending
- Aggressive buyback plan

Negatives include:

- Short term issues with lower growth rates than expected in Q2
- Law of large numbers
- Difficult to asses sales potential of drug portfolio
- Pension plan under funded by 1.3b
- Option costs of 700m a year

4/28/02, 36.76

Papa John (PZZA) – asset play

Update I think this is a solid idea. The price is cheap and same store sales comparisons are easier going forward (+0.3, flat, flat, +.0.5, -.0.1). Even modest same store sales combined with slightly higher margins ought to be enough to get this doggie moving. See evaluation below.

This is not a particularly brilliant or worthy idea especially since it was written up several dollars earlier and I thought then that the current price (near $30) would represent full value but everyone is entitled to a change of mind. Besides, I like it.

Papa John currently runs 593 company and 2149 franchised restaurants in the United States. There are a number of units overseas, especially in England (another 2 company and 181 franchise), but these have not added much to profitability and thus can be safely ignored. At $29, the market cap is 659 million. The year end (12/30) balance sheet shows 17m in cash and 192m in total liabilities. Long Term Debt stands at 105m. Take the difference and a conservative enterprise value is 834m on the high end to 764. Trailing income is 47.2m, with 35.2m in d/a, for 82m in cash flow.

Here is why I like the stock:

- Cash flow. Paying 764 to 834m for 82m in cash flow seems pretty cheap in a world where 30 year treasuries yield about 5.7%. CapEx is estimated at 38m in 02, so a good part of that cash flow is free cash flow. CapEx will likely be in a range of 35-40 barring some event for the next few years per the company.

- Option grants for 01 and 00 were more than reasonable. In the words of the CFO, the days of 1m share grants are over. In 00 197,000 grants were dolled out, with 207,000 last year. This compares to 22m shares outstanding. Thus, your purchase is not going to get diluted from you.

- Share buybacks. PZZA has used 217m in the past 3 years to buy back shares. Sure, they went into debt to do it, but the buybacks represent management at its rational best in my opinion. PZZA recognized operational issues with their growth strategy (translation – some new areas stunk) and thus put a halt to it. How many former growth stock managements are going to do that? And because they think making pizza is the thing they should do, management did not go out and acquire a hospital chain or energy trading company or anything like that. Instead, they bought shares. They purchased another 1m shares in the 1st quarter. The company is currently company with about 150m in LTD.

- Same store sales get easier. Same store sales have been dismal in the past year but March saw the first positive number for both company and franchise units in the past year despite the timing of Easter. Thus, wretched sales make for easier comparisons starting in April.

- The product. Just a personal opinion (backed up by numerous awards), but I think the company makes a good product and retains some limited loyalty in its client base. Thus, there is no reason to think that business is going into the toilet anytime soon, especially with the company's one product focus.

- Relative valuation. Among the better known restaurants (APPB, EAT, CAKE, CEC, OSI, RYAN, etc.) PZZA is on the low end.

- Heavy insider holdings. More than 34%, with founder and CEO Schnatter more than 28%.

What I do not like about this company:

- This is no growth stock. Of course, that has not seemed to matter lately (see the miraculous increase in RYAN in the past year for proof). Company units are actually down so far this year, so expect no growth there. The company would like to see franchises re-accelerate unit growth to a higher level but that is not going to happen in 2002. If the price moves much higher the buyback will begin to make less sense.

- Special charges disease. PZZA has had its share of charges in the past few years, including some asset write-downs, franchise loan receivable write-offs, and some goofy litigation brought forth by a Pizza Hut. The litigation appears dead for now, though the trend in write-offs is worth watching as it is a clear indicator of the health of part of the franchise base. There is no way to predict such things which explains why I did not give PZZA any credit for other assets on the balance sheet.

- This is a pizza chain. Competition is the norm with this industry, and pizza alternatives at Supermarkets or eat-in buffet's for $4 does not help matters. This seems to be factored into the price.

A number of other things could go right for this company, including improving cheese and labor costs, though those are all wild cards.

4/25, 29.25

Talbot's (TLB) - stalwart

TLB operates 828 stores under various concepts including Misses (448), Petites (212), Kids (61), Woman (42), Accessories and Shoes (41), and Outlet (24). The clothing is 99% TLB branded. Store growth has moderated the past few years, with stores up 5%, 7%, and 11% in the past three years respectively. Before 1998, store unit growth was generally over 15%. Plans are for 85 new stores this year (99m in CapEx) and TLB should end the year at 884 stores (including one closure). The first quarter saw 28 new stores added, though total sales were down 2%, same store sales down 7.2%, and catalog sales were down 11%. Gross margins were way down though SGA was kept flat. Operating income was down 15%, with EPS down 8% with lower share counts. The company blames higher markdowns in the 1st quarter though SGA was improved by not advertising on TV in Q1. Catalog circulation will be down 11% this year due to elimination of poorly performing books. Inventory was down 20% year over year and should be down going forward. Account receivables were up 12% year over year. They spent 17.8m in share buybacks in the first quarter. All but six stores are leased. Option grants have been high. Salaries are very high and the top 2 people got 25% of the option grants. The company is majority owned by Aeon USA (57.9% of shares), though executives own 6%. TLB has the follow same store sales for the previous year (-0.3, 0, 7.4, -0.9, -8.3, -12.5, -12). TLB trades for 19.3x trailing earnings and 13.6x cash flow (23.3, 15.7 w/options). Earnings are expected to be 29c in Q2 even with negative same store sales in Q2. They expect fall season results to be better. Margins last year were actually at an all-time high, and growth can continue in the various concepts (including a Talbot's Men they will first open in 03) but will likely be modest as a percentage of the store count (as has been the case the last 3 years). The catalog has likely peaked out (sales were 267m last year). VL predicts $2.25 next year assuming an 8% net margin (16.9x earnings). I will likely retain the small position I have and then re-evaluate in another 3 months.

5/26/02, 38.15

Limited Too (TOO) – fast grower

Too operates 473 apparel stores primarily for girls age 7 to 14 in the TOO format. A secondary concept, Mishmash, targets the 14 to 19 year age group, though the concept is as yet unproven with only 9 stores so far. TOO was another spin-out from Limited (LTD), becoming a public company in 1999. TOO has been a fast grower, with store counts of 312 five years ago, 352 in 1999, 406 in 2000, and 459 in 2001. Margins have expanded the last several years, with both gross and SGA margins improved, helped by higher same store sales before last year's came in flat. The balance sheet is in good shape, with cash flow supporting store growth. Plans are for 50-55 stores this year (11% sqft growth). Another 50 TOO stores per year gives them 4 years of growth with this concept. The CapEx budget is 50 to 55m, though only 17-20m is for stores. First quarter results were strong, with sales up 16%, same store sales up 4%, and higher gross margins and improved SGA resulting in a 49% increase in earnings. The only negative is that this was driven by higher margin and multi-unit sales, not transaction counts. Inventory is lower than last year but the company says that inventory levels were abnormally high last year. The company is planning on floating a 2.4-2.8m share offering, all of which will go to TOO and will substantially improve the balance sheet. They are up against a flat same store sales for Q2, then +5 for Q3 and -2 for Q4. TOO trades for 23.7x trailing earnings (24.7x with options considered), 17.3x cash flow (17.9). Merrill Lynch has an estimate of $1.52 this year (19.9x), $1.80 next year (16.8x), for a one year growth rate of 18%. Mishmash might very well be the key for longer term growth so keep an eye on it. Also, one negative to keep in mind here is that the CEO is grossly overpaid.

5/13/02, 30.3

Wet Seal (WTSLA) - fast grower

WTSLA operates 579 female fashion oriented apparel stores (Wet Seal, 460 stores, teen customer; potential is listed as 600-800; Arden B, 87 stores, 20 age group, potential of 150-200; Zutopia, 32 stores, 5-12 years, potential at 300). In recent years top line has been modest, up 8% in 1999, 11% in 2000, and 4% in 2001. Store counts have gone from 548 three years ago to 571 last year as many stores have been closed. Plans for 2002 include 50 WS, 15-20 Arden B, and 10-15 Zutopia, the majority which will open in fall; plans to close 27 -- this is a net 10% growth rate. They will also remodel about 20 stores. In the 1st quarter they opened a net 3 WS stores, 3 Arden B, and 2 Zutopia. Zutopia was a concept that they acquired in 2001. After hitting a longtime peak in net margins in 1998, margins fell the next year before moving up in both 2000 and 2001. All the improvement is coming in gross margins due to lower markdowns and higher initial markups. While there is always some caution on how the numbers are derived, the gross margins are actually at an all-time high. This trend continued in the first quarter, with gross margins much higher and SGA worse as they continued with more advertising. Sales were up 10% (same store sales up 8.2%) and operating income up 78%, though EPS was up 58%. The balance sheet is liquid, with the fiscal year end balance sheet showing 102m in cash and 88m in total liabilities. All stores are leased. Inventories are actually down 8m from last year's first quarter and down 24% on a sqft basis as they had greater sales of full-priced merchandise. They expect gross margin improvement going forward. The CapEx budget is 50m, in line with current cash flow. Option grants are absolutely horrible with more than 6% of the share count granted last year, and the cost of these options is exaggerated by the volatility in Seal's stock price. The CEO got 11% of the option grants last year. Insiders own 3.3% of shares. The CEO is well paid but the other salaries are a bit more reasonable. Going forward, Seal has the following same store sales for May to Nov (+7.3, -.0.6, 4.4, 12.4, 3.2, -4.6, 1.3). Seal is riding the fashion wave in romantic looks right now (the hippie/bohemian and plantation look), apparently better than anyone else. How long this can continue is unknown, though the store rationalization has to be helping margins. The longer term concern here is saturation and the fickle nature of this industry. After all, Seal has missed trends before. At $23.54, it trades for 21.6 earnings, 14.5x cash flow (lower adj), though the option plan inflates the valuation significantly. With continued gross margin pressure and if they can put up positive comps, the stock is likely to go higher, though even the CapEx budget is irritating. I expected them to generate significant free cash flow this year but instead the CapEx and cash flow budgets will be more equal. Keep in mind that Seal has been through peaks and valleys before. Right now, 3% sounds right, not 5% previously thought.

5/23/02, 23.54

FIXED INCOME

My objective in fixed income is to achieve a return after fees which is higher than a 1 year CD rate. The current rate on a 1 year CD is 2.69% according to the website bankrate.com.

At a price of $9.84 if Blackrock Strategic Term Trust (BGT) achieves its $10 objective by year end combined with a modest dividend the return should be approximately 2%, significantly higher than our objective. Since BGT's net asset value was $9.94 last week, the chances of achieving $10 is likely very high, though nothing is assured. Please note that TIS's fixed income rate is 0.25% yearly.

CONCLUSION

I hope this review has given you a better understanding of my investment philosophy and your portfolio composition. I welcome any questions or comments you might have at any time. I appreciate the trust you have placed in my firm to manage your assets.

Paul E. Taylor