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Value Investor INSIGHT

The Leading Authority on Value Investing

Less is More

While he casts a narrower net than most investors, Saturna Capital's Nicholas Kaiser has proven more than adept at bringing in a consistently winning catch.

Nearly 50 years after being dubbed "Nick the cynic" by high school classmates, Nicholas Kaiser continues to wear the appellation with a certain pride. "Investing isn't exactly a business for the gullible," he says.

Kaiser's skeptical nature has produced excellent results for investors. His Bellingham, Washington-based Saturna Capital now manages $3.1 billion, while his flagship Amana Growth mutual fund has earned a net annualized 10.2% since its 1994 inception, vs. 7.5% for the S&P 500.

Despite the market's recent new-found optimism, he's currently finding plenty of contrarian opportunities in such areas as semiconductors, health insurance, natural gas, leisure travel and non-residential real estate construction. See page 2

INVESTOR INSIGHT

Nicholas Kaiser
Saturna Capital

Investment Focus: Seeks companies whose stocks have fallen from previous heights for reasons he believes will be corrected sooner than the market expects.

Due Diligence

Low expectations, the saying goes, are one of the keys to happiness. As Kian Ghazi has shown, they can also be equally key to successful investments.

INVESTOR INSIGHT

Kian Ghazi
Hawkshaw Capital

Investment Focus: Seeks companies for which intensive proprietary research sheds insight to confirm that high- or low-expectations stocks are mispriced.

Kian Ghazi isn't particularly fazed by the frustrating dead ends and oftentimes less-than-receptive sources that investors can face in their day-to-day research efforts. "I have a fairly intense need to know," he says.

This quest for knowledge has served investors in Ghazi's Hawkshaw Capital well. Since the end of 2003 his long/short equity fund has earned a net annualized 6.3%, vs. 2.4% for the S&P 500.

With the gap between where his portfolio companies trade and his appraisal of their intrinsic values at a historically wide level – indicating an average 65-70% upside – Ghazi is finding opportunity today in such areas as videogames, online services, for-profit education and wireless infrastructure. See page 9

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Investor Insight: Kian Ghazi

Kian Ghazi of Hawkshaw Capital explains why he wants all his ideas to be home-grown, how he has refined his intensive research process, the risk-assessment question he asks before pulling the trigger on any investment, and what he thinks the market is missing in Electronic Arts, The Knot and Aviat Networks.

You've described your strategy as "expectations arbitrage." Describe what you mean by that.

Kian Ghazi: For our longs we screen for the most down-and-out, lowest-expectations stocks and for our shorts we screen for the most-loved, highest-expectations stocks. At valuation extremes the likelihood for mispricings is highest. Investing isn't necessarily about picking the horse that's going to win the race, it's about identifying the one for which the odds are most mispriced – a horse that's expected to come in 8th, but we think it's more likely to come in 4th.

When we're buying our stocks right, expectations are so low that more bad news won't send the stock much lower, while a whiff of good news will send it nicely higher. Our screens focus us on stocks with the greatest potential asymmetry in their risk/reward profile and then our deep-dive research helps us distinguish the value investment from the value trap.

In our last interview [*VII*, July 29, 2005] you described a fairly broad and eclectic idea-generation process, but today your ideas come entirely from your own valuation screens. Why?

KG: Our shift to screening only was originally conceived as a productivity enhancer, to point us to a more fertile hunting ground for ideas. As time went on we noticed another benefit: an entirely organic idea-generation process keeps us thinking independently and helps us avoid the herd mentality that naturally comes from sourcing ideas from others. Michael Mauboussin did an interesting study of the commonalities among money managers with successful long-term records. The first three factors won't surprise you: they were value investors, with concentrated portfolios and low portfolio turnover. But interestingly, they were all located outside of the New York City to Boston beltway. The takeaway is they were away from the fray. Even though we're located in the middle of midtown Manhattan, we don't rely on idea dinners, paid network services, or even all our smart friends in the business to source ideas. Our screens keep us focused on off-the-beaten-path stocks that other managers aren't paying attention to or probably wouldn't like. It's in those kinds of ideas that we think our investigative research can really distinguish itself.

Don't valuation screens spit out equally well-trod ideas?

KG: We've developed atypical value factors that, if history is a guide, have excellent predictive value. I'd rather not share the details, but we leveraged research already done by people like David Dreman, James O'Shaughnessy and others that show value strategies outperform over long periods of time, and from there basically manipulated the financial statements in unique ways to identify value that we thought wasn't obvious at first blush. Electronic Arts [ERTS], which we'll talk about later, is a good example of a company that wouldn't hit most traditional value screens, but it hit ours.

Since launching Hawkshaw you've sought competitive advantage through your "deep-dive" research. Have you refined your approach in that regard over the years?

KG: A big change we made in 2006 was to stop using paid network services like Gerson Lehrman's or Vista's to help source our research contacts. Today, 99% of our contacts are unpaid, internally-

Kian Ghazi

Deep Dive

In choosing the name Hawkshaw for his investment firm, Kian Ghazi chose an 1800s colloquial term for detective, meant to connote the investigative research with which he wanted to set his firm apart. For each long or short portfolio position, he and his analysts augment traditional fundamental research with a disciplined effort to interview at least 10 independently sourced industry experts – such as private-competitor CEOs, large customers and former employees – for insight that refines the investment thesis. "You can succeed as an investor without it," Ghazi says, "But I can't imagine making tough decisions without this kind of information."

He says his justification for making the effort has evolved: "I would have said early on the main advantage of this type of research was getting an informational edge. Today I'd answer differently: The understanding we've developed and the ability to go back to contacts when something happens is invaluable in those difficult moments when one of your stocks is down 30-40% in a short period. Decisions made then drive your alpha – the biggest benefit of our deep-dive research is helping us make the best judgments in the most unemotional manner possible."

sourced, highly targeted leads that we cold call. The two big problems with paid networks are that it seems like everyone is talking to them, making none of the insights proprietary, and because the contacts are paid, they have an incentive to tell you what you want to hear. Also, since we're often focusing on quirky, lesser known companies, the types of contacts that we would want are much less likely to be in their databases.

We've structured our time to allow us to perform 10 or more high-value interviews throughout a three- to six-week research process on every investment we make. Our goal is to identify the critical issues involved for any given investment and then find the people who should have insights into those issues so that we can confirm or refute our variant view.

Can you give a fairly recent example of a key issue and who you contacted?

KG: In early 2009 we were looking again at Ann Taylor [ANN], an idea we spoke about five years ago. The stock was at $4, the company had $2 per share of net cash and we anticipated it would get another $1 per share in tax refunds from the federal government. Through our modeling we concluded that even in a draconian economic scenario in which comps were off 40% in 2009, with cost cuts and reduced capex the company would still be at or very close to breakeven. Against that protection on the downside, we saw upside of at least $30 if they got to only 80% of historical store-level productivity.

At such a horrible time for the economy, we keyed in on one main question – how flexible were its lease obligations? If they had little ability to modify or get out of leases as conditions warranted, they might have had less flexibility than we would have been comfortable with to navigate the crisis. The solution for us was not just to listen to the company's take on the subject, but to speak to a variety of experts on mall-based leases. We spoke with former SVPs of real estate at other national retailers and former members of Ann Taylor's real estate and legal teams. We determined they had a variety of outs if they needed them, giving us added confidence to buy the stock at a multi-year low. [*Note*: Ann Taylor shares currently trade at $22.50.]

Are there market sectors in which your brand of research is tough to execute?

KG: We generally avoid areas where we think we'll be challenged to uncover unique insights. With financials, for example, there's enough of a black-box element to most of the companies that we consider our research time better spent in other areas. We also avoid industries like energy, where we think we're at a disadvantage to the 10-20 year analyst expert at another firm. We will invest in technology, but generally not in those areas that are changing so rapidly that we have to continuously execute our research to maintain our understanding of the business.

ON RESPONDING TO NEWS:

The beauty of public-market investing is that you can change your mind and step to the sidelines and watch.

How generally do you look at valuation?

KG: We run a very structured and concentrated portfolio, with only 12-15 longs at any given time, so we have the luxury of taking what we think is a very conservative approach to valuation. We look two to three years out and conservatively project after-tax operating earnings, adjusted for normal capital spending and taking into consideration any cyclical factors or other temporary issues that are impacting the company or industry. We don't like paying for growth beyond year three, so we typically capitalize those earnings assuming GDP-like growth or less and with a 10% discount rate, which implies multiples of 10-13x. We buy only when we see at least 50% upside from the current price to our appraised value. With this approach our upside is driven by earnings and free cash flows, not multiple expansion.

Describe some positions you've sold recently and why.

KG: One reason we sell is when a company hits our appraisal value. We bought shares in the high-teens of SonoSite [SONO], a medical-equipment company that makes portable ultrasound equipment, thinking it had invested in growth and that there was an opportunity for them to either achieve that growth or right-size costs for the existing level of demand. They ended up both growing the top line and reducing costs, so as the stock got above $30 a few months ago we thought the market had realized the earnings power we had identified and we sold most of our position.

We will also exit a position if there is meaningful divergence in events from our thesis. Earlier this year we liquidated our holding in Core-Mark, a convenience-store distribution company, after management detailed a more competitive pricing environment. They considered it temporary, but it wasn't obvious to us that it would be as short-term as management believed. The beauty of public-market investing is that you can change your mind and step to the sidelines at times to wait and watch. That's what we've decided to do for now with Core-Mark.

Turning to a specific out-of-favor idea, describe your thesis for videogame developer Electronic Arts [ERTS].

KG: The company is a leader in the industry, known best for its sports franchises like Madden Football and FIFA Soccer, as well as internally created properties like The Sims, Battlefield, and Need for Speed. Three-quarters of sales come from selling boxed videogames at retail stores, while much of the rest comes from selling higher-margin digital games or digital add-ons that are downloaded directly.

Things started to unravel at EA starting in late 2008. The company's strategy of trying to grow into its bloated expense base led to a series of disappointing quar-

ters with missed estimates and "guide-downs." The self-inflicted problems were made even worse by weak consumer spending – at the start of 2009 analysts were still expecting 10% industry growth for packaged videogames, which ended up turning into a 10% decline for the year. After 25 years of industry growth, many people interpreted the decline as the beginning of a potentially destructive shift to digital distribution, similar to what happened in the music business.

In late 2009 EA announced a title-reduction plan, shrinking its game portfolio by 25%, as well as additional cost cuts and headcount reductions. The market reacted as if this were bad news and that it was a sign that EA was backing away from a packaged-games business in secular decline. The stock, which had been above $60 just over a year before, ended 2009 at around $17. Around then we built EA into one of our biggest positions.

What do you see driving earnings back in the right direction?

KG: We see three primary levers to improving profitability. The first is the initiative to prune money-losing game titles, which we consider a positive sign that management has abandoned its grow-at-any-cost mentality. We estimate that effort can add 25 cents per share to the company's earnings power.

The second driver of improved profitability will be the launch in 2011 of EA's Star Wars "massive multi-player online" [MMO] game, which has been in development since 2007. MMO experts we have spoken with say this is literally going to be the most expensive video game ever made. Once it launches, what is now a 10-cent per share earnings drag could become a meaningful contributor to the bottom line. If Star Wars attracts 1.5 million paying subscribers – compared with 12 million for Activision's World of Warcraft – we estimate it could produce 30 cents in EPS. With the development spending going away, that results in a 40-cent EPS swing.

Finally, because the company had until fairly recently been pushing too many units into the sales channel, it has had to offer significant price protection to retailers to help them clear out excess inventory. As this spending normalizes, we project another 40-cent benefit to EPS.

If we layer our incremental $1.05 per share of earnings potential on top of EA's fiscal March 2010 profits, we think the company within the next two or three years can generate $1.50 in EPS. This would represent a 16% margin, which seems achievable relative to EA's past peak of 27% and Activision's current 26%. Against today's share price, that's a 10.4x P/E – excluding the cash on the balance sheet, the P/E is only 7x.

That certainly sounds cheap for a videogame company, but not so much if the industry is in secular decline. What's your take on that?

KG: During a period in which some clothing retailers – similarly dependent on consumer spending – were putting up negative-30% comps, it strikes us as crazy for people to conclude on 2009 numbers that packaged videogames are doomed. We've vetted this issue with industry veterans and we consider the pullback an aberration, driven by general weakness in consumer spending and the sharp decline of the music category, which had been grow-

INVESTMENT SNAPSHOT

Electronic Arts
(Nasdaq: ERTS)

Business: Develops, publishes and markets videogames for gaming consoles, PCs and handheld devices. Popular franchises include Madden NFL, FIFA and The Sims.

Share Information
(@10/28/10):

Price	**15.63**
52-Week Range	14.06 – 20.24
Dividend Yield	0.0%
Market Cap	$5.16 billion

Financials (TTM):

Revenue	$3.82 billion
Operating Profit Margin	(-5.5%)
Net Profit Margin	(-9.1%)

Valuation Metrics
(@10/28/10):

	ERTS	Nasdaq
Trailing P/E	n/a	13.9
Forward P/E Est.	18.4	16.1

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Dodge & Cox	11.0%
Primecap Mgmt	7.9%
T. Rowe Price	7.8%
Vanguard Group	3.6%
State Street	3.2%

Short Interest (as of 10/15/10):

Shares Short/Float	4.8%

THE BOTTOM LINE

Kian Ghazi sees three main levers to improved company profit: the pruning of money-losing titles, the 2011 launch of its Star Wars online game, and a normalization of retailer subsidies. At 13x his $1.50 per share estimate of earnings power two to three years out, plus net cash, he appraises the company's share value at $25-27.

Sources: Company reports, other publicly available information

ing so rapidly with the success of titles like Guitar Hero and Rock Band. Excluding music, the industry declined only 3% in 2009.

Longer-term, we believe the shift to digital will be an opportunity for publishers rather than the threat many fear. Of the $60 retail price for a videogame, more than $20 of that goes to packaging, shipping, console royalties and retail margins. In the digital world, EA retains that $20 hit to gross margins, making either the sale of each unit much more profitable, or allowing it to cut prices and increase demand at the same profit per unit. There will certainly be issues to work through as technology and business models evolve – which will happen over many years, not just a few – but we believe the publishers of content are ultimately operating from a position of strength.

The shares, at $15.65, are down more than 10% this year. What's your estimate of intrinsic value?

KG: In the base case I described earlier, if you apply a 13x multiple to the $1.50 of unlevered earnings power and add back net cash, we appraise the business at $25-27 per share.

We also see many free call options offering incremental upside. A snapback in consumer demand that drives 10% industry growth would add 50 cents to EPS. The Star Wars MMO capturing 3 million subscribers instead of 1.5 million adds another 30 cents to EPS. Each time a new sequel to a key franchise sells 2 million more units than before – not at all unheard of – that adds about 15 cents to EPS. It's also not impossible to imagine that a company spending 25% of revenues on R&D could hit the jackpot and develop the next Grand Theft Auto or Call of Duty. If one or all of those happen, we'd expect to see a share price well above our base-case estimate.

How protected are you on the downside?

KG: One way we come at that is to analyze the value of the company's enduring sports and Sims franchises, which currently account for about 50% of total revenues. Based on our analysis, we believe those properties generate 90 cents of normalized EPS before allocating general and administrative expenses, which could be cut if they were sold. Using a conservative 13x multiple on that and adding the net cash implies a value of approximately $17, above where the stock currently trades.

ON THE KNOT'S USERS:

The company calls its target users GEMS, for "Girls Engaged in Massive Spending" – an attractive demographic.

Why do you think the market is misreading The Knot [KNOT]?

KG: The company's primary business is TheKnot.com, a website with wedding-related content for newly engaged women. In the U.S. there are about two million weddings per year and 80% of those engaged women provide The Knot with their name, e-mail address and wedding date in order to unlock content and tools on the website. The company calls its target demographic GEMS, for "Girls Engaged in Massive Spending." As you can imagine, this is a very attractive demographic for advertisers.

The core of the business is creating free online content, against which the company sells national and local advertising. It also generates commissions through its wedding registry business, where people can search the name of the bride, find out where she's registered and then shop her registries through The Knot.

Over the past three years the company has faced one disappointment after another. At its peak in 2007, revenues were growing at a 35% clip and operating margins were in the high teens. Growth then took a hit, first from vendor attrition after a planned steep price increase and later more broadly from the weakening economy. In 2008, management disappointed investors again when it guided down margins so that it could invest for a year in upgrading the company's IT infrastructure – an investment that later became permanent so the company could retain the additional IT people it hired for ongoing growth initiatives. Lastly, earlier this year The Knot's biggest registry partner, Macy's, decided to pull some of its business back in-house. The stock, as high as $31 in 2007, fell to around $7 by the end of August.

We sense a variant view coming on.

KG: We believe this is a classic case of a good business facing temporary challenges and with a cost structure sized for growth. We consider it a "heads I win, tails I don't lose much" opportunity.

Two years of investing in its systems has made the company more scalable and flexible, supporting several initiatives to help accelerate online ad growth. For example, to better demonstrate the advertiser ROI, the company now provides each local vendor with an online dashboard so they can see how many times their profile has been viewed and the names of the brides who have looked at the profile. They've also developed tools to help vendors create their own profiles without needing a Knot representative to walk them through it. With the resulting savings, Knot built a new customer-service team, with the express purpose of lowering vendor churn. The early read is that this group is on track to reduce annual churn by as much as 300 basis points.

We expect these initiatives to increase sales productivity and reduce churn, fueling growth in online ad revenues in the 10-20% annual range. If we're right, given the company's 70-80% incremental margins, we think it can beat consensus 2011 EPS estimates by more than 100%.

Describe any competitive threats.

KG: One of the things we like most is that there aren't large competitive threats from a Wal-Mart or Amazon. The Knot is the Amazon of the bridal niche, and through word of mouth, it enjoys a net-

work effect that creates a real competitive advantage. The company spends next to nothing on member acquisition costs as women hear about The Knot from friends and family. So any potential new entrant in the business would likely struggle to gain an audience and would have to fund many years of significant start-up losses to both create the necessary content and to pay to attract the eyeballs. After 14 years in the business and challenges from many competitors, The Knot still attracts 4x the number of visitors as the second-largest site, WeddingWire.com, and 7x as much as the third-largest, Brides.com.

Is Macy's pulling some business in-house an ominous sign?

KG: Macy's was the only retailer that had its entire registry site hosted by The Knot. After the change it's now like every other retail partner, paying only for traffic that The Knot sends its way. This is really how the relationship should have been structured all along.

Isn't the long-term decline in the number of U.S. weddings a secular headwind?

KG: The number of weddings has been declining by about one-half of a percent annually for a couple decades. But that's a relatively minor trend against the secular shift from offline wedding-related advertising moving online. Only 12% of advertising spending occurs online today, despite the fact that the Internet represents nearly 35% of the time spent consuming media. We think it's inevitable that that gap narrows over time, dwarfing the impact of the decline in marriage rates.

How are you looking at valuation at the current share price of $9?

KG: For our base case we're assuming 10% annual revenue growth, 70-80% incremental margins, and a 15x multiple on unlevered earnings 2-3 years out. (The multiple we're willing to use is higher because of the franchise value we see here.) That results in an intrinsic value of around $13. If revenue comes in higher, which wouldn't surprise us, we'd do much better than that.

If the growth we're expecting doesn't materialize, management has acknowledged it can right-size the business, and we estimate $10-15 million in growth-related investments could come out. In that scenario, with flat revenues, the company would earn about 25-30 cents per share. At a conservative 12x multiple, plus $4 per share in net cash, we estimate the downside for the shares at $7-8. Given the company's market leadership, the competitive barriers to entry and the fragmented base of brides and advertisers, we struggle to see how we can lose meaningful money from our average purchase price in the $7-8 range.

Is management up to the task here?

KG: The founder, David Liu, is the CEO and he's been long-term minded in the investments he's willing to make. That was painful for investors when the stock had very high expectations behind it, but we've been quite impressed in our interactions with him. He has a real vision for the business and I believe he's open to outside input, particularly about the over-capitalized balance sheet. We learn a lot

INVESTMENT SNAPSHOT

The Knot
(Nasdaq: KNOT)

Business: Provider of primarily online media services to the U.S. wedding, newlywed and pregnancy markets. Brands include The Knot, The Nest and The Bump.

Share Information
(@10/28/10):

Price	**9.00**
52-Week Range	6.90 – 11.34
Dividend Yield	0.0%
Market Cap	$306.4 million

Financials (TTM):

Revenue	$111.3 million
Operating Profit Margin	4.9%
Net Profit Margin	(-3.8%)

Valuation Metrics
(@10/28/10):

	KNOT	Nasdaq
Trailing P/E	n/a	13.9
Forward P/E Est.	75.0	16.1

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Wellington Mgmt	7.4%
Kornitzer Capital	7.3%
Invesco	6.7%
Weitz & Co	6.5%
Vanguard Group	4.5%

Short Interest (as of 10/15/10):

Shares Short/Float	6.3%

THE BOTTOM LINE

After three disappointing years, Kian Ghazi expects the company's strong market position and investments to help accelerate ad growth to start paying off. Assuming 10% annual revenue growth, 70-80% incremental margins and a 15x multiple of his estimate of earnings two to three years out, he pegs the firm's intrinsic share value at $13.

Sources: Company reports, other publicly available information

about a business in our due diligence and we're happy to share the feedback with management. We're much more comfortable when the CEO shows an interest in that feedback, good or bad, and that's certainly been the case here.

Tell us about another off-the-beaten-path idea, Aviat Networks [AVNW].

KG: Aviat is a telecom-equipment company that sells microwave radios for the backhaul portion of wireless networks. Their equipment serves as the pipe that hauls the customer data off the towers and onto the network backbone.

Network operators basically have three options for backhaul: copper, fiber optics, or microwave. Copper is being phased out because it can't keep up with the exploding capacity demand. Fiber has almost unlimited capacity, but has large upfront costs and requires digging trenches to put the fiber in the ground. Microwave is the only wireless option and the one that is typically most cost-efficient, which is why it has, and is expected to maintain, about 70% of the global backhaul market.

Aviat is the byproduct of the 2007 merger of Harris Corp.'s microwave division and Stratex Networks, and by most accounts the merger has been a disaster. The integration has been slow and rocky – the company is on its third CEO in four years – with the problems exacerbated by the economic crisis. In the past two years revenues have dropped 40%, and over that time the stock is down 60%, to around $4.40. Taking out $2 per share in net cash, the company trades at less than 0.3x currently depressed revenues and below tangible book, indicating the market assumes negative results will go on in perpetuity.

Telecom equipment has proven to be a pretty tough business.

KG: Without question, but our discussions with industry contacts both domestically and internationally suggest that product quality, features, design and service levels all matter, and that Aviat's products and service are well-regarded. Incumbency is also key, so the company's broad installed base gives it an important leg up in maintaining business with existing customers. So while it's definitely a tough industry, Aviat's been at it for 50 years and we think is still well-positioned to be successful going forward.

At this price, we believe expectations are way too low for Aviat. Its revenues have stabilized at roughly $120 million in each of the last four quarters and looking forward there are a number of reasons to be optimistic. The company has been picking up large customer wins, including Verizon, BT and India's Uninor, which should start contributing more meaningfully to revenue growth.

We also hear that spending in emerging markets, which provides roughly 50% of Aviat's revenues, is picking up after a sharp decline in 2008 and 2009. One problem has been that low-cost Chinese competitors have gained share in emerging markets by offering financing on terms that Aviat wasn't willing to match. As the financial crisis has eased, we believe vendor financing will once again become secondary in the vendor-selection process to product and service quality, where our contacts tell us Aviat is superior to its Chinese competitors.

INVESTMENT SNAPSHOT

Aviat Networks
(Nasdaq: AVNW)

Business: Design, manufacture and sale of a range of wireless networking products and services used primarily by wireless service providers and network operators.

Share Information
(@10/28/10):

Price	**4.37**
52-Week Range	3.36 – 8.25
Dividend Yield	0.0%
Market Cap	$259.6 million

Financials (TTM):

Revenue	$478.9 million
Operating Profit Margin	(-7.8%)
Net Profit Margin	(-27.2%)

Valuation Metrics
(@10/28/10):

	AVNW	Nasdaq
Trailing P/E	n/a	13.9
Forward P/E Est.	14.1	16.1

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Ramius LLC	5.6%
Vanguard Group	4.4%
Dimensional Fund Adv	4.2%
Disciplined Growth Inv	4.1%
Hawkshaw Capital	3.6%

Short Interest (as of 10/15/10):

Shares Short/Float	3.1%

THE BOTTOM LINE

Kian Ghazi believes the company is better positioned to capitalize on strong secular growth in wireless infrastructure spending worldwide than the market seems to expect. Assuming 10% annual sales growth over the next two years and improved gross and operating margins, he estimates the company's intrinsic value at $11 per share.

Sources: Company reports, other publicly available information

Looking at the big picture, the bad economy has only slowed what should be a major secular tailwind for the wireless backhaul market, driven by the dramatic increase in mobile data usage globally. The backhaul pipe has become a bottleneck for network traffic, and operators are having to build out their infrastructure to keep pace. Most industry experts believe the $8 billion global mobile backhaul equipment market will grow at a 10% annual rate over the next three years. Aviat should be a key beneficiary of that.

In terms of profitability, even telecom-equipment providers can make a margin. The company's publicly traded pure-play peers, DragonWave [DRWI] and Ceragon Networks [CRNT], have both achieved 9% margins and are targeting 10%-plus longer term, as is Aviat.

How aligned is Aviat's cost base relative to its revenue level?

KG: One key to our optimism that Aviat can hit its profitability targets is the return of Chuck Kissner as CEO. He had run Stratex prior to the merger and he has essentially come out of retirement for a second time to help turn around the company, the last time being in 2001 after the telecom bust. In August, after six weeks on the job, he announced a restructuring plan to cut operating expenses by nearly 20%. He's also refocusing the organization on the core microwave-radio product – accelerating R&D in next-generation backhaul equipment – while exiting non-core money-losing businesses.

Once the cost cuts are done, with no revenue growth Aviat should earn low-single-digit profit margins and nearly 20 cents in earnings per share. Applying a 10x multiple and adding in the cash justifies a share price of around $4, which protects us nicely on the downside.

How are you looking at the upside?

KG: Over the next two years with secular tailwinds and an improving global economy, Aviat should be able to grow sales at 10% annually, bringing revenues to a quarterly run rate of $145 million – still 25% below the historical peak. Assuming a 35% gross margin, which is achievable as the company completes its shift to outsourced manufacturing, Aviat should earn 9-10% operating margins. At that level, adding back cash and using a 13x multiple on unlevered earnings, we arrive at an intrinsic value of $11 per share – 150% above today's price. Even at $11, the shares would trade at just 0.9x revenues, while both DragonWave and Ceragon currently trade at about 1.2x.

ON PROCESS:

One element we've added is to ask what could send the stock down 30% and we would *not* want to add to our position.

I would add that the quality of Aviat's business – in terms of its moat and ability to generate returns on capital – is at the low end of what we typically find attractive. But we can live with that as long as the risk/reward profile is as compelling as we think it is here.

Two years ago [*VII*, October 31, 2008] you laid out for us the investment case for Universal Technical Institute, which you still own. Given the regulatory environment for for-profit education, update briefly your case for it today.

KG: Central to our analysis of UTI from the beginning has been, "Does the education it provides offer a good ROI to prospective students?" If the answer was no, it didn't matter what the growth potential was or what margin potential it had, we weren't going to be interested. Our analytical work has always shown the ROI, even unlevered, was very attractive for students. Being an auto mechanic today is more like being a tech professional than a grease monkey, so students need to learn the latest technology from the highest-quality sources, and UTI is the gold-standard in the industry. That's been validated by every metric we can identify: it has the best graduation rates in the industry at 70%, it has the best job-placement rates at more than 90%, and it has among the lowest loan-default rates, of around 5%.

That all suggests the students graduate, they get jobs, and that their jobs are good enough that they can pay back their loans. That's all exactly what regulatory reform is meant to promote, so when the regulatory storm hit this past summer and took all for-profit education stocks down sharply, we felt very good about UTI and reloaded as the share price went from $25 down to as low as $16. The stock is now back above $19 and very recently it appears the market is starting to differentiate between the various players. When Apollo reported results earlier this month that took its shares and the shares of others in the industry down another 15-25%, UTI shares didn't budge. That indicates to us that the regulatory overhang should rightly continue to dissipate for the company. They shouldn't be painted with the same brush.

Can you give recent example where your emphasis on downside risk led you to pass on an investment that otherwise looked quite interesting?

KG: One element we've added to the tail-end of our analytical process in recent years is to consider scenarios that could send the stock down 30% or more and we would *not* want to add substantially to our position. Common examples would be things like the loss of a giant customer, or market incursions from a powerful competitor. Given the outsized positions we take, we want in a disciplined way to contemplate those scenarios up front and pass on the investment if they're even somewhat likely.

An example of this in practice was our interest in Winn-Dixie [WINN], the #3 grocer in Florida behind Publix and Wal-Mart. The company had come out of bankruptcy and based its turnaround strategy on upgrading its stores over multiple years, requiring significant capital investment. We saw a lot of potential for increased margins and cash flow, but our

concern was that Wal-Mart or Publix could decide to short-circuit Winn-Dixie's drive to become more competitive by stepping on its throat with heavy price competition. That's what I would have done if I were them. The margin of safety was narrow enough that we would have been unlikely to buy more Winn-Dixie stock if a big competitor made such a move and the shares fell 30%. As a result we decided not to invest.

Are you one who has put more emphasis on macro views since enduring the economic crisis?

KG: One key reason we structure our portfolio to consistently have relatively low net long exposure – about 30%, beta-adjusted – is that I concluded early on that I'm not going to add alpha by swinging around our net exposure based on my macroeconomic views. That's just not my core competency, so our focus is on executing our fundamental research.

But that's not to say we don't consider the macro environment. We preserved capital very well in 2008 – the fund was down only 3% – which was obviously helped by our short book, but also was a function of our deliberately shifting the long side of our portfolio to a more defensive posture in the first half of 2008. We sold several economically sensitive positions and shifted towards recession-resistant and counter-cyclical businesses like Universal Technical Institute and Core-Mark, which held up relatively well.

ON SHARPER IMAGE:

I didn't appreciate how fast the balance sheet could unravel when the turnaround didn't materialize quickly enough.

On the subject of risk, what did you miss in an ill-fated pick from our last interview, Sharper Image?

KG: I learned early on, the hard way, that levered balance sheets give turnarounds dangerously little room for missteps. I decided that companies with more than modest amounts of debt just don't fit in the context of a concentrated portfolio and we adjusted our screens accordingly. With Sharper Image, I found a creative way to make this same mistake. I failed to appreciate how quickly what appeared to be a strong balance sheet could unravel when a money-losing company's turnaround didn't materialize quickly enough. The lesson is to focus more holistically on a company's financial strength. In all the ideas we've discussed today, you'll notice that not only do they have substantial net cash on the balance sheet, but they also have positive free cash flow and, for the most part, assets that would be highly saleable in a pinch. VII

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