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Contrarian Bear

Interview With Michael Margolies, Chairman, Avalon Research Group

By SANDRA WARD

ALWAYS AHEAD OF THE PACK, Margolies saw an opportunity to provide hedge funds with unbiased independent research as far back as 1995 when he founded Boca Raton-based Avalon Research. Acquired last year by London-based trade publisher Metal Bulletin, Avalon has expanded its customer base to include institutional clients that are also served by its new sister company, Montreal-based BCA Research, respected for its macroeconomic research. By taking a contrarian bent and digging deep into a company's operations, Margolies and his team come to investment conclusions that mostly run counter to consensus and offer clients profitable opportunities for their portfolios.

Barron's: *Hedge funds are so herd-like now. Are you contributing to that trend?*

Margolies: I don't think so. What is contributing to that trend is the number of hedge funds out there fishing in the same pond. There is so much money chasing the same ideas it has impacted returns. Quite frankly, the idea of 20%-a-year returns without any risk or volatility is just silly. The investors who are putting in the money, mostly the fund-of-fund guys, don't have a tolerance for risk. Either investors are going to have to adjust their expectations for returns or managers are going to have to find some new and greater strategies to generate those returns. The amount of capital around and the competitive nature of investing and changes in technology have resulted in information arbitrages closing very quickly. That said, I would rather have my money managed by many of our hedge-fund customers than have it in an index fund or other type of investment. For all that's been written about hedge funds lately, I haven't seen it emphasized anywhere that most hedge-fund managers have a substantial portion of there own net worth in their funds.

How are the changes in the business impacting what you do?

We have been around a long time and we try to identify securities that are trading on what we perceive to be misperception and uninformed opinion. We take positions where we significantly disagree with consensus on a small set of metrics that are key drivers of a stock story. What's been negative for us is that an abundance of information creates a deficit of attention in our customer base. There have been so many upstarts in the independent research field that there is now a lot of competition. We have adapted our business to focus on developing deeper relationships with firms and on names that we think really matter.

How do you come up with your ideas?

We have a pretty good team of analysts here and we have a director of research, David Hines, who has been around a long time. Our ideas come from a lot of industry conferences and a lot of talking to customers and observing general trends within the industries we follow. We also look to the stock market for clues -- watching what groups are hot and what groups are not. We use what is called a step approach: analyzing the story line, time line, earnings line and price line. If a story line is very compelling and after examining the components of that story line it turns out some things are true and some are not, we have something to work with. We can look at the time line of a certain story and determine if it might be a little aggressive. We had a buy recommendation on Apple Computer, for instance, because we thought that the Street's time line was too conservative for the adoption of iPods. We will look both ways and try to figure out where information arbitrage opportunities live.

Brian Smith

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What industries do you focus on?

Health care, retail, consumer, financial and technology. We also have a catch-all space for special situations.

Are you having a hard time coming up with ideas these days?

It is definitely tougher. It is a no man's land of valuations and there aren't any real trends in the market. Ideas are hard to come by and bigger-cap ideas are even harder.

Why is that?

There is more competition and more information getting into the market quicker. Information moves at the speed of a mouse click now. Back 15-20 years ago it might have taken three, four or five days for a story to get around. Now it is 20 minutes, soup to nuts.

What are some of your ideas now?

Alliance Data [ADS] is one. Wall Street values Alliance as a transaction-service company when really the credit-card service segment generates the bulk of their earnings. It is really a sub-prime credit card company with a transaction-service card multiple. It has had three consecutive quarters of weaker than expected results for transaction services. The first quarter of '05 they had $11 million less than expected following a miss of $15 million in the fourth quarter of '04 and a miss of $5 million in the third quarter of '04. Their largest client is The Limited [LTD] and weak sales growth at The Limited continues to drag down their transactions and their credit sales.

What's the difference in multiples for credit-card companies and transaction- service companies?

A good credit-card company trades at 8 to 10 times earnings and this trades at 20 times. Eventually the Street will realize this is a credit-card company with all the risks and business metrics associated with a credit-card company and the multiple will come down.

What about the risk they'll sell their credit-card business?

Then they won't have any earnings; it generates most of their earnings.

Where do you see Alliance shares headed?

The stock is at 37.53 and 28 is our price target. Red Hat [RHAT] is another one we've been on since the

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20s and we think it is going lower still. It was trading just below 11 and rallied to around 13 1/2 on news that Michael Dell invested in it. But that was mischaracterized: His investment trust bought a $99 million convertible bond and they recorded it with the SEC, and so it appeared that Michael Dell had just bought $99 million worth of Red Hat even though they bought the convertible some time ago.

Why do you think it's going lower?

We expect Red Hat's earnings growth to be curtailed significantly because they will need to increase their SG&A expense to protect their market share. Their cash flow metrics continue to disappoint. Cash flow has been disappointing every single quarter and we believe that '06 is at risk of a disappointment as well. They lowered their cash flow guidance for 2006 to 60% of revenue versus the previous guidance, which was 60% to 70% of revenue. They also lack transparency in some of their metrics.

Such as?

In the fourth quarter new metrics were introduced for bookings and billings but details were not released and there are no specifics on past quarters for comparison and no detail on the amount of off-balance-sheet or long-term deferred items. Bottom line for Red Hat's future is that Linux is a free software and companies will buy these package versions, but the real money is in servicing and in customizing them. We view Red Hat as a services company trading at a software multiple. It has got a pretty steep multiple for a services company. The Street is looking for 30 cents in '06 on a $13.50 stock, which puts it at 22 times earnings and it's not growing.

Interview -- Part II[1]

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