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Heard In California
Branching Out Could Help Make Advanced Marketing a Bestseller
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Costco devotees like to load up on toilet paper and canned goods, but lots of best-selling books also find their way into the store's oversize shopping carts. That's where Advanced Marketing Services comes in. The San Diego company is the book supplier to the warehouse stars, shipping about one million books a week, mainly to Costco and Sam's Club stores. Advanced Marketing's sales have multiplied along with the superstores, but its stock is selling at discount-store prices.

Shares are trading at about \$15, nine times First Call's consensus earnings estimate for 2000, while analysts predict annual earnings growth of about 13% over the next five years. Add to that the company's lack of debt, its book value of about \$9 a share and its \$30 million in cash, and Advanced Marketing is a good value play, the bulls say.

Marc Robins, president of Red Chip Review, a Portland, Ore., small-cap research company, says the current book-selling season gives investors "a short-term reason to get excited about this company." This summer's offerings include some particularly hot sellers like Thomas Harris's "Hannibal" and anything from the Oprah's Book Club reading list. And once those sales start showing up on the balance sheet, he says, the stock could get a boost.

Mr. Robins has the company on his A-list of buys, as does Robert Jacapraro, an analyst at Sidoti in New York. And aside from any short-term pop, the analysts also see long-term potential. "The stock's low valuations and the company's improving operating trends have created a window of investment opportunity," says Mr. Jacapraro.

The window has been open for a while, in part because of Advanced Marketing's client list. The company does most of its business -- 77% last year -- with Costco of Issaquah, Wash., and Sam's Club, a unit of Wal-Mart Stores, Bentonville, Ark. While the successful chains are enviable business partners, the level of exposure scares off some investors, who fret over the possibility of a breakup in the relationships.

"It's always been a level of concern," says David Allen, an analyst with Granite Financial Group in San Diego. "And I think that's why the {price/earnings ratio} remains at a lower level than it would otherwise be."

But while business with Costco and Sam's Club is growing, every year that business is becoming a smaller part of Advanced Marketing's sales. Chief Executive Michael Nicita says the company's strategy is to make itself indispensable to its two biggest customers while diversifying beyond them. To that end, Advanced Marketing has been expanding to other types of retailers and it is developing its own publishing arm.

Charles Tillinghast and Loren Paulsen started the company in 1982, delivering 24 books to a club store out of the trunk of a Volvo. Mr. Tillinghast is now the company chairman, Mr. Paulsen is an executive vice president, and sales hit \$501 million in fiscal 1999, ended March 31.

Advanced Marketing buys books from publishing houses, concentrating on bestsellers, well-established older books and specialty areas such as business, cooking or gardening. Its buyers look for books with the

potential for broad appeal and quick turnover, fewer titles with more predictable sales. They're distributed to customers from one of four warehouses, in Sacramento, Dallas, Baltimore and Indianapolis. The company handles book selection, ordering, delivery and returns of unsold stock.

Michael Clayman, publisher of Warehouse Club Focus, an industry newsletter, says the company's strategy of keeping the big guys happy is wise, given the continued growth in warehouse clubs. He notes that comparable-store sales at the big three clubs -- Costco, Sam's and BJ's Wholesale Club of Natick, Mass., also an Advanced Marketing customer -- grew 6.6% in 1997, 8.3% last year and are on track to grow 8.6% this year.

Mr. Clayman says Advanced Marketing is in a good position, because it's well-entrenched and couldn't easily be replaced.

As part of the effort to maintain that advantage, Advanced Marketing introduced a computerized vendor-managed inventory system to track sales and make forecasts, and thus orders. The company credits the system with reducing the percentage of returned books to about 20% from 28% in one year. (Estimates on returns in the overall book industry vary widely. Some say there is no way to calculate an average; others put it at between 20% and 25%.)

Meanwhile, Advanced Marketing has been expanding its customer roster, adding retailers including Office Depot, Fry's and Petco. Last year, it signed a deal to supply the 228 stores in Kmart's western region.

Mr. Allen says the Kmart agreement involves mainly lower-priced paperbacks, but has the potential for expansion within the chain or duplication with other, similar retailers.

"More international expansion is a good row for them to hoe," adds Mr. Allen, who has a "buy" rating on the stock and a 12-month price target of \$19.

The company had about \$36 million in sales outside the U.S. last year, with the biggest chunk in Britain. Since March 1998, it made two acquisitions in England, picking up a pair of distributors of specialty books, mainly in gardening, crafts and gifts.

Longtime shareholder Irving Kahn, chief executive of Kahn Brothers in New York, says the potential for higher-margin business comes from Advanced Marketing's publishing arm, which operates three imprints.

"They're trying to identify specific areas like parts of children's books, art, horticulture, nutrition, where there's a chance...to be smart and make a good selection of authors and get attractive margins," says Mr. Kahn. His firm is Advanced Marketing's biggest outside shareholder, with about one million shares, or a nearly 12% stake. Insiders hold about 36% of the stock.

And then, of course, there is the Internet angle. While Advanced Marketing doesn't sell books online and doesn't plan to, it is a supplier to Amazon.com. Mr. Nicita says the amount of business with Amazon isn't yet "material" to Advanced Marketing's bottom line, but is "growing at a pretty fast clip."

Mr. Jacapraro, the Sidoti analyst, sees more potential in the virtual world. "They don't emphasize it much now," he says, "but I think their role as a supplier to online book merchants...could increase and that could provide a little more growth." Mr. Jacapraro has a \$25, 12-month price target on the stock.

Internet vendors, with their discount pricing, are a potential competitor to Advanced Marketing. But both Internet sellers and warehouse clubs gained market share in sales of books to adults last year, even while overall unit sales declined. Internet market share was close to 2%, up from less than 1% a year earlier, according to NPD Group, a market-research firm in New York. Warehouse club shares reached 6.4%, from 6%. At the same time, total book purchases by adults declined nearly 3%, according to the study.

Still, Mr. Kahn, the investor, isn't worried about a demise of the book-selling business. "In general, I'm bullish on literacy," he says. "I think the world is by no means oversupplied with books."

Looking Good: Shares of Keravision surged 52%, to \$26.625, continuing a climb started in June after the company said it expects to report second-quarter revenue at least 50% above analysts' expectations. The

Fremont company won approval from the U.S. Food and Drug Administration in April for its implants to treat mild nearsightedness.

Out of Fashion: Children's apparel retailer Gymboree skidded 38%, to \$6.25, after announcing that it will report a bigger-than-expected loss in the second quarter. The Burlingame company said continued softness in its boys' line and higher markdowns were main contributors to the anticipated loss.

Powering Down: Epicor Software shares fell 24%, to \$5.375, after the company said it expects second-quarter earnings will be at or near break-even, with revenue slightly below the first-quarter level. The Irvine company said a general industrywide slowdown in demand for enterprise resource planning systems software was partly responsible.

Big Deal: Vertel shares shot up 51%, to \$2.875, after the Woodland Hills company announced a deal to create network integration software for Lucent's operations support system applications. The alliance could grow to \$20 million over three years.