Columbia Business School

Graham & Doddsville

An investment newsletter from the students of Columbia Business School

Issue XI Winter 2011

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"Consistency of effort wins the game" — Larry Robbins

Mr. Robbins founded Glenview Institutional Partners in 2000. Prior to founding Glenview, Mr. Robbins spent six years at Omega Advisors. He earned a B.S. in Engineering and Business from University of Pennsylvania.

G&D: How did you first get interested and involved with investing?

Larry Robbins (LR): I went to University of Pennsylvania and did a dual degree program in management and technology, receiving an engineering degree and a business degree. Like most kids, I thought I was going to return to the place that I grew up and into the same business that my father was in. My father was an accountant. When everybody in the last year of school was interviewing for consulting firms or investing firms, I did not know what an investment bank was, but decided that it would be a good idea to interview there. For my summer internship I was trading options for O'Connor and Associates on the floor of the Chicago Board of Trade and the Chicago Mercantile Exchange, and I absolutely loved it, growing up from a horse racing background. I was scared,

Larry Robbins, Glenview Institutional Partners

though, that if I learned that business and then wanted to do something else seven

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"Small-Caps, Big Winners" — Robert Robotti

Robert Robotti is the president of Robotti & Company. He began his career in public accounting. Prior to founding Robotti & Company, Bob Robotti was a vice president and shareholder of Gabelli & Company, Inc.

Mr. Robotti holds a B.S. from Bucknell University and an MBA in Accounting from Pace University. He is a certified public accountant.

G&D: Mr. Robotti, you graduated from Bucknell University before getting your CPA and an MBA from Pace University. How did you first become interested or involved with investing?

Robert (Bob) Robotti (BR): It was actually happenstance — good fortune. The accounting firm I worked for was the auditor for Tweedy, Browne Company. The very first thing I did, while I was still in college, was to work on the audit of Tweedy, Browne and TBK Partners, which was a great entrée to value investing. At the time, Ed Anderson managed the

Robert Robotti, Robotti & Co.

firm and Howard Browne was still very active. Tom Knapp was a fixture in the office; Chris Browne and

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Welcome to *Graham & Doddsville*

Pictured: Bruce Greenwald and Marty Whitman at the Columbia Investment Management Conference in February 2010.

We are pleased to present you with Issue XI of *Graham & Doddsville,* Columbia Business School's student-led investment newsletter co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Investment Management Association.

This issue features an interview with Larry Robbins, portfolio manager of Glenview Institutional Partners. Mr. Robbins outlines clever analogies for the market, his intense research process, and a handful of ideas that he currently finds appealing.

The issue also features an interview with Robert Robotti, who has managed his firm's capital for nearly 30 years, focusing on small– and mid-cap stocks and has compounded 13% net over the past decade. He employs a value-focused, research intensive approach.

We also talk with Artie Williams '02, Jennifer Wallace '94, and Judd Kahn, who operate a disciplined long-only equity fund that begins with a consistent process based on valuation and business quality measures.

We aim to offer specific investment ideas that are relevant today. The current issue includes four student investment ideas, all presented at the finals of the Moon Lee Prize for Excellence.

Please feel free to contact us if you have comments or ideas about the newsletter as we continue to refine this publication for future editions. Enjoy!

The Value of Quality, *and* a Consistent Process — Summit Street Capital

Jennifer Wallace '94, Artie Williams '02, and Judd Kahn

Artie Williams, Jenny Wallace and Judd Kahn are the Managing Partners of Summit Street Capital Management. Together they manage quality-biased value portfolios of U.S. Equities that have returned 89% net since launching in April, 2009. Artie also teaches Applied Value Investing here at Columbia and Jenny sits on the Advisory Board of the Heilbrunn Center for Graham and Dodd Investing.

G&D: Artie, you have a unique background prior to become an investment manager. Why did you make the transition?

Artie Williams (AW): I majored in accounting as an undergraduate. I was drawn

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Trip to Omaha with Warren Buffett

Columbia's Omaha Group with Mr. Buffett.

"Feel free to ask anything you like, except what we are buying and selling" and "throw me some fast balls— I don't want to fall asleep up here!" Mr. Buffett commented as he addressed more than 125 business school students in Omaha on January 14, 2011.

What do you wish you knew earlier in your career?

- More about human behavior - learning how people act; what they like and don't like.
- Understanding value investing was easy - got that in the first five minutes of reading Graham's work.
- Communication is more important that modern portfolio theory and CAPM and other things that get you in trouble.
- Communication is not only speaking but understanding how people think.

Patience and Investing

- Don't have to swing at every strike in investing. Wait for the ones you understand.

Are information advantages the basis for a sound investment strategy?

- Not so much an informational advantage, but an understanding advantage.
- People can have the same information, but arrive at different conclusions.

Successor at BRK

- Plenty of internal candidates. Important that successor is fairly young. Person who takes over will need to go through a learning curve. Hope they would have job for twenty years.
- Most important is to maintain culture that exists, which leads to certain operational advantages. Most managers joined when we bought businesses.

High frequency trading

- Buffett doesn't understand it, but expects that we will learn about it over next few years.
- Best estimate of gross earnings for all high frequency traders ~$20 billion/year.
- This is a frictional cost and comes from investors. It's a tax on investors they don't see.
- If there was a transfer tax of $20 billion on traded securities, you would hear yelling and screaming, but because you don't know where it comes from, the in-

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Trip to Omaha with Warren Buffett

Pictured: Patrick Todd '11 and Warren Buffett '51

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vesting public is not focused on it yet.

Algorithms

- History is important to understanding businesses but not for trading strategies.
- At Solomon, the traders used to always say something like 'it would take a four-sigma event for this trade to go bad.'
- It's not sigma (we're not flipping coins!) It's human behavior that causes these events (i.e., Fed does things, politics are involved, or markets face distressed selling).
- Buy a business that you can understand, which is cheap.

Mistakes

- Try not to dwell on mistakes because it will only cloud your judgment in your next decision.
- Rather learn from other people's mistakes.

Would someone be able to replicate your investment performance?

- Sure. Remember, my initial capital base was small ($9,800). "My first decade was the best, second was second best, etc. It's harder to perform as your capital grows.
- You will see in your lifetime several bubbles, a series of recessions, and maybe a panic. Be greedy when others are fearful. Stay away from leverage.

How has investing or the business environment changed over last fifty years?

- Game hasn't changed – "I do the same thing today as when I left Graham's course sixty years ago."
- To be a successful investor, you need a bedrock philosophy and a good temperament.
- You need to be able to simply write out why you are buying the business. i.e., "I am buying Microsoft because…"
- If you have 160 IQ sell thirty points because you won't need it in investing.

You once said that a reputation takes twenty years to build and five minutes to ruin

- Buffett's closest encounter with his reputation came in 1991 with Solomon when he accepted the temporary CEO position (against Munger's advice) after a trader had been found to illegally use customer accounts to purchase treasury bonds on behalf of Solomon.
- Buffett realized he couldn't get a grasp of all the facts and was terrified that he was getting involved with something that he couldn't control, but he took the job anyway.
- Buffett was there for nine months, four days and managed to control the situation.
- At first, Solomon executives were trying to treat it as a PR problem.
- Buffett: "This isn't a PR problem, it's a real problem" and fired the PR firm.
- The media is a huge factor in the business. You have to understand it yourself.
- At BRK, Buffett always worries that someone is doing something wrong.
- Strategy is to set a tone that minimizes those issues so that small mistakes don't multiply and eventually end up on Buffett's doorstep.

Views on Philanthropy?

- See givingpledge.org.
- "Have everything in life I want. Just makes sense to give."
- Five years ago I found people younger than I, who were good at giving away money and I left the job to them.

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Larry Robbins

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years later, I would only know how to trade options. So investment banking seemed to give a pretty broad foundation for whatever you wanted to do afterwards.

Gleacher & Company was a fantastic first place for me. There were five partners, some people in the middle, and ten analysts — therefore, very small deal teams. While the hours were long, you learned a lot in a short period. As a boutique, they only had a handful of clients. I worked with four or five companies consistently over a two-and-a-half year period and got to work on a variety of transactions. After that, I wanted to work on and learn about forty or fifty companies a year, not four or five. At 24 years old, I did not have a rolodex of clients to bring in so I could not be a senior person at Gleacher. But educationally, it had done such a good job of exposing me to a variety of transactions that I had reached a plateau. So between twenty-four and a rainmaker, there was not much to do other than manage people and process, which I had no interest in. So it was not out of the love or passion for investing, but really out of the desire to learn more and see different situations that I left. I also thought the stock market was great, because it doesn't know your age. You don't need a rolodex; you don't need to have contacts or connections. It is a level playing field where 25-year-olds compete with 55-year-olds, and whoever works the hardest and the smartest can do the best job.

So it was almost by accident that I went into the hedge fund and investment business, and I worked for almost six years for Leon Cooperman at Omega Advisors. They had a few people there that were in their late thirties through mid fifties, so they were looking for a second generation with five to eight years of buy-side experience. I had two and a half years of non-buy-side experience, but Lee was wonderful. He saw that I was a hardworking kid who wanted to learn and gave me an opportunity. Omega had a down year in 1994 so I was coming into a high-watermark situation. I was so young and inexperienced, that I did not realize how risky that was to walk into a high water mark situation. But nonetheless, I got a great education.

> ***"The stock market is great, because it doesn't know your age. You don't need a rolodex ... It is a level playing field where 25 year olds compete with 55 year olds, and whoever works the hardest and the smartest can do the best job."***

G&D: What do you think is your biggest advantage against other investment management professionals?

LR: I grew up in the Midwest as a student and a hockey player. Playing hockey, you quickly learn that it is a team sport where everybody is good and that you need to work hard, and you need to work hard throughout the whole game. You never know when that lucky break will be, so you always need to be working hard and paying attention. Consistency of effort often makes the difference between who wins and who loses. Clearly, you need to have a certain talent level to be on the team and in the game, but what differentiates people in hockey who win games and who don't is the consistency of effort. Our firm, Glenview Capital, is named after Glenview, Illinois, where I first started playing hockey when I was 5 years old. So as much as I learned from University of Pennsylvania, and the great lessons I got from Eric

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Larry Robbins

Pictured: Tom Russo and Jean-Marie Eveillard at the Graham and Dodd Breakfast in 2010.

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Gleacher & Leon Cooperman, a lot of the lessons that I learned growing up as a kid in the Midwest were just as important for me going forward.

So what differentiates us vs. others? I don't think that I have met someone who is very good in the investment business who isn't hard-working, bright, talented, and focused. I am not necessarily competing with them, as much as just trying to compete to be the best that I can be and Glenview can be the best investment firm it can be. We know that the key is to realize that on January 1, when the sheet reads zero point zero, we have to remember that it's not about what you did before, but about that persistence and continuity of work effort. So I believe that remembering that and always having that focus is what differentiates us.

G&D: You have a reputation for creating clever analogies—how would you describe the state of the U.S. equity market today?

LR: We had two principal analogies that we used for 2010 that I think are still applicable for 2011. The economy was like bowling with gutter guards. In the late '90s, which was the most wonderful time for the market in the last hundred years and probably will be for the next hundred years, the ball just rolled down the middle of the lane and never deviated. It was 4% economic growth with very low inflation. There was a small scare in the emerging markets in the third quarter of 1998, but if you actually just stared at the U.S. economic statistics, there was little deviation. So you had almost no volatility in the economy, combined with gridlock in Washington and

"Consistency of effort often makes the difference between who wins and who loses … We know that the key is to realize that on January 1st, when the sheet reads zero point zero, we have to remember that it's not about what you did before, but about that persistence and continuity of work effort."

low valuations as starting points, so it was like a ball rolling down the middle, hitting the head square-on and everyone getting a good score at the end of the those five years. In the last ten years, it seems like there have been a couple of gutter balls, where things have just gone way off to one side or another.

Given where the macroeconomic picture is today, that ball is not rolling down the center. It is bouncing off at both gutters, so the Fed has an interest in preventing that. It has never really been tested, the way it has been recently on the deflation and recession side. Usually, from a period of normal interest rates, the Fed has the option to reduce those interest rates in a way to stimulate spending, reduce funding costs, add liquidity to the system and ultimately pull out of a recession. The fact was that we already started with low interest rates and then went into economic decline meant the Fed had to go beyond and create additional tools, quantitative easing, QE2, etc. The market wasn't sure just how committed the Fed and central banks of the world were to maintain that left gutter guard, to keep us out of the recessionary, double-dip, deflationary gutter. But we have had fiscal stimulus, monetary stimulus, intervention in the markets by purchase of government securities, propping of private enterprises by the government. These tools that the Fed has used, which are extraordi-

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nary in the context of history, have been, in total, effective at keeping the ball out of the left gutter.

So the economy is again growing at a somewhat of a normal rate. But twice in 2010 we bounced off that left gutter. In May of 2010, when the European sovereign crisis took forefront, and the European economies slowed down significantly and the U.S. economy started to slow down. However, central banks around the world, as well as the IMF and others, decided to fortify that left gutter. Germany backed Greece and the other troubled European economies, so the ball moved toward the center. We again saw the ball drift left in August through October 2010, which obviously led to QE2. This was when the economic data started coming in somewhat squashy after we got through the post recessionary bounce from inventory channel fill. So we saw $600 billion of additional purchases of government securities. That signaled that even though the Fed had a $2 trillion balance sheet, it is willing to get it up to $2.6-3.0 trillion and hold the line.

G&D: What do you define the right gutter to be?

LR: On the right side, the right gutter is inflation or hyperinflation. And we think that gutter is easier to hold, because from a zero-interest-rate policy, it will be easy to tighten things and slow it down. It is not really easy to do that without bouncing us right back to the left gutter again. That is going to be the trick. So the first analogy we would make is that if the late '90s were about just bowling right down the middle, now this is bowling with gutter guards, but we think that the Fed has enough resources at its disposal to address these issues, just like in 2010 when the ball bounced a couple of times to the left, but it hit the pin. It was as normal of an equity market as anybody has seen in the last ten years. The equities basically did treasuries plus eight-hundred basis points of return. That is close to what the textbooks say equity markets are supposed to return overtime. So it was the most normal year, but it didn't feel that way because we were bouncing from one crisis to the next. Coming in to 2011, it feels the same way, except it feels we are first going to bounce off the right gutter, where people are worried about inflationary pressures, particularly in food, energy, other raw materials, but not labor or shelter in the United States. And then from there, the question is do we just bounce off and come back to normal, or do we bounce off that and go right back to the left gutter, and then if so, is there a QE3, etc.

> ***"The first analogy we would make is that if the late 90s were about just bowling right down the middle, now this is bowling with gutter guards."***

G&D: And the second analogy?

LR: The second analogy refers to the investing stool. There are really four legs to the stool, and those legs make it pretty solid. The four legs coming into 2010 were the dual engines of economy and liquidity that were both constructive. The principal basis upon which we invest is not based on any one particular economic forecast, but the question for us is, can the economy grow fast or can the economy grow at all? I think those conditions are such that the economy is growing, albeit at a modest pace. Liquidity is quite ample. In fact, you could even make the case that liquidity is excessive. So those two legs of the stool still hold. The third and fourth legs of the stool are low valuations and high excess cash balanc-

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Columbia Business School is a leading resource for investment management professionals and the only Ivy League business school in New York City. The School, where value investing originated, is consistently ranked among the top programs for finance in the world.

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es at U.S. corporations. U.S. corporations came into 2010 with $1.4 trillion in cash, the highest level of cash held in the U.S. ever by non-financial public corporations, so it is not just world banks holding excess levels of cash to ensure liquidity. Despite the fact that we saw increased buybacks and M&A activity, they still ended the year with $1.5 trillion in cash.

This is a high-class problem but it is nonetheless a problem, with $1.5 trillion earning precisely zero. It is a lazy asset. It is the equivalent of having a baseball team with Albert Pujols on your bench. Well, having Albert Pujols on your bench makes everybody feel good, but if you go through the entire season and you never take him off the bench, it is the biggest wasted asset ever. Companies were initially sitting with all the cash, feeling good, thinking that no matter what happened, they could pull Albert Pujols off the bench, they had that excess cash. Even if their bank failed, they would be ok. Now, we are getting to a point where in 2011, people are feeling stupid about wasting the asset and are starting to think about deploying it. That is very constructive if you own an undervalued equity, because either somebody else will buy that company, the company will buy back its securities at a discount, or the company will do something intelligent by buying another company in a disciplined manner. Going from 0% return on that equity to something like a 10-12% on that equity should be pretty doable.

So those analogies that were present in 2010 are still present in 2011. We think those four legs are still there. Not only is that analogy helpful as a framework for communicating with investors, it is also helpful with the risk-management process. The economy and liquidity legs of the stool are subject to change and can get out of control. So we monitor those things and to the extent that we feel that those economic and liquidity conditions are changing from what we think are generally solid and constructive, start to take legs off the stool. One leg falling would not make the stool fall down. Two legs falling and all of a sudden we need to change our portfolio. So this analogy not only helps in terms of constructing our outlook, but also in managing the risk in our portfolio and giving us a heads up as to when to take action on risk management.

"U.S. corporations came into 2010 with $1.4 trillion in cash … Companies were initially sitting with all the cash, feeling good, thinking that no matter what happened, they could pull Albert Pojols off the bench..."

G&D: How do you describe your fund's investment process and how do you go about generating ideas?

LR: Basically, we are in the recycling business. There are very few businesses that are public companies today that we haven't looked at, and even if there are IPOs, we often have seen these companies in the past. Nielsen Media is becoming a public company next week. I owned Nielsen Media before it was called Nielsen Media, when I was working for Leon Cooperman. It was then part of Dun & Bradstreet, then it was part of Cognizant, and then it was spun off. So it is funny that our services team presents this great new IPO, Nielson Media, and I am dusting off a memo from 1998. Even though there are 7,000 public companies

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in the U.S., when you narrow your search to companies with market cap sizes and type of businesses that make sense to us, we are really dealing with maybe a 1,000 or 1,500 truly investable companies that fit our definition of a good business. We define a good business as a business with high recurring revenue stream, defensible, cash generative, etc. Truth be told, we have looked at a lot of them. So idea-generation is more about idea revisiting today, than it was when we started our fund. Ideas can either come from the team, bottom up, or from me, top down, or any combination therein, but because of the fact that we know those players, we are often reacting to stock price dislocations. Xerox happens to be a top-ten position. We have followed the company for a long time. They announced an acquisition of Affiliated Computer Services a year a half ago, and the market hated it and the stock went down 17%, and therefore, that one event caused us to drop everything we were doing and do the analysis on Xerox.

So you can get some exogenous event where the security price movement then causes the change in management. Or a regulatory change, such as in healthcare recently, can bring something to our attention. There has been a lot of noise about defense spending, changes in the for-profit education field. Big changes in raw materials costs, environmental concerns would be consequential for conversion businesses like packaging. So observation of those conditions is another way in which idea-generation starts. Every six months, we have a "what grows" session in which we take a giant step back and say, "We're not venture capitalists, we're not smart enough to figure out who's the next Facebook or the next Groupon, but where's the growth going to come from over the next three, five, ten years secularly, and how can we position ourselves to take advantage." We identified healthcare, for example in 2004, and it was really a 2006-2008 phenomenon. There's also an echo effect, where we predict from 2012 to 2018 there will be a second-wave generic cycle. Sometimes it's thematic, sometimes it's stock-specific, and sometimes we'll go to a conference and we'll see a presentation of a company which looks like it knows what it's doing. We then do intense research.

"Every six months we have a "what grows" session in which we take a giant step back and say, "we're not venture capitalists, we're not smart enough to figure out who's the next Facebook or the next Groupon, but where's the growth going to come from over the next 3, 5, 10 years secularly, and how can we position ourselves to take advantage."

Pictured: Glenn Greenberg at the Security Analysis 75th Anniversary Symposium (Fall 2009), with Bruce Berkowitz (left) and Tom Russo (right).

G&D: What does "intense research" mean for your firm?

LR: We do everything that you would expect a good research firm to do. We're team-oriented. We have seven different groups, six sector-specific and one functional. Those groups work as a team, with senior and junior people. A full investment plan will be generated and then there will be an investment committee that meets on it. We generally turn that two or three times, back and forth

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with questions. Of course, we will have several meetings with management. We have a group of proprietary research analysts that will help us talk to industry experts to find out not only trends but to discover technical issues. Is WiMAX slower or faster than LTE, and how much of an advantage or disadvantage is there? We don't just call up sell-side research firms covering those companies, nor simply talk to the Chief Executive Officers. We need to be talking to radio engineers and wireless engineers to find out all the differences between those two systems and try to understand them better. That combination of analysis helps us understand those complex issues a little bit better. What we're trying to do is complete a jigsaw puzzle, and we're collecting more and more pieces. If I asked you to solve a Wheel of Fortune problem but only gave you two letters, you would have a hard time coming up with the answer. What we're trying to do is uncover as many letters as possible and put together the mosaic.

G&D: Could you talk us through a particular stock or industry you like?

LR: Let's talk about Heath Maintenance Organizations. We've owned HMOs on and off in the past. They were about 20% of our fund by the second quarter of '09 and then were reduced to as low as 2%. Today, they're approximately 9% of our fund. We own three: Cigna, Aetna, and WellPoint. What do we look for? We look for businesses that have a good medium- and long-term growth outlook and are cheap relative to the cash flows that they are currently generating. In general, we're looking for low-teens or better growth. HMOs have been vilified by the press and by constituents in Washington and their business practices have come under intense scrutiny. If you look at the overall healthcare landscape, coming into 2008 the average healthcare traded at a 110% relative multiple, and coming into 2010 they traded at a 70% relative multiple. The market multiple went from 18x or 19x to 13x or 14x, and healthcare went from 10% to the right of that to 30% to the left.

> ***"What we're trying to do is complete a jigsaw puzzle, and we're collecting more and more pieces."***

So, healthcare multiples got crushed. Why? People were uncertain about what healthcare reform meant, and therefore the multiples of the stocks were hurt. Despite the uncertainty, healthcare stocks did what they are supposed to do: grow regardless of the economic environment. Lots of stocks went down, but the company earnings went up and that therefore created the double-whammy for valuation. Today, Cigna trades at 8x earnings, Aetna and WellPoint at 9x, so these stocks are exceedingly cheap.

There were three elements of healthcare reform that really affected HMOs. The first is that there is a profitability cap called "medical loss ratio" or "MLR" minimums that regulates the maximum gross margin that the industry is allowed to have. Any industry which has regulated profits is worth less than one without. The second thing is that there are new industry taxes, some of which may be passed onto the customers, but for the most part, it will hurt the companies. The third thing out of healthcare reform is that there are 37 million people who are now uninsured and who will be entering the market in 2014. The HMOs will get their fair share of these customers in 2014, which can only be positive for these companies. Margins may not be as great for

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the companies as now, but nobody is arguing that this will make the economics worse. There is some concern that some existing customers in the high profit-margin bracket might slip into the lower bracket. When we do the math, we find that in spite of that mix-shift, profits should still improve in 2014.

So when you think about the profits of HMOs, you think about it as headwind offset by some tailwind. You should have earnings declining in 2011 and then two normal years of growth in 2012 and 2013, and an elbow upwards in 2014. So if you ignore the left side of the graph, and start with 2011, you start to think to yourself that with the accelerating tailwind in 2013 and 2014, that this is a pretty good investment. It's probably going to move faster than the overall market. Where's the market trading? 14x. Where are these guys trading? 9x! Not to over-think it, but there are only two things that matter in investing. What are they going to earn, and what multiple are people going to put on that. Let's not make our business any more complicated than this.

The headwinds from healthcare reform are going to be fully reflected, there are going to be many different cycles, but we should be back to the general trend of HMOs, which is a low single-digit population and membership growth. The price in general is proportional to the cost trend, so if the cost trend is up 7.5%, prices will also go up by about 7.5%. Therefore, if you have 1.5% membership and 7.5% price growth, you have 9% topline growth and 9% COGS growth. Therefore, you have 9% gross profit growth, and you shouldn't have to grow your administrative costs by 9%, and therefore that should lever up to 12% EBIT growth. You have productive use of free cash flows because nearly all HMO earnings require no additional capital invested, and therefore, you should be able to get to a 15% earnings growth trajectory on a constant balance sheet. We know that the EBIT growth can't get too high because of these MLR caps, such that if costs go up only 6%, you can't price it up 10% because that's above the allowable amount. It would literally have to be refunded under the new health plan.

G&D: Does it concern you that healthcare spending is approximately 16% of the U.S. GDP, and that at some point in the future there may be political pressure to restrain these expenditures?

LR: In the first half of 2009, nearly every business was in contraction. Yet, pharmaceutical consumption went up 3% in the first half of 2009 in the U.S.. Why? Because there's no choice. It's based on demographics and it's not a nice-to-have, it's a need-to-have. Healthcare spending will undoubtedly continue to rise. If you're a sick person, you don't think about your spending in terms of percentage of GDP. You think about it as what is necessary to do.

Unfortunately, the healthcare reform debate got a little bit confused because there were two dueling objectives. First, as a moral concept, should the United States offer healthcare coverage to all? Second, should we bend down the cost curve, and if so, how should we do it? There was a lot of political rhetoric on both sides, but I think people confused one with the other. If one wants to reduce the cost curve, the best way to do that is to introduce competition throughout the system such that there is price transparency and proper economic incentive to deliver either better quality at the same price, or the same quality at a lower price.

The reason we like PBMs (Pharmaceutical Benefit Managers) is because they actually do that within the pharmaceutical space. In the 90s, there was on average between 8% and 14% drug price inflation every year. If you look at drug price inflation in the last decade, it's been about 2%. The reasons are generic

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> *"There are only two things that matter in investing. What are they going to earn, and what multiple are people going to put on that. Let's not make our business any more complicated than this."*

Larry Robbins

Professor Bruce Greenwald at the 2009 G&D Breakfast

Bruce C. N. Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Described by the New York Times as "a guru to Wall Street's gurus," Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.

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drugs and the presence of for-profit companies who have been contracted by payers in order to create competition. I know that Lipitor is not exactly the same as Zocor, but in 80% of cases they're equally effective, so I'm not going to pay a monopoly price to Merck. Whoever gives the lower price, between Pfizer and Merck, is going to get the bulk orders through Medco, Express, or CVS. They created price competition by somewhat commoditizing these specialized drugs. As a result, they eliminated the cost inflation to the point where inflation basically doesn't exist in the pharmaceutical field.

Yet, if someone goes and gets an artificial knee, the person paying doesn't determine what brand they get. In fact, those companies have 80% gross margin and 50% operating margins. One might say that's because they're highly engineered components, but so are the automobile parts that we trust our lives and our kids' lives with and those too have become commodities. I believe that there will have to be a serious effort to bend the cost curve down, but you need to create for-profit incentives for for-profit companies to create competitive environments to drive down prices or drive up quality of outcomes. The best way to get people to do it is to pay them to do it. That has worked with PBMs, but I think you're going to see that with other aspects. While the HMOs have been vilified in the press and Washington for being the bad guys, let's still remember what an HMO does. It buys health goods in bulk to deliver lower prices to customers. HMOs are not necessarily the villain here; if you take HMO profits away in the last ten years, it's a blip. The increase in healthcare spending over the decade is $1 trillion and HMO profits are only $9 billion. That's not the issue. The issue is how to empower HMOs to drive down the cost by creating competition.

"One of our largest holdings is McKesson. We like businesses that are simple to understand and simple to discuss."

G&D: Given their connection to the HMOs, do you favor any drug companies?

LR: One of our largest holdings is McKesson. We like businesses that are simple to understand and simple to discuss. McKesson is a drug distributor. It distributes drugs between point A and point B. There are three large players in the United States, McKesson, Amerisource-Bergen and Cardinal Health, and they have over 92% of the market share. So we know that next year people are going to need to swallow pills and that people are going to need somebody to distribute them. In general, it is a rational and competitive environment, with all of them having long term contracts with clients. There are reasons why there is an incumbent advantage, because you don't want to change suppliers unless you have to. So normally, pharmaceutical services are a good business, because there is population growth, growth in pills per head and there is innovation.

In 2004-2005, they moved from an inventory inflation model, where they would buy a lot of inventory in advance of price increases and then sell it at the higher price, pocketing the difference, to a fee-for-service model, whereby they get paid essentially cents per pill. As a result, they did not have to carry high working capital and high inventory, so the industry

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Bill Ackman and David Einhorn at the G&D Breakfast, 2010.

Columbia students have the privilege to hear from experienced practitioners in value investing, who frequently give guest lectures at the school.

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became much more capital-efficient. There are a couple of tailwinds that make this good business a much better business for the next three to five years. If you distribute Pfizer's Lipitor, which is patent-protected, you have to pay whatever price Pfizer will charge. But if you distribute generic Zocor, and there are twenty companies that make it, and McKesson buys in bulk, all those companies compete to give it the best price possible. So all of a sudden, McKesson becomes Walmart, where they are the largest purchaser in the industry and therefore they get to buy things at a discount. Even though the price of the generic pill is lower, the cents of profit per pill for distributing a generic pill ends up being higher. So as more pills go generic, McKesson's gross margins and profit margins go up.

The other tailwind is that there are 37 million Americans that are going to go on health plans in 2014. Right now, they get triage care. If they have an emergency, they will be stabilized, but there are no annual or wellness visits for these people and they don't get a prescription. All those people in 2014 will now have access to health plans, which will result in incremental prescription volume. When you own the highway, and 10% more cars go through, you will collect 10% more tolls.

G&D: What other characteristics do you like about McKesson?

LR: 20% of McKesson's business is in healthcare information technology (HCIT). That business was depressed in 2009 because of the weak spending environment. Companies and hospitals were nervous, so there was limited spending on these systems. In 2010, there were significant investments that needed to be made in order to prepare for the electronic medical record and prescription rules that came into effect and became mandated under the healthcare plan. We think that in 2011 and beyond, we will see a resumption of normal growth in that business, and the HCIT should grow north of 15% EBIT. So as a result of these tailwinds, the two engines of the company, the 80% distribution business, and the 20% HCIT, are both growing at or above a normal rate. The third reason we like McKesson is that it is grossly overcapitalized, or at least was grossly overcapitalized. They had $1.5 billion of net cash on a business that could easily be levered a couple of times debt-to-EBITDA. So coming into last year, we believed they had $700-800 million of dry powder that was earning nothing and could be earning 10-12%, where the accretion math could be quite powerful. They deployed about half of it last year. They did $1 billion of stock repurchases and authorized $1.5 billion more. They spent a couple of billion dollars buying U.S. Oncology. So they deployed about half of the bucket, but of course the bucket replenishes every year as they generate free cash flow. We believe their cash bucket going forward is $4.5-5 billion dollars.

So you have accelerating growth with a reasonably low valuation. Based on our numbers, it is still trading at only 10.5x 2012 calendar year earnings because 2012 is a big earnings year for them. So you not only have a company that is trading at less than 11x one-year forward-earnings, but you also have an overcapitalized balance sheet, where they can continue to use those earnings productively and we have certainly not fully deployed the balance sheet within our earnings estimate. As a result, we are highly confident on the growth case. And we think that no matter what happens to the world, it is unlikely that McKesson will be trading at less than 10.5x earnings a year from now.

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G&D: Is there anything you wish you knew earlier in your career?

LR: Starting out in the hedge fund business, I spent ten times the amount of time evaluating an investment than I did interviewing a person. Yet that person will impact ten, twenty, or thirty stocks in your portfolio, so you should do much more diligence on that person than you do on any individual investment. I used to be a very casual evaluator of people. Being a Midwest, optimistic, wide-eyed kid, I would look at somebody and see the potential and believe in the best. I was not a skeptic. As one builds a people business, one needs to have a balanced approached. One still needs to be optimistic about people, but also need to be realistic that just because somebody seems to have a good connection with you, it is worth spending the time to find and pick the right people. So I wish I knew that earlier.

Also, consistent a little bit with the Midwest naiveté, in my second year of business, the markets were shocked by the revelation that three of the fifty largest companies in the United States, Worldcom, Enron, and Tyco, lied about their financial statements. We were long one of these, Tyco, and while we had chased down every accounting rumor alleged about the company, we could not conceive that management would be accused of effectively embezzling company money by using restructuring charges to fund personal expenses like apartment relocation and renovation. It was inconceivable to me that you could have fraud on such a massive scale. Six years later, it was inconceivable that Bernie Madoff could have a multiple-billion-dollar fund that was a ponzi scheme, that you could have fraud on such a massive scale. When I say inconceivable, I mean that if somebody had told me those stories, I would say that they were so far-fetched, that there would be so many checks and balances, that there would be no way that those things could happen. So I think I have a little bit better appreciation today, and I wish I had then, to not only expect the unexpected, but just how bizarre and severe the unexpected could be.

"Starting out in the hedge fund business, I spent ten times the amount of time evaluating an investment that I did interviewing a person. And yet, a giant step back, that person will impact ten, twenty, thirty stocks in your portfolio, so you should do much more diligence on that person than you do on any individual investment."

We learned that lesson by being caught short Volkswagen in a short squeeze where we had twice as many shares borrowed as we were short. We had borrowed them under lock for a term that was between three and six months, depending on which shares we had. So even though we had recognized the potential for a short squeeze, we had thought that we had taken care of that. Yet when the stock quadrupled, prime brokers increased by twelve-fold their margin requirements, and we had to put forty-eight times the margin that we had forty-eight hours ago. This meant that no matter how many shares you had borrowed, you did not have continuity of ownership. So things like these cause you to think expansively about just how many 1% tail risks are out there, and to be humble about just how many of those things you can control, to make

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sure that you balance and survive. Those are the first three that come to my mind, but frankly we could spend all day on this topic.

G&D: What are some of the best ways that MBA students can prepare to become better investors in the long term?

LR: One of the difficult things about being a good fundamental investor is that you want to start out with all of the information, but then you want to synthesize it down to just the important factors. It is always a struggle to not be myopic – you want to make sure that you constantly think about and react to new information. But you do not want to be chasing your tail. You want to be focused on the truly important things. To a certain extent, you need to trade against the market and not overreact to every little thing that can change. You really can prove to yourself whether you know something or not if you can give a five-minute elevator pitch. If you cannot summarize a complex situation in a three-to-five minute discussion, you do not really understand it.

Sometimes we catch ourselves mumbling or meandering—that is a good indication that we should not have such a big position. You need to go back and rethink those things that you are uncertain about. We publish these fifteen-page quarterly letters because it forces us to write down and communicate in a clear fashion what we think and why we think it.

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There are a lot of crumpled-up pieces of paper that end up next to the garbage can when we do that. Yet, a lot of times they are a reminder that there are a couple of questions that we still have about an investment that we really should be addressing. It also helps because by synthesizing it, you sometimes realize just how good the investment that you have is. In those cases, you should add to your position. For example, if you can lay out the bear-case and explain why it is wrong, that should enhance your conviction.

Going through this process makes you a better communicator as well. When you join an investment management firm, you need to be able to concisely communicate all of the various complexities of the investment case. We could talk about it for two days, but here are the six things that matter. Boom, boom, boom—here is the catalyst, here is the valuation, here is the bear-case and why we can defeat it. The easier you can do that, the more valuable you will be to whatever organization you join.

There are some brilliant people who are not great communicators, which suggests two things. One, even if they get it right, they will have a hard time getting their idea represented in the portfolio which is bad for investors, bad for the person they are working for, and bad for themselves. Two, if they cannot organize their thoughts verbally and succinctly, then maybe their thoughts are not organized between their ears.

G&D: A lot of our readers are MBA students or recent grads committed to a value

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investing approach, but there aren't a lot of disciplined value-investing firms. What advice do you have for someone who can't find the ideal organization for their first job?

LR: With no disrespect to your school or mine, it probably mattered less about which school we chose and more about what we did when we got there. Whether someone goes to Columbia, Penn, Harvard, Chicago, or wherever, is not the most important factor. If you go to a good school, you will get out of it what you put into it. There is so much to learn at a variety of different investment organizations that it is not about picking the exact right one—it is more important to get your foot in the door and get your head in the game. Working with Leon Cooperman was a great educational opportunity to learn by observation. He did not sit me down and teach me lessons every day, but I had an opportunity to observe the way he would interview management and how he would manage his team and investments.

I also had an opportunity to network with other firms and talk to management teams. If you truly are a sponge, you can learn a lot in many different environments. Do not overvalue the perfect job opportunity. Take the one that is in front of you and run with it. Most good money managers I know skipped their 20s or early 30s. I certainly didn't have anywhere near the best social life, but it was a great opportunity because stocks do not understand your age. If you are willing to invest your time and energy, you can learn a lot just by being around. Regardless of the type of firm you are at, you still get to attend conferences and network with others. If you are good at observing, you can then pick the best pieces from other people and other firms.

G&D: Value investors are well known to be early on a lot of investments, whether it's buying an asset or selling an asset—how do you take that into consideration when you are constructing the portfolio?

LR: We know that we are habitually early. We try not to be, but we still are. We started a debt-only fund in the third quarter of 2007. There were almost no opportunities in corporate fixed income on the long side in the preceding eighteen to twenty-four months. But, given the fact that mortgage prices caused capital calls at certain places, they started selling-off higher-quality paper at significant discounts. We began to accumulate distressed debt in late 2007 and early 2008. Not too long after, out returns were wonderful (15% annual returns, net of fees, over a twenty-four to twenty-eight month period). Of course, corporate credit fell off in the third and fourth quarter of 2008, so it was not a smooth 15% return and the timing could have been better.

We are habitually early like most value investors are. Assets can trade wherever the market wants them to, and with many impatient investors, that is part of the reason that the opportunities are there. We are all trying to learn how to time our investments better. But we would much rather suffer a bit of a drawdown than not take advantage of an opportunity. We will not stand there with the bat on our shoulder, even if we know that there is an occasional time when we may swing too early.

G&D: Any final advice for our readers?

LR: You should be a voracious reader and sponge of information from other investors. With all the ideas out there, you do not have to agree with them or adopt them, but you should consider them. If you really want to be a good investor, you cannot just be involved, you have to be committed. It really is not just a job, it is a passion.

G&D: Thank you Mr. Robbins.

"You should be a voracious reader and sponge of information from other investors … If you really want to be a good investor, you cannot just be involved, you have to be committed. It really is not just a job, it is a passion."

Robert Robotti

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John Spears were young analysts and Walter Schloss and Eddie Schloss sat in the offices searching through annual reports. The firm was originally called Tweedy, Browne and Reilly. Joe Reilly was a retired partner, but would come in every day, and I'd sit in the office with him and chat about investing. His insight and encouragement were invaluable. Shortly thereafter, I left that accounting firm and was hired by one of their other clients, Mario Gabelli (MBA '67). I worked directly for Mario as his CFO for three years when he was only a twelve-person firm. Although I had no role in stock picking, I knew everything about what stocks Mario liked, why he liked them, and what he was buying for clients. I became totally enamored with value investing. No one could ask for a better education in value investing. Of course, both Tweedy and Gabelli's original core were small-cap value, and I decided I wanted to emulate these greats.

G&D: What pushed you to take the initiative and start your own firm?

BR: I went to Pace for my MBA. I didn't go to Columbia, so nobody was going to hire me. The only person foolish enough to hire me to pick stocks was me, so I had to strike out on my own.

In addition, Gabelli sure didn't need me to help him pick stocks. He has a phenomenal mind and is a phenomenal investor.

G&D: What was the most difficult aspect of starting a firm?

"… our primary separate accounts composite has compounded annually at 13.02% net of fees over the last decade versus 6.33% for the Russell 2000 and 1.41% for the S&P 500. This is fairly representative of our performance over time."

BR: It's a unique thing that people can do in this business. From 1983 to 1991, the firm didn't have enough critical mass to grow. The business just broke even, mainly due to a modest payroll. Our investments did well, but the firm wasn't profitable. I was already married, but I didn't have children or a mortgage or any of those significant financial obligations for the first eight years until the firm gained critical mass and started to grow. That personal financial staying power is a luxury that a lot of people don't have.

G&D: What do you think is the biggest advantage that has allowed your firm to grow, especially over the last twenty years?

BR: I think it is as simple as providing good returns for our clients. It sure has not been due to any marketing prowess on our part. For example, our primary separate accounts composite has compounded annually at 13.02% net of fees over the last decade versus 6.33% for the Russell 2000 and 1.41% for the S&P 500. This is fairly representative of our performance over time. On an absolute basis, we have not experienced a down five-year period and on a relative basis we have outperformed both indices in most periods. Our returns are driven by our ability to identify mispriced securities and have the conviction to invest based on our research. We accumulate securities that are mispriced by the market. It sounds simple, but at the same time it is frequently quite difficult. If you follow this type of process, it is important to act

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independently based only on the conclusion of your work. You can be wrong sometimes, but you must rely on your own work and your own judgment.

We are also extremely fortunate to have the right clients. They are patient investors that are willing to stick with us even through the trying times, which are inevitable if you are an investor. It is not so much the quantity, but the quality of the clients that enables a manager to maintain the long-term view that is so vital for successful investing.

G&D: Have you found it any more difficult as your capital has increased?

BR: No. We still manage a modest amount of capital. In aggregate, it is just over $500 million.

G&D: Do you look to grow your assets further?

BR: Growing the firm is really as much an obligation to the people who work here as it is to me. My lifestyle isn't really going to change if our assets under management continue to grow. I like what I do, so I'm going to continue to do it. However, there are people who are coming to work here like David Kessler who graduated from the Columbia Value Investing Program in 2008. They are looking to work in a place where they can grow over time and that will provide them with opportunities. It's an obligation to my team to make sure that the firm continues to grow so there's economics for them to continue to work here, and there's a future for them.

G&D: Can you talk about how your accounting roots have helped you as an investor?

"It is not so much the quantity, but the quality of the clients that enables a manager to maintain the long-term view that is so vital for successful investing."

BR: We tend to invest in smaller-cap companies where the accounting is going to be a lot less complicated. General Electric is a company I've thought about a lot over time. I wouldn't want to be the auditor of GE because whatever numbers GE wants to put out, they can put out. You can spend 365 days a year with a big accounting team, and you still won't be able to understand all the numbers that GE wants to put together. With smaller companies, the auditors have a much easier time auditing the numbers, so the reliability can be greater. Additionally, understanding accounting and financial statement construction helps an investor gain an even deeper understanding of the business itself. It enables you to ask the right questions and have the right concerns. I think my knowledge of accounting is an extremely important part of the success I have had as an investor. An accounting background has also given me an increased understanding of whether or not the numbers on a company's financial statement truly reflect the economic reality.

G&D: The focus of your investing has been to find undervalued, out-of-favor, micro-small-, and mid-cap value stocks. How would you describe your strategy?

BR: Our strategy is to find securities, that when looked at with a long-term horizon, are significantly mispriced by

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the market. We tend to find these opportunities in companies that are misunderstood or out-of-favor. The 'out-of-favor' category frequently means companies in operating or financial distress. Of course, this strategy comes with its own risks. Like many value investors, we are sometimes 'too early'. Over the years though, some of our most successful investments were the result of finding undervalued companies and accumulating a position, only to see them get cheaper—occasionally a whole lot cheaper. That happens more frequently than I would prefer, but we invest in a company when we believe its share price has become attractive relative to its valuation. We accept that the stock may continue to trade lower. This can happen for a multitude of reasons. Sometimes fundamentals deteriorate, in which case we need to reassess our view of the business value. At other times, the markets overreact, providing a dramatic investment opportunity.

G&D: Do you have any examples?

BR: One business that we think meets those parameters today is Builders FirstSource (BLDR). It is a supplier/distributor to the homebuilding industry. As you might imagine, the company has been losing money consistently since 2007. In 2005-2006 it generated $2.3 billion in revenue; last year sales fell below $700 million. It has lost money over the last couple of years, but that's been mitigated somewhat because working capital has come down dramatically, since they need to hold a whole lot less inventory as they sell to homebuilders. In addition, they received a sizeable tax refund last year which was the result of being able to carry back losses for five years.

G&D: How about valuation?

BR: The stock trades at about $2.00 per share and there are 96 million shares outstanding. It's got $100 million in cash, and $160 million in debt, so plenty of cash on the balance sheet. That being said, they burned through another $35 million in cash over the past twelve months, net of a tax refund, which is concerning. Still, I think the company as it exists today can generate $1.5 - $2.3 billion in revenues, when you build 1 million to 1.5 million homes in America. In that case it can generate $100 - 200 million in EBITDA compared to an enterprise value today of roughly $250 million.

Of course we don't know when homebuilding is going to go back to 1 million to 1.5 million homes, but at some point it will do that on a normalized basis. In the meantime, there is enough cash to get the company through these tough times. In addition, the long-term trend in the industry is for continued consolidation. Builders FirstSource has grown through acquisition, and the industry is still very fragmented, which shows that when things eventually stabilize, they have the ability to go out and make more acquisitions to augment the cyclical rebound we would anticipate in this business. As I mentioned, with its current footprint, the business can probably generate $2.3 billion in revenues, when homebuilding gets back to 1.5 million new homes, but the footprint is probably going to become larger. We think that the earnings potential of the business should imply a stock price that is significantly higher than it is today.

G&D: Do you think that a company in this situation should be making acquisitions with its excess cash flow?

BR: It's difficult to execute an acquisition strategy today. This is a very regional business and there can be multiple competitors in each region. If a certain region has only a few competitors, then they are probably operating at just over breakeven. In these markets it might make sense. But if there are multiple competitors in the same regional market, then they are all probably losing money. In this environment, it would

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be difficult to create enough synergies through acquisition to turn operations profitable. You can't just take two players in a region that are losing money and combine them to make a profitable business.

Instead, management should try to winnow down the business to lose as little money as possible, while exiting as few markets as possible, because once you leave a market it is very difficult to get back in. It's a difficult process, and that's why they're still burning cash today. A year ago, Builders could have decided to exit certain regions. They wouldn't have lost as much money, but they would be permanently out of those markets. At the end of the day, we have to believe that management will make some adjustments to continue to minimize cash losses so that the cash they have available will give them the ability to weather the storm.

G&D: Who does Builders FirstSource compete against? Is it Lowe's and Home Depot, or is it the wholesaler?

BR: Builders sells directly to homebuilders themselves, not to the do-it-yourselfers, home remodelers, or small contractors that Lowe's and Home Depot focus on. There is one national firm, ProBuild, which is much larger than Builders and at least three other super-regional firms including BMC Select, Stock Building Supply, and Lumber 84. There are also many small regional competitors. None of these competitors are public companies. Two of the super regional competitors, BMC Select and Stock Building Supply, went through bankruptcy reorganizations in 2009. Stock Building Supply was a wholly-owned subsidiary of Wolseley, the British company. Gores Capital helped to recapitalize the company in 2009 and now controls it. ProBuild is a private company controlled by the Johnson Family of Fidelity.

"We think that Builders FirstSource performs a very important service to the homebuilder for which they will be profitably paid in a normal homebuilding environment."

Longer-term, the larger players will continue to grow their share as the larger homebuilders have become an even bigger percentage of overall homebuilding. To a certain extent, the national builders will prefer suppliers who can handle their business on a national level. Larger distributors also have volume-buying advantages. Even if this is all passed on to their customers, which is the case in today's competitive landscape, it will still make them more attractive to do business with as they will be able to sell at lower costs. In better times, these larger distributors will have opportunities to keep some of these volume pricing advantages as incremental margin.

Another valuable service these suppliers provide to homebuilders is component assemblies, such as roof trusses, floor trusses, wall panels, etc. Homebuilders continue to outsource component assembly as there are clear advantages over doing it themselves. We think that Builders FirstSource performs a very important service to the homebuilder for which they will be profitably paid in a normal homebuilding environment. It's just that the entire industry has been decimated over the last few years, and no one knows exactly when it will recover.

G&D: Are you concerned with timing and catalysts? Is that part of your process?

BR: In many situations, including turnarounds such as these, the timing is inevita-

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bly a significant unknown. However, I think we can all agree that when a catalyst manifests itself, that uncertainty dissipates, which will lead to a repricing of the security. For example, a pickup in homebuilding will undoubtedly lead to a repricing of Builders shares. However, we don't require that a catalyst be known before we begin investing as long as we believe that the conditions are right for stabilization, that the financial condition of the company provides it with staying power, and that the valuation is extremely discounted.

I have always believed that the existence of a catalyst creates its own risks. Unless you are the first one to identify the catalyst, you are probably paying some premium for the probability that catalyst will occur. You are paying a reduced discount. As with most situations, there are tradeoffs. If a catalyst doesn't work out, you pay the price for that. That means there's additional risk in the stock price.

G&D: You have been successful with investing in special situations. Are there any situations that attract you in general?

BR: Our strategy is to buy undervalued securities that are mispriced by the market. So, we are generally attracted to the classic special situations like significant share repurchases, spin-offs, and rights offerings. We are particularly fond of rights offerings, especially when one of the companies we know well is involved. The externalities of a rights offering, overlaid on a company that you know well, creates a powerful combination.

"I have always believed that the existence of a catalyst creates its own risks. Unless you are the first one to identify the catalyst, you are probably paying some premium for the probability that catalyst will occur."

Our largest holding is Subsea 7 (formerly Acergy, formerly Stolt Offshore). I'm going to refer to the company as Acergy to differentiate from Subsea 7, which is historically a separate company that merged with Acergy just this year. We have been shareholders since the mid-1990s. As such, we have a deep knowledge of the company and its business. In 2004, the company ended a period of operational and financial restructuring with a rights offering. We used that opportunity to significantly add to our holding.

G&D: What does the company do?

BR: They do deepwater installation of sub-sea equipment for the oil and gas industry. Acergy's specialty is installing equipment 3,000—5,000 feet underwater. As you might imagine, there is a technological complexity to the business. In addition to specialized equipment and process experience that is necessary, the engineering skill required is dramatic. We believe the combination of technology, equipment, and experience provides Acergy with a competitive advantage and forms high barriers to entry. We think this is an aspect that investors don't necessarily appreciate. Historically, four companies have done the vast majority of deepwater installations, and then on January 7, 2011, Acergy merged with Subsea 7. Today, Acergy has the largest fleet and in many markets is the top competitor.

G&D: How did the merger affect market share within the industry?

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BR: I think it was positive for everyone, especially Subsea 7/Acergy. The combination of fleets provides opportunities for efficiencies on contract executions. This is very promising for margin improvement. Each geography around the world is its own market, and prior to the merger, Acergy and Subsea 7 were top competitors in different markets. Of course, we think the Macondo disaster in the U.S. Gulf of Mexico will complicate matters for new entrants into the business. Any major oil company will only want to work with a company that has significant experience with installations in 5,000 feet of water. At that depth, if you have a leak, you have a problem. Experience and safety records will strengthen the incumbent's competitive advantage.

G&D: Why do you like the business?

BR: The addressable market is growing significantly. Deepwater finds are not only the largest, but also the most economic. The size of the average field is two billion barrels. You end up with a fully-developed cost of $5-6 a barrel. Today, there are four deep-water provinces in the world: West Africa, Brazil, Gulf of Mexico, and the North Sea. I think in ten years, there could be fifteen deep-water provinces in the world. For example, today there is significant activity off the east coast of Africa, including discoveries off Mozambique. Activity off the West Coast of Africa continues to expand beyond the primary market of Nigeria and Angola to Ghana, Sierra Leone, and Mauritania. It looks as if the entire West Coast of Africa may be prospective. There has also been development off the coast of Australia, Malaysia, China, and India.

"We think the growth of deep water development will be dramatic, and this company is extremely well positioned to benefit from that trend."

As with the activity off Mozambique, natural gas discoveries have now become economically viable in deep water too. The viability of natural gas as an economic hydrocarbon is a dramatic development for deepwater activity. Seismic and other exploration tools can identify structures that are hydrocarbon-prone, but you still need to drill a well into the structure to find out if it fact actually contains hydrocarbons. Until recently, the only economic hydrocarbon in deepwater was oil. Now natural gas discoveries can also be economic which will only encourage future explorations. The additional exploration should inevitably lead to discoveries that will need to be developed. We think the growth of deep water development will be dramatic, and this company is extremely well positioned to benefit from that trend.

In 2001, Acergy acquired a competitor operating in West Africa. That acquisition proved to be life-threatening as some of the contracts this company had were bid at very aggressive rates. Those contracts were further complicated by problems associated with supply procurement executed by their international oil company customer, Shell, in Nigeria. As if not challenged enough, Acergy experienced technical difficulties that can be associated with such deepwater projects. So, in 2002–2003, the company ran into financial trouble that required a comprehensive restructuring.

G&D: How did the company get back on their feet? What did you see that made you believe the reward for participating in the rights offering was worth the risk?

BR: During the period of financial trouble, a new management team was brought in including a new CEO, Tom Ehret, who had been the CEO at industry leader Technip. They raised institutional capital a couple of times. They also went back to Shell to negotiate compensation for the issues with Shell's procurement. I believe Shell appreciated the need to ensure that viable, competent contractors were a necessary component of their deepwater installations.

Keep in mind that Shell had its own issues. Around the

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same time, Shell had announced that it was eliminating 30% of its worldwide reserves! It acknowledged that almost one-third of its total reserves were not economically viable. I believe then, as now, the major oil companies are in denial. Replacing their reserve base is extremely problematic. They didn't want to acknowledge that they were (slowly) liquidating. Instead, the major oil companies were determined to show that they were growing their reserves and deepwater development was critical to their success.

This is an important backdrop to Acergy's industry—the major oil producers, like Shell, needed Acergy and its competitors to execute deepwater projects. At the same time, the industry was consolidating. The confluence of events led to fundamental changes in contract terms. Conditions shifted from favoring the operator of the field to favoring the contractors that installed the subsea equipment. This marked a period of continual margin improvement now clearly visible, even if it was temporarily moderated by the 2008 - 2009 world financial crises.

One impact of these changes is that today this is a negative working capital business. The business is almost entirely funded from operations, because of the prepayment terms of their contracts from the likes of Shell, Exxon Mobil, and Total. That was another signal of the strengthening position these contractors had with their customers. We don't envision that changing, given the dramatic increase in development contracts we expect them to be awarded.

"I believe then, as now, the major oil companies are in denial. Replacing their reserve base is extremely problematic."

Getting back to the rights offering—in May 2004, the company was in the late stages of a financial turnaround when the company did a public rights offering. As a result of their listing on the Oslo exchange, Acergy was required to offer shareholders same financing terms that they had offered to institutions in previous financings.

The rights offering was priced at $2.20 per share. Pro forma for the rights offering, Acergy would have no net debt. So this company, that just a year ago was teetering financially, had now restructured and paid off all of their debt through capital raising activities.

With this one last financing activity, public investors could get a free ride after the majority of capital had already been raised. So after the offering, an investor was getting a chance to invest in a $440 million market-cap company with no net debt, $1.2 billion in revenue, and which two years prior was generating a 15% EBITDA margin. The replacement value of the equipment was in excess of $400 million. We thought that the industry could get back to where it was in terms of margins. We believed this company could do even more than $1.2 billion in revenues. With $1.2 billion in revenues, and 15% EBITDA margins, the company could generate $180 million in EBITDA, while it was being valued at only $440 million.

So to go back to the question about what why we

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thought the risk/reward equation was asymmetrical: the answer is that participating in the rights offering had been largely 'de-risked'. By the time of the offering, the balance sheet had been repaired and the management strengthened. Even more important, the valuation was predicated on the price level the prior year, when the company's position was precarious. This is one of the positives of a rights offering—they are determined based on the market price of a company's stock, not on an estimate of its intrinsic value. A rights offering can also provide an opportunity to invest substantial capital both through the offering and in the open market. Specifically, in the case of Acergy, we fully subscribed, oversubscribed 100% and bought heavily in the open market. All in, we quintupled our position.

G&D: Do you frequently look for rights offerings?

BR: Rights offerings are definitely one of the things that we look for. As I mentioned, the price is set by the offering price level, not a company's intrinsic value. Occasionally, as was the case with Acergy, the disparity is great. One factor we look to see is if there are insiders who participate in the rights offering. Insiders probably know more about the long-term prospects of the company than the market does. In addition, the capital a company raises will often fundamentally change the financial viability of the business itself. There are all these fundamentally positive things about rights offerings, and the value you get compared to price can be much higher because of the dynamics of the rights offerings.

"Rights offerings are definitely one of the things that we look for. As I mentioned, the price is set by the offering price level, not a company's intrinsic value … the capital a company raises will often fundamentally change the financial viability of the business itself."

G&D: The most grueling part of investing is often just generating the idea—how do you go about it?

BR: There are eight of us here who generate ideas. There's a plethora of names that are always coming to us, and a number of the analysts have been doing this as long as I have. Each analyst has refined their own process. The process of stock selection is an art. The most important thing for people is to be motivated and passionate about what they do. I give broad discretion to the analysts to go out and find what they want to find, develop an idea, and tell me why their idea makes sense. I also want them to share it with not just me, but with the other analysts here as well, to leverage each other's thinking and experience. The combination of passion, talent, and experience allows us to keep the ideas flowing. We have an open-door policy, no formal investment committee process.

G&D: Could you walk us through another investment you have made?

BR: Another great company case study from a valuation standpoint is NewMarket. Today it is down to less than 3% of our portfolio. One of our analysts found the name because the company had bought back 30% of their stock in 1997 at roughly $46 per share (after adjusting for a one-for-five split). What was even more interesting was that the Gottwald family, who controlled the company, did not tender their family shares. The Gottwalds had a long successful history of making money. A year later, the

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stock was at $35 per share, which is when we began buying.

NewMarket at the time was Ethyl Corporation. The Gottwald family controls NewMarket and I think their history of capital allocation is important. In 1962, the Gottwalds controlled Albermarle Paper Manufactering Co., which borrowed $200 million to purchase Ethyl Corp. Ethyl was a 50/50 JV between GM and ESSO and was 13x the size of Albermarle. "Jonah Swallows the Whale," the headline read. Ethyl made petroleum additives, including an additive for leaded gasoline which was in decline, because leaded gasoline was on its way out. They paid a modest price to buy a business from two institutions that did not want to own a sunset product, and leveraged up to do that. Over the years, Ethyl generated huge amount of cash to pay down debt and diversified into many other business. Then starting in 1989 they began restructuring, and spun off Tredegar, then First Colony and finally in 1999, the non-petroleum additive chemical business into Albermarle.

These spin-offs were another thing that attracted our interest. We figured, if someone is spinning off pieces like that, it is a clear indicator that they are concerned about shareholder value. Two or three years after spinning off First Colony, they sold it to GE, which was a very tax-efficient thing to do. Shareholders paid capital gains tax on the sale to GE but avoided the double taxation had Ethyl sold directly to GE. This increased our conviction that the Gottwalds really thought about shareholder value. By the time of our first purchase, the stock was trading at a discount to where the company repurchased their own shares.

"These spin-offs were another thing that attracted our interest. We figured, if someone is spinning off pieces like that, it is a clear indicator that they are concerned about shareholder value."

The additives business for fuel, oil, and lubricants was a consolidating, mature business. From 1992–996, NewMarket bought out Texaco's and Amaco's additives businesses, helping consolidate the industry down to just four players. Then they looked around and didn't see any other acquisition opportunities, so they leveraged up.

G&D: How levered was it?

BR: At peak, they had $650 million in debt or well above 3x trailing debt-to-EBITDA. They figured that they would continue to generate a lot of cash.

Unfortunately, the U.S. economy weakened, Asia had troubles, and the phase out of leaded gasoline accelerated. One of NewMarket's competitors, Oronite, a division of Chevron, built a new facility, because it was growing in Asia. That brought on more capacity, and the supply and demand equation fell out of balance.

The largest company in the business was Lubrizol, which is a publicly traded company with 35% market share. Lubrizol was telling its investors that it was going to be able to grow its top line organically. Well, in a mature business where there was no growth, especially one that was going through such a consolidation phase, you could not execute a growth plan successfully. It became much more competitive and the margins were really compressed. At the same time, their customers, such as Quaker State and Pennzoil, merged. Now, the customer was coming back saying that whoever had the lowest price would get the business.

G&D: What happened with the business?

BR: We were convinced that the Gottwald family would not let this business go. After all of the spinoffs, different family members were each running different businesses. Part of that decision was probably for family unity purposes. What often happens when you have a third-generation family business is that all the members end up fighting over control. The family tears itself apart and the company usually ends up getting sold. The Gottwalds said, instead, we'll split the company and

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different people will run different pieces.

I had this vision that every time they got together for Thanksgiving, all the family members would tell Bruce Gottwald, one of the family patriarchs who was running Ethyl, "Bruce, look at all the money we're losing in Ethyl." Bruce was not going to let this thing go under, because Bruce's personal reputation was tied to this company, and he did not want to come to Thanksgiving dinner saying that he had filed for bankruptcy.

They did things to make sure the Company would survive. In 2002, the stock got down to less than $4. At the time it had 17 million shares outstanding. That was less than a $70 million dollar market cap for a company that was generating $650-$700 million in revenues. Debt had been paid down to $300 million and the stock was trading for roughly 1.5x trailing free cash flow. There were only four competitors in the industry. You weren't paying anything for the business at what was a low-point of a cycle.

G&D: What made you think the industry would figure out a way to generate a rate of return that was worth the cost of capital?

BR: Well, there sure was no catalyst in place, but we thought the valuation was extremely cheap. Although EBITDA was less than half of where it was in 1997 at $90 million, debt had been paid down to $300 million, which we thought was manageable. We also had faith in the Gottwalds when we bought more, based on their level of high insider ownership (close to a third of the company). They weren't going to let this thing go. It was a core supplier in the business. We also believed that as a result of the industry consolidation to just four players, the business would be able to generate returns that were much higher than the level at that time. Three years later, in the spring of 2005, the stock had rebounded to $15 per share. But that's when the best risk/reward appeared. Lubrizol, their main competitor, went out and bought a company that made chemical additives for hair care products. That business was growing 6-7% a year.

"Bruce was not going to let this thing go under, because Bruce's personal reputation was tied to this company, and he did not want to come to Thanksgiving dinner saying that he had filed for bankruptcy."

With that, Lubrizol decided to run the petroleum additives business for cash as it acknowledged this was a mature business. They shut down a plant, raised prices, decided to get a return on the assets, expanded margins and turned away business if they could not make money. You had the pricing leader in the business suddenly saying that they were going to be running things differently. But what proceeded to happen was that the earnings did not go anywhere, because oil prices went up significantly, and oil and derivative petrochemicals are the raw materials that go to make NewMarket's product. The costs kept going up, but so did the industry's selling prices—just not soon enough. You would see the margins contract due to rising costs, but then turn around and expand due to the pricing discipline within the industry. Eventually, you know that the reason margins expand is because the supply/demand fundamentals are

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allowing that to happen. The industry had gotten pricing discipline. At some point, the raw materials are going to stop going up and the margins are going to expand. You could see that the earnings were going to go up.

I did a model on the company and gave it to the CFO, saying that they should generate $4 a share in annual cash. Now, some of it was because of the excess depreciation from buying and consolidating all those companies, and because they didn't need to put anywhere near the amount of money back into the business. He said "from your lips to God's ears." The stock was trading at $15, less than 4x that free cash flow estimate, with margins likely to expand significantly. We bought more and also encouraged the company to repurchase shares. Since then, the company has bought back stock, which I also think has been a positive. Companies can often be stubborn about buying back their own shares. Luckily that wasn't the case with NewMarket.

G&D: It is interesting though, how often companies don't buy back their own stock when the stock is undervalued.

BR: There are many different reasons. One reason is that boards and management are afraid that a buy-back will result in less available float which might prevent institutions from buying the stock. In the meantime, the important metrics are the earnings per share and the value per share, and clearly buying back shares for less than what they are worth increases the earnings potential and value of the business. Over time, the market will inevitably recognize that economic reality. If the right conditions exist, this is how you create value with a really low-risk basis.

"The important metrics are the earnings per share and the value per share, and clearly buying back shares for less than what they are worth increases the earnings potential and value of the business. Over time, the market will inevitably recognize that economic reality."

G&D: Getting back to NewMarket, how did the story end?

BR: It was a great buy-back then, yet nobody wanted to own it. The only people that wanted to own it were people like me who had owned it for five years, and had probably lost money in the interim. It turned out that I was wrong about the earnings estimate of this company. I thought it could generate $4 in cash annually. Today, the company earns roughly $3 per share quarterly, or $12 per share annually. It's a $120 stock.

Now, you have this industry, with four competitors who are competing in an intelligent way, making very high returns. Lubrizol has no interest in changing that dynamic. There's some growth in the business. It looks like a fundamentally different business today, yet it is the same business that it was in 1998, same business as in 2003, with vastly different valuations, and vastly different financials.

G&D: What kind of returns are they reaping at $12 of earnings per year? Is it attractive for other people to enter?

BR: The business is a low growth/no growth, mature business. Four companies dominate the business. There are barriers to entry and there is still some opportunity. The real oppor-

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tunity for NewMarket is still a consolidation play, because Lubrizol is the biggest player with 35% market share. NewMarket has less than 20% market share. One of the companies in the middle is Infineum, which is a joint venture between Shell and Exxon, and from time to time, each probably thinks maybe they should get out of the joint venture. The fourth competitor is Oronite, which is a wholly-owned subsidiary of Chevron. Six years ago or so, Chevron took the rest of their chemical businesses and merged them with Conoco Philips because there were some efficiencies that could be realized. With this additives business, there were no efficiencies, so it stands on its own.

The logical thing for one of these guys is to say, why am I in this business? Should I get out of it? I can't sell it to Lubrizol because of anti-trust issues, and Infinium may also be too big. The only buyer in town is NewMarket because it is the smallest. And if they sell to NewMarket, and take back part cash, part stock, the synergies of putting these two companies together could be really dramatic. The opportunity to execute that last piece of the consolidation is a real opportunity that sits out there and makes us labor to make a decision about what to do with the stock. Today, it trades at a reasonable multiple of earnings, close to 10x, and the prospects are reasonable. The family is out there thinking about how to create value, but it's not cheap anymore. The business is clearly firing on all cylinders today, and we don't see that that is necessarily going to change, but things happen and people did not anticipate what would happen to the business in 1998.

G&D: How do you think about selling or trimming down a position like that in the context of your portfolio?

"Our buy decisions are always predicated on valuation more than anything else. The sell decisions are a little bit different, though, because we do have more history and knowledge of the company, so there are more qualitative factors that come into play."

BR: Our buy decisions are always predicated on valuation more than anything else. The sell decisions are a little bit different, though, because we do have more history and knowledge of the company, so there are more qualitative factors that come into play. Who are the people running the business? What do we think of them? We realize that is clearly one of the more important components of valuing businesses. What is the value of the management and their capability to reinvest capital? What are the opportunities to reinvest in the business? Those are important things to assess in addition to the valuation. The longer you own the company, the better sense you have about management's thinking process and capabilities.

Going back to Subsea 7, although it is the biggest position we currently hold, it clearly does not have a discounted valuation today. The stock today is trading at $25 per share, and the company will earn somewhere between a $1.00-1.20 a share, so it is trading clearly at a high multiple of earnings. It has a relatively modest book value, so from all of the standard Ben Graham valuation methodologies, it's a pretty rich price. But one of the most important things that happened with the merger is that Kristian Siem, who used to own 40% of Subsea 7, now owns 20% of the combined company. The concern we always had about Acergy was that the board did not own any stock. We had gone public with that concern, among others, by writing a letter to the board and sharing our view with all owners of the business. We had complained about some of the decisions they have made which we believe might have been different had they thought like owners. We think the best way to think like an owner, is to be an owner. We have been activists with Acergy, pushing them to do things including implementing a mandatory board director share ownership policy for the company.

In 2008, when the world was at peril, this company had $300 million in net cash on the balance sheet and it

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Columbia students and Professor Greenwald at Moon Lee Prize for Excellence in Applied Value Investing Competition.

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got down to an $800 million market cap. We thought that the peripheral assets alone were worth $800 million, including the $300 million net cash, so we thought buying stock made all the sense in the world. The customers of the company were major international oil companies. Even if the world went into a financial collapse, which I think it was at risk of doing then, those customers would still be in business. Clearly, the market's valuation was very wrong and the balance sheet gave the company the flexibility of doing repurchases. There was an opportunity to significantly increase shareholder value.

G&D: What about today?

BR: Today, I don't have that concern, because suddenly you have this guy, Kristian Siem, thinking about shareholder value and how to create it. Based on my understanding and conviction about the business, I think the top line of this business will more than double over the next five years, and the margins will expand. There are only three major companies in the space and there are huge barriers to entry. They have land-based engineers in addition to equipment, who are working on extremely complicated projects that get even more complicated over time, so all of those things have created barriers to entry in a business that is not overly capital intensive. For example, revenues more than doubled from 2004 - 2008 , the number of shares came down a little bit, maybe 10 million shares. The company went from having zero net debt to having $400 net cash on the balance sheet by the end of 2009. They doubled the size of the business, financed it internally, and did not issue shares or take on debt in the process. I think these are attractive attributes, and now you also have the efficiencies from having two different fleets and not having to move equipment nearly as much, getting higher utilizations which will also benefit margins. We own a stock today that is not a Ben Graham value stock, but our conviction level about what the earnings and growth of those earnings look like, leads us to conclude that it is still an attractively valued investment.

"Value investing isn't something that is practiced in much of the developing world, and in Asia it clearly makes sense to pursue our approach."

Needless to say, we own shares in all of the companies I mentioned and over 1% of the outstanding shares of each one.

G&D: Can you discuss what prompted you to start investing abroad after spending over two decades investing primarily in the United States?

BR: Historically, we have primarily invested in the United States and Canada. Five years ago, one of my analysts, Isaac Schwartz, came to me and insisted we should be investing in Asia. His argument was simple. Today, there are a lot more people practicing value investing in the United States than when I started, so there is less inefficiency in the market, and finding undervalued securities can be more difficult. Value investing isn't something that is practiced in much of the developing world, and in Asia it clearly makes sense to pursue our approach. Isaac traveled to Asia for an extended period of time and returned convinced that the opportunities were significant. So, in 2006, I went with him to Bangkok. I was thinking to myself, I can't even speak English very well, let alone speak or read a foreign language. But I just couldn't ignore Isaac's enthusiasm and conviction.

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"The Asian markets are fundamentally different than the U.S. markets. We think those differences result in Mr. Market being much more manic-depressive. … If you are a disciplined investor who understands the difference between the price of a security and its intrinsic value, you can often find a large disparity between what these companies are trading at and what they are really worth."

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I didn't think this was something we would have the capability of doing. As it turns out, Thailand was a great place to go to, because the management teams of even the small-cap companies are conversant in English. The financials are all translated into English. There is frequently additional information that is not available in the United States. For example, companies with multiple businesses often provide both consolidated financials as well as operating company financials. You can then disaggregate the companies, look at the individual accounts, and manipulate the data to get a lot more information and a better understanding of the different businesses. At the time of our visit, in Thailand, many stocks traded for high single-digit P/E ratios and 8-10% yields while the government bond was yielding 6% - 7%, so it was a pretty straightforward opportunity. Gee, the company has no debt, there is cash on the balance sheet, and earnings are positive. Some of these companies have been public for twenty years. It's not like they have been public for three years, which makes it easier for management to manipulate the earnings. I said to myself, "I get it. It is easier to find bargains in Thailand than it is in the United States."

Now Isaac lives in Hong Kong and manages our Asian investments with me. He spends all his time visiting with companies and doing primary research on current and potential investments throughout Asia. I join him several times a year, meeting with the managers of our current holdings, as well as candidates for investment.

G&D: Is there a particular country you are focused on?

BR: Our focus is entirely on bottom-up research, so the short answer is 'no'. Instead, we search for undervalued investment opportunities wherever we can find them. Isaac and I have visited companies in eleven different countries around Asia since the beginning of 2006. Isaac has actually been to even more countries in search of opportunities. Today, the majority of the capital is invested in Southeast Asian countries, with less than 10% invested in Thailand. More recently we have visited a number of Central Asian countries, and investments in Kazakhstan and Mongolia are now two of our top ten holdings.

We believe there are two key advantages to investing in Asia. First, the Asian markets are fundamentally different than the U.S. markets. We think those differences result in Mr. Market being much more manic-depressive. There is a lot of money in U.S. markets from endowments, pensions, and individuals that will always be invested in equities. This permanent capital leads to less volatility. Wealth overseas is still not invested in equities, or if it is, it's invested in speculative capital, not investment capital. The institutional capital invested in equities in these markets is most frequently from foreign investors. As a result, the capital flows in and out depending on whether or not foreigners want to be in that country. All of that capital movement translates into higher volatility in prices. If you are a disciplined investor who understands the difference between the price of a security and its intrinsic value, you can often find a large disparity between what these companies are trading at and what they are really worth. In addition, the multiples at which the premier companies trade is very pronounced from the valuations at which the vast majority of the public companies trade at.

The other advantage to investing in Asia is the obvious one: that over the next ten years, most emerging markets will grow and likely grow faster than the U.S. markets. The world is flattening and the relative growth in Asian economies should be measurably greater than the growth of the U.S. economy, even if the United States is due for some catch-up at this stage of the world recovery.

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G&D: How do you handle currency risk?

BR: As a matter of policy, we generally don't hedge on any of the currencies. Hedging is a process in itself that requires time and attention. We prefer to focus our time on company specific research. That decision is made much simpler since we also believe that the long-term outlook for most emerging market currencies is positive vs. the U.S. dollar. We think the axiom noted by much smarter investors tends to apply here as well. We would much rather end up with a bumpy 15% return instead of a smooth 10% return. We're going to be in these markets ten-plus years from now. Not hedging should add extra return over time, and it makes all the sense in the world.

G&D: What reservations do you have about investing in these countries?

BR: One issue that comes up regularly is whether foreign markets have weaker corporate governance and a litany of related issues. Having been an investor in the United States for thirty years, we have often invested in companies that are undervalued because there may be a controlling shareholder, and maybe that controlling shareholder 'forgets' that there are other shareholders. We've been involved in well over twenty class-action lawsuits in the U.S. where we've been the main plaintiff because we believe that the company effectively disadvantaged its outside shareholders. The particulars of such a situation are frequently difficult to get a judge to understand. We have had some success in litigation, but there are other situations where someone has done something clearly egregious and wrong, and we haven't been successful in court. Management and/or boards can and do destroy shareholder value, whether it is intentional or whether it's a misunderstanding of what shareholder value is. In America, it happens all the time, so it's not like it's something new to us just because we are investing in Asia. There are valid concerns about corporate governance. You just have to be on the lookout for the same warning signs that you have to look for in the United States.

"We think the axiom noted by much smarter investors tends to apply here as well. We would much rather end up with a bumpy 15% return instead of a smooth 10% return."

G&D: Some investors won't get involved with corporate governance issues because they believe it is not worth their time. How do you justify the effort it takes to pursue governance issues, and do you think it is a good return on that time?

BR: Like I said, there are times that we've been extremely successful, and it has been a good use of our time and capital, but there are many cases where it does not create a productive end result. Even when the facts are on our side, we are often unsuccessful, which is all the more frustrating. The fact of the matter is, we are long-term shareholders, and as such, we believe it is our obligation to advocate what we believe is right.

G&D: Thank you very much, Mr. Robotti.

Todd is a second-year MBA student. He spent the summer interning with a long-short equity fund in New York. Prior to enrolling at Columbia Business School, he spent five years in distressed/ turnaround private equity. He has never operated a chainsaw.

Blount International, Inc. (BLT)

Todd Brunner
TBrunner11@gsb.columbia.edu

All amounts in millions of dollars, except per share data

Capital Structure	
Share Price	$14.87
Fully Diluted Shares	50.693
Market Value of Equity	**$753.8**
Plus: Debt	374.7
Less: Cash	91.0
Enterprise Value	**$1,037.5**

Multiples	LTM PF	2011E
EV/EBIT	9.9x	7.9x
EV/(EBITDA-CapEx)	9.1x	7.5x
EV/EBITDA	7.8x	6.4x
FCF Yield	8.3%	10.1%
P/E	12.2x	10.0x
P/Book	24.3x	6.6x

Summary Financials	LTM PF	2011E
Revenue	661.8	715.2
EBITDA	133.3	162.3
EBIT	104.3	131.0
EPS	$ 1.22	$ 1.48
CapEx	18.9	24.0
EBITDA - CapEx	114.3	138.3
Free Cash Flow	62.8	76.4
Tangible Capital	246.4	242.9
Book Equity	31.0	114.6
Total Assets	608.4	580.5
Dividend Yield	0.0%	0.0%

Trading Statistics	
Insider Ownership %	0.7%
Short Interest %	4.4%
Average Daily Volume	218,284
Short Days to Cover	**9.7**

Returns	LTM PF	2011E
ROTC	42.3%	53.9%
ROE	198.6%	65.5%
ROA	17.1%	22.6%

Investment Thesis:

I recommend purchasing shares of Blount International, Inc. ("the Company" or "BLT"). BLT is a misunderstood, sparsely followed $1 billion chainsaw component manufacturer that dominates a niche market with 60-70% global market share. BLT is not tied to the domestic housing market, with over 70% of sales coming from international markets. At a cyclical average free cash flow yield of over 10%, and underlying organic volume growth in excess of global GDP, investors can buy this strong niche franchise at a significant discount to its intrinsic value. I believe the equity trades at a margin of safety of 45-55% at current prices.

Dominant Position in Niche Market: In its primary products, saw chain and guide bars, BLT has a global market share of approximately 60-70%. Saw chain is a consumable product that is replaced every 5-10 days by professional users, who make up nearly 75% of BLT's sales volume. BLT's largely exclusive distribution network of over 9.500 provides broad reach to its professional customers that are located outside the traditional retail distribution network.

Strong Brand Portfolio and Loyal Customers: The Company's portfolio of brands, which include Oregon and Carlton, are responsible for BLT's sustained high margins and returns on capital. Professional loggers that I have spoken with have a strong brand affinity to their preferred product. Independent tests have shown little to no difference between BLT brands and its primary competitor, Stihl, yet professionals retain their ingrained brand preferences.

Misunderstood: Buy-side investors that I have spoken with have an immediate negative reaction to BLT: "I don't want to buy a housing-related company." This misconception has created, I believe, a great opportunity for current investors. A total of 28% of BLT's sales are in the U.S., where housing drives the overall forestry market. But wood-framed housing construction is largely a U.S. phenomenon. As a result, 54% of the North American forestry harvest is used to produce sawnwood and veneer, compared to only 19% for the rest of the world. Furthermore, only 13.8% of global forestry volumes are from North America, so it represents a small piece of the overall market. In fact, the head of IR at Sappi (South Africa-based, NYSE-listed company) told me that the single most difficult part of his job is convincing U.S. analysts that housing doesn't drive their forestry/paper market. BLT generates a 10+% cyclical average free cash flow yield without the benefit of a U.S. housing market—any domestic recovery represents a free option to BLT investors.

Underfollowed: The sell-side covering BLT consists of Capstone Investments and Longbow Research, neither of which have issued a research note since November 2009. Both analysts currently have a hold/neutral rating on the Company. BLT was covered by JPMorgan and UBS prior to the financial crisis.

Secular Tailwinds: BLT has seen organic volume growth of approximately 3.2% from the 2001 trough to the 2009 trough, while global forestry volumes have only marginally increased over that period. The increased volume can be attributed to a secular shift in emerging markets from hand tools to chainsaws. I estimate that currently only approximately 45% of timber felled globally use a chainsaw, yielding an immense runway for continued growth in chainsaw consumable products.

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Blount International, Inc. (Continued from previous page)

Cash Flow: Low ongoing capital requirements owing to BLT's installed manufacturing base lead to a high level of free cash flow generation. BLT trades at a PF LTM 8.3% free cash flow yield, and operating leverage will lead to a dramatic pickup in free cash flow over the remainder of the cycle. BLT's CFO estimates 50% incremental operating margins over the next few years as a result of further utilization of fixed assets.

Near-Term Catalyst: According to my projections, BLT will handily beat Q4 2010 earnings expectations. The street's EPS estimates are stale at $0.16 vs. my $0.28, which I consider a conservative estimate. A significant earnings beat could potentially lead to increased coverage and a re-rating by the investment community.

Business Description:

BLT manufactures and sells a range of cutting chain, chainsaw guide bars, cutting chain drive sprockets, and maintenance tools used primarily on portable gasoline and electric chainsaws. Blount also offers concrete-cutting equipment, including diamond-segmented chain, which is used on gasoline and hydraulic powered saws and equipment for construction markets. The Company sells its products to professional loggers, construction workers, homeowners, equipment dealers and distributors, and OEMs. BLT offers its products under the Oregon, Carlton, Windsor, SpeeCo, and ICS brand names, as well as private label to Husqvarna.

Valuation

I believe the Company's equity has an intrinsic value today of approximately $27.00 per share (versus today's price of $14.87), representing a margin of safety in excess of 45%. The intrinsic value is based on a mid-cycle EBITDA–Capex multiple of 12-14x, which I believe is appropriate given the attractiveness of the business. Note that Blount's unadjusted LTM EV/EBIT multiple is approximately 12.5x. Note also that BLT traded at an average ~11x EBIT from 2000-2007 when it was a much less attractive business. Management has driven three positive changes since then: (a) improved capital structure, from leverage over 5x EBITDA to 2.5x today; (b) management sold the more cyclical capital equipment business to Caterpillar in 2007, which represented 30% of sales; and (c) sales exposure to the U.S., and therefore the housing market, has declined from 50% to 28%. What remains is a less-cyclical, appropriately levered consumables business tied primarily to the global economic cycle that is deserving of a premium multiple. An eventual recovery of the U.S. housing market (which I have not included in my projections) is a free option for investors in this solid underlying business.

BLT Valuation

	Low	High
Mid-Cycle Normalized EBITDA	$162.3	$162.3
Mid-Cycle CapEx	24.0	24.0
EBITDA-CapEx	**$138.3**	**$138.3**
Multiple	12.0x	14.0x
Enterprise Value	**$1,659.8**	**$1,936.5**
Plus: Cash	91.0	91.0
Less: Debt	374.7	374.7
Equity Value	**$1,376.1**	**$1,652.8**
Fully Diluted Shares	50.749	50.749
Implied Share Price	**$27.12**	**$32.57**
Current Price	$14.87	$14.87
Margin of Safety	**45.2%**	**54.3%**

Investment Risks/Considerations

Currency and Commodity Risk: BLT does not hedge currencies or steel prices. Although manufacturing and sales are global, the Company is more exposed on the cost side to Brazilian Real and Canadian Dollars, and more exposed on the revenue side to Euros. Cold-rolled strip steel is the primary commodity used in BLT's products and represents 23% of BLT's COGS. Historically, the Company has been successful at passing through any significant changes in f/x and steel pricing to its customers. I view f/x and commodity pricing as a short-term margin risk, but I expect long-term margins to remain intact owing to the Company's significant pricing power.

"Empire Building" Management Team: Despite generating significant free cash flow, the Company does not pay a dividend and has not repurchased shares in the last five years. Management has stated its intention to use $100mm to $200mm of internally generated free cash flow over the next three years on small, tuck-in acquisitions. Additionally, approximately 1/3 of senior management compensation is tied to short-term EBIT and FCF targets, which could incentivize destruction of shareholder capital via acquisition/growth. I would much prefer a management team that is willing to "grow old gracefully" and anticipate CEO Josh Collins to do so once his strategic vision for the Company has been realized (Collins joined BLT in late 2009). Management has not issued shares in over 5 years and acquisitions to date have been value accretive and strategically aligned with the existing business.

"What we're really focused on is, can we create value at the enterprise level that's flowing through to the shareholders on a risk-adjusted basis...?"

–CEO Josh Collins, Aug 9, 2010

TJ Carter is a second year MBA student and member of Columbia's Applied Value Investing Program. Prior to Columbia Business School, TJ worked in investment management concentrating on value-oriented investing across the capital structure.

TJ was the winner of the 2011 Moon Lee Prize Competition for his pitch on The Williams Companies.

The Williams Companies (WMB) - TJ Carter, tcarter11@gsb.columbia.edu

Recommendation: Buy
Target Range: $36 to $43 per share
35% to 60% upside

<u>Investment Thesis:</u> The Williams Companies (WMB) is an integrated natural gas energy company with operations in exploration & production, pipeline transportation and midstream gathering and processing. Under new leadership, I believe a break-up of the highly volatile E&P from the MLP assets – pipeline and midstream – will unlock substantial value. I believe the current share price at $27is pricing in low natural gas prices and no chance of a break-up. With a spinoff of the E&P business as a catalyst to unlock value, I value WMB at $36 to $43/share, or a 35% to 60% upside to the current price, with considerable downside support at $23/share at my low case. I view the two new businesses as "New WMB" and "E&P Spin" as depicted below:

Williams (WMB) @ $27/share
Williams Partners (ticker: WPZ)
73% Common Interest
GP Interest - 2% Economic Interest
Incentive Distribution Rights
Other
Canadian Midstream
Domestic Olefins - Ethan Cracker
25.5% Gulfstream Pipeline
Exploration & Production
4.8 TCF proven reserves
over 1,000 MMcfe/d production
69% Apco Oil & Gas Int'l interest
Significant Bakken & Marcellus Inv

New WMB
Williams Partners (ticker: WPZ)
75% Common Interest
GP Interest - 2% Economic Interest
Incentive Distribution Rights
Other
Canadian Midstream
Domestic Olefins - Ethan Cracker
25.5% Gulfstream Pipeline

$1.0 bln in FCF
13x to 15x
$23 - $28

E&P Spin
Exploration & Production
4.8 TCF proven reserves
over 1,000 MMcfe/d production
69% Apco Oil & Gas Int'l interest
Significant Bakken & Marcellus Inv

$1.37-$1.66/mcfe
+ Investments
$13 - $15

$36 - $43
Target

<u>Situation:</u> By separating the E&P business from the MLP business, each business could be sold to investors that appreciate its attributes. Those investors interested in E&P are more familiar with the attributes of the business, including leverage to natural gas prices, significant exploration/development expenditures, and low/no dividend distributions. While on the other hand, the WPZ LP and GP interest will be appreciated by investors looking for consistent free cash flow, muted volatility, and higher dividends. I believe there are three main reasons that WMB shares are mispriced:

1) Skepticism over when/if E&P will be split from the Midstream/Pipeline businesses. There has been speculation over when Williams will finally split the business. There appears to be significant investor fatigue. I believe that a separation of the businesses will be announced in 2011 for the following reasons:

First, Midstream/Pipelines restructuring failed to unlock value. In January 2010, the Company announced a major restructuring that contributed WMB's significant mid-stream assets to WPZ and merged the Company's separate gas pipeline MLP (WMZ) with WPZ. Since the announcement, WPZ shares have rallied about 50% while WMB shares have improved less than 10% - despite WMB retaining 75% of the interest (LP + GP) and the incentive distribution rights to WPZ.

Second, management owns WMB, not WPZ. All directors and executive officers hold 3.6 million shares of WMB and virtually zero WPZ units which means that management, along with WMB shareholders, did not participate in the run-up of WPZ units.

Third, management change. Steve Malcolm, former Chairman and CEO, was an impediment to a spin and his stated priority was to the integrated operating model. At the May 2010 Analyst Day, Steve Malcom said, "The second priority is to use our integrated business..." (first priority to executing on current projects). As of January 3, 2011, Alan Armstrong, former Midstream President, has taken over as CEO. Mr. Armstrong's stated priorities are to 1) reposition E&P, 2) grow WPZ cash flow, and 3) unlock value. At the Wells Fargo Conference in December 2010, Mr. Armstrong said in responding to the SOTP discount, "Now is the time to take further steps" and "market is not appreciating value of E&P business."

2) Complexity. The street and other analysts' valuation estimates vary widely due to several factors, including multiples, E&P valuation, tax treatment, EBITDA estimates, treatment of IDRs, among others. The complexity has led to varying SOTP analysis which have tended to be backward looking.

Underestimating earnings power - I believe this complexity has led to an underestimation of earnings power. In my analysis below, I focus on the free cash generating ability of New WMB.

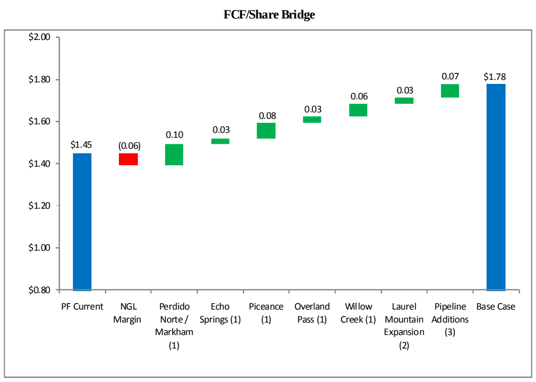
The Williams Companies (Continued from previous page)

I bridge operating income at New WMB from $1.5 billion currently to $1.8 billion translating to $1.45 growing to a $1.78 FCF per share. As an example of where I differ from the market—In this cash flow estimate, I forecast the Incentive Distribution Rights (IDRs) growing to ~$415 million based on the inclusion of these incremental projects ramping while the market assumes IDRs at ~$250 million focusing on current cash flow distributions at WPZ.

3) Low natural gas prices — Prices have dropped significantly from over $10/mcf to under $4/mcf. While there is evidence that the long-term natural gas prices should be higher than it is today with average fully loaded costs at $5.20/mcf (not including a profit margin), **I assume that prices remain depressed at $4 to $5 per MMcfe in my valuation scenarios.** Any improvement in natural gas prices would be upside to my valuation.

Business/Valuation:

***New WMB ($23 to $28/share)* -** Midstream operations produces approximately 60% of PF cash flows. The business boasts industry high returns (averaging 23% ROIC over the past 3 years), significant free cash flow generation, and growth opportunities, Pipeline operations produces approximately 40% of PF cash flows. This business owns and operates critical infrastructure, operating essentially a toll road for natural gas with 100% fee based revenues. With projects in-the-ground and fully paid for, I forecast FCF/share to grow from $1.45 to $1.78. I value the cash flow stream at 13x to 15x by balancing the very high quality nature of the fee-based pipeline business, attractive benefits of the IDRs, and some commodity exposure in the midstream business. This valuation range is favorable to comparable companies that trade from 15x to 17x FCF (various large cap MLPs and publicly traded GPs).



E&P Spin ($13 to $15/share) - E&P's 4.8 Tcfe reserve base is primarily in the Piceance basin in the U.S.. The Company has allocated capital well with an average development cost of $2.07/mcfe compared to industry average of $3.37/mcfe. In addition, E&P has a 67% interest in APCO (South American E&P company) and significant investments in Bakken and Marcellus that aren't captured in the reserve base. For valuation, I first calculate the reserve value based on a liquidation (PV10 methodology) and adjust for the investments and net debt. I value the reserves based on $4.50 to $5.00/mcfe natural gas yielding a value of $1.37 to $1.66/mcfe proven reserve which compare favorably to comparables at $2.28/mcfe proven reserve (comparable used were BBG, QEP, UPL—all in regions near WMB with similar economics). I then adjust for the other investments and net debt (APCO equity, Bakken and Macellus investments).

***Value - $36 to $43/share (35% to 60% upside)* -** More importantly, I believe downside is limited with the current trading price covered by the value of NEW WMB.

Risks - Natural gas prices decline further, NGL profitability declines, interest rates rise sharply impacting yields on MLPs, and Alan Armstrong does not pursue a value enhancing transaction.

New WMB Valuation			
	Low	**Base**	**High**
New WMB EBITDA	2,228	2,519	2,595
FCF to WMB	873	1,049	1,094
per share	$ 1.48	$ 1.78	$ 1.85
Yield	9.1%	7.7%	6.7%
Multiple	11.0x	13.0x	15.0x
Value to WMB	**9,608**	**13,633**	**16,403**
per share	**$ 16.29**	**$ 23.11**	**$ 27.80**
E&P Valuation			
Reserve Value - PV10	**Low**	**Base**	**High**
Proven Reserves (MMcfe)	4,800	4,800	4,800
Nat Gas Price per mcf	$ 4.00	$ 4.50	$ 5.00
PV 10 Value ($/mcf)	$ 0.71	$ 1.37	$ 1.66
Reserve Value/share	$ 5.81	$ 11.17	$ 13.47
Other Investments - Debt/sh	$ 0.56	$ 1.63	$ 1.63
E&P Value to WMB	**3,761**	**7,552**	**8,907**
per share	**$ 6.38**	**$ 12.80**	**$ 15.10**
Total	**$ 22.66**	**$ 35.91**	**$ 42.90**
Current Price	$ 26.60	$ 26.60	$ 26.60
Upside / (Downside)	-13%	37%	63%

"WMB is cheap with a catalyst. The market is underestimating the earnings power of the pipes/midstream business and the likelihood of an E&P spin off to unlock value."

Eric is a second year MBA student in the Applied Value Investing Program. He spent the summer interning with a value-oriented long/short equity fund in New York. Prior to enrolling at Columbia Business School, he worked in the non-profit sector and was the drummer in an art rock band.

The Greek Organization of Football Prognostics (ATSE: OPAP)

Eric Hagemann
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OPAP SA (ATSE:OPAP)		
Fair value:	**€ 25.00**	(8.0x EV/EBIT)
Upside potential:	**68%**	
Price per share	€ 14.91	(4.5x EV/EBIT)
x shares oustanding	319.0	
Market cap	4,756	
Less: net cash	710	
Enterprise value	4,046	

	2005	2006	2007	2008	2009	2010E
Revenue	3,695	4,633	5,066	5,520	5,441	5,288
EBIT	688	721	824	976	932	912
% EBIT	*18.6%*	*15.6%*	*16.3%*	*17.7%*	*17.1%*	*17.2%*
Dividends paid	449	472	525	618	655	395
% of cash from ops	93%	98%	109%	128%	136%	67%
Normalized Dividend Yield: 13.5%						

Investment Thesis:

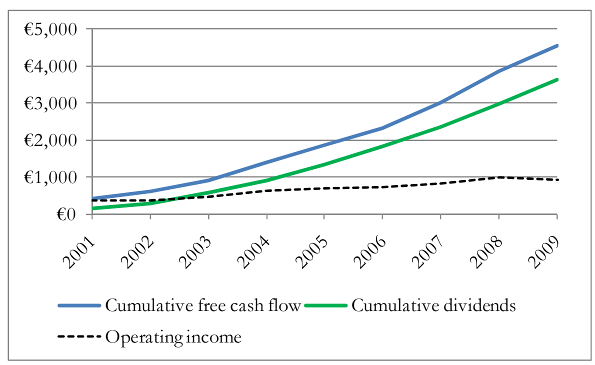
The Greek Organization of Football Prognostics, also known as OPAP S.A., is the exclusive operator of sports betting and numerical lottery games in Greece. OPAP is an exceptional enterprise that happens to be in Greece, and has traded down accordingly. I will try to demonstrate that due to structural characteristics of the business, OPAP is fairly well insulated from Greece's problems. Accordingly, the significant discount arising out of Greece's unpopularity among investors presents a buying opportunity.

Business Overview:

OPAP can be thought of as a hybrid between Off-Track Betting and the state lottery. About a third of revenues derive from sports betting, two-thirds from lottery games; the lottery games are marginally more profitable than the sports betting, but not significantly so. OPAP conducts its business through a network of 5,200 bricks-and-mortar agencies throughout Greece and Cyprus. The agencies are mom-and-pop operations run largely at the expense of the dealers, whose only income consists in an 8% commission on gross revenues. They vary widely in size and quality of operations; but OPAP enjoys the important benefits of paying its agents strictly on commission and foisting expenses such as rent and utilities onto the dealers.

OPAP was established in 1958 as a state-run enterprise and privatized in 1999, ahead of Greece's accession to the European Union. It remains 34%-owned by the Greek government. OPAP's license is based on a 20-year agreement with the government that expires in 2020, and is currently under discussion to be extended to 2030 at a likely cost of €300–500 million.

With few reinvestment requirements and a legally protected monopoly, OPAP generates a great deal of free cash. What is exceptional is the consistency with which the company deploys it. During the past five years, around 90% of free cash flow has been paid out in dividends. What has not been paid out has largely been added to the balance sheet or used to pay down debt (of which there is none outstanding).



Why is OPAP cheap?

OPAP has historically traded around 8x EV/EBIT, within a range bounded by 3x and 15x. While there are some company-specific issues that I will discuss later, the most important driver of OPAP's current cheapness (at 4.5x EV/EBIT) is the overhang on Greek stocks generally. OPAP has slightly outperformed the MSCI Greece index over the past three years, but not by much; and during that period, two-thirds of the capital that had been invested in Greek stocks has since been pulled out. It is also worth bearing in mind that the aggregate capitalization of Greek stocks is a paltry $70 billion or so, compared to about $13 trillion in the New York Stock Exchange. It would be unsurprising if mispricings were deeper and more persistent in Greece than in higher profile markets.

Yet, I will argue that Greece's sovereign debt crisis, even as it relates to Greece's future GDP growth prospects, is of limited relevance to OPAP's financial performance even in the near term.

OPAP S.A. (Continued from previous page)

1. **Financial strength.** Unlike a number of other Greek companies—for example, Greek banks—OPAP's solvency is not in question. OPAP has no debt, €700 million in cash (of which virtually none is Greek government debt instruments), and a history of strong cash flow generation.
2. **Margin stability.** Operating income as a percentage of sales is inherently stable. OPAP's largest costs by far are the prize payouts and agent commissions (about 70% and 8% of gross revenues, respectively); other expenses consume another 5% of sales. In effect, over 90% of OPAP's costs are strictly variable. Because sales and operating income co-vary almost one-to-one, significantly disrupting the flow of operating income requires a disaster on the top-line.
3. **Revenue stability.** Yet, OPAP's revenues are remarkably stable, no doubt thanks in part to the habitual nature of gambling generally. Even in the crisis environment of the past two years, when unemployment has risen from 9% to almost 13%, OPAP's revenues have contracted only 2–3%. Meanwhile, operating income has barely budged. For an investment where downside protection is of particular concern, low operating leverage is a wonderful attribute.

Valuation. Due to these characteristics, not only is OPAP well insulated from capital market disruptions and macroeconomic distress in Greece, but its value lends itself particularly well to measurement. A wide margin of estimation error is obviously anathema to sound valuation; and in OPAP's case, the relevant valuation inputs are subject to less error than usual. Accordingly, I am valuing the company off of a €900 million operating income run rate, with 8.0x EV/EBIT as a base-case multiple.

The choice of multiple has several anchors. First, publicly traded bookmakers in far more competitive markets (e.g. Ladbrokes, William Hill) trade around 8.0x EV/EBIT. Second, the implied P/E ratio of 12x implies an earnings yield of 8.5%, which, given that OPAP pays out most of its earnings, approximates the cash yield on the stock. And in a normal state of the world, large investors ought to be happy to take an 8% dividend yield from a company as profitable and stable as OPAP.

	Bear	Base	Bull
EV/EBIT multiple	6.0x	8.0x	10.0x
x operating income	€ 900	€ 900	€ 900
Enterprise value	€ 5,400	€ 7,200	€ 9,000
Plus: net cash	€ 700	€ 700	€ 700
Equity value	€ 6,100	€ 7,900	€ 9,700
÷ shares	319.0	319.0	319.0
Value per share	€ 19	€ 25	€ 30
Implied P/E (ex cash)	9.0x	12.0x	15.0x
Normalized dividend yield	10%	8%	6%
Implied upside	28%	68%	104%

Additional Considerations. There is plenty of reason to believe that OPAP's €900 million operating income run rate will continue to grow. First, Greece is legalizing online betting—reportedly a €2 billion unregulated market—which will allow OPAP to recapture some share from the black market. Second, OPAP is launching new games including virtual horseracing and live betting. Third, Greece is in the process of legalizing video lottery terminals, which OPAP is the only logical player to operate on a large scale. OPAP will likely not be the only operator of VLTs, but thanks to its existing infrastructure and strong gaming-related store traffic, it should capture the bulk of this new market.

Risks

Online bookmakers. OPAP pays out about 70% of amounts wagered on sports betting. Online bookmakers operating in Greece illegally pay out over 90%. The bear case is that OPAP is losing share to online. However, if OPAP's inferior pricing were really important, we would expect to see it hemorrhaging sales in its bookmaking business. It has not done so. And while internet penetration rates in Greece are lower than the European average (46% vs. 58%), even in sophisticated markets like the UK, a healthy bricks-and-mortar bookmaking industry—with lower payouts than online—continues to thrive.

Euro exposure. It is natural to think about hedging one's Euro exposure in the context of this investment. However, if there exist long-term, high return investment opportunities denominated in euros, then having overpaid slightly for the euro will become less and less important a component of one's annualized return as the holding period grows longer and longer. Moreover, on the scenario that OPAP stock appreciates and the euro collapses, the euro-denominated opportunity set available to value investors would likely be very good: after all, this would be a distressed environment *ex hypothesi*; so it could be desirable to sell OPAP and buy into new euro-denominated, high-return opportunities.

Greece leaves the Eurozone. First, given the upside potential (and the "get-paid-while-you-wait" feature of the investment), I believe we are well compensated for this risk. Second, the relative cost to its neighbors of keeping Greece on life support (indefinitely, even) versus the consequences of the Euro experiment being declared a failure does not argue in favor of Greece abandoning the Euro.

"OPAP's revenues are remarkably stable, no doubt thanks in part to the habitual nature of gambling generally. Even in the crisis environment of the past two years, when unemployment has risen from 9% to almost 13%, OPAP's revenues have contracted only 2–3%."

Iridium Communications, Inc. (Short)

Patrick Sullivan
psullivan11@gsb.columbia.edu

Iridium Communications, Inc.
(NASD: IRDM)
Price: $8.02
(January 28, 2011)

Patrick is a second year MBA student participating in the Applied Value Investing Program. While at school, he has worked at two value-oriented hedge funds. Prior to enrolling at Columbia Business School, he spent three years at a $2 billion private equity firm focused on the aerospace, defense and government services markets. He also spent two years as an investment banking analyst. Patrick holds a BS from Vanderbilt University.

Patrick was awarded 2nd place at the Moon Lee Prize Competition for his pitch on Iridium.

Current Capitalization and Trading Statistics		Performance and Valuation Multiples	
Ticker	IRDM	2010E Revenue	$351.3
Date	1/28/11	2010E EBITDA	156.4
Share Price	**$8.02**		
x Fully Diluted Shares Outstanding (1)	71.99	2011E Revenue	$342.1
= Market Capitalization	**$577.4**	*% Growth*	*-2.6%*
- Cash & Short Term Investments	104.6	2011E EBITDA	161.6
+ Total Debt (2)	135.1	Stock 52-Week Range	$6.27-$11.13
= Total Enterprise Value (TEV)	**$607.8**	Average Daily Volume (in millions)	0.41
+ Debt to be Funded (3)	1,800.0	Float	52.8%
Enterprise Value Incl. Net Debt to be Funded (3)	**$2,407.8**	Short Interest	12.4%
Multiples Incl. Debt to be Funded:		**Consensus Multiples:**	
EV / 2010E Revenue	6.9x	EV / 2010E Revenue	1.7x
EV / 2011E Revenue	7.0x	EV / 2011E Revenue	1.8x
EV / 2010E EBITDA	**15.4x**	EV / 2010E EBITDA	3.9x
EV / 2011E EBITDA	**14.9x**	EV / 2011E EBITDA	3.3x

(1) Fully diluted for all outstanding warrants and options assuming the Treasury Stock Method. (2) As of October 29, 2010.
(3) Management has funded NEXT with a delayed draw Credit Facility in the amount of $1.8 billion (cash on hand and future FCF will be used to fund the satellites as well per Management plan).
(4) Normalized capex calculated as $3 billion of capex required to fund and replace satellites every 15 years.

Investment Thesis: Iridium ("IRDM" or the "Company") represents an attractive structural short investment with numerous identifiable catalysts. Iridium has announced plans to spend approximately $3 billion on Iridium NEXT, the Company's next generation satellite constellation. Importantly, the investment in Iridium NEXT is required as IRDM's current satellite constellation is approaching its end of life (and was designed with an initial end of life in 2008 per IRDM's original IPO prospectus). I believe Iridium's plan to borrow at least $1.8 billion (12x 2010E EBITDA) coupled with increasing competition in an already challenged industry will likely result in Iridium entering a "Chapter 22" restructuring (Chapter 11 restructuring was accomplished following the $5 billion investment and launch of the current satellite constellation in the late 1990s). Every industry player has been through at least one Chapter 11 restructuring, yet no capacity has been rationalized. IRDM is following a well-traveled path of investing huge amounts of capital while destroying all equity value for shareholders.

Given the 12-15 year finite life of Iridium NEXT, IRDM needs to generate $200 - $250 million in average annual FCF over the satellite's useful life just to break even on the satellites (even before earning any return on the invested capital). Iridium is projected to generate approximately $120 million of FCF in FY 2010. Based on my research and discussions with numerous retail vendors, mobile satellite phone users, Iridium's #2 customer (~10% of total Revenue), Iridium's primary competitors, and numerous industry experts, I expect Iridium's EBITDA growth to be to flat / negative over the next 5-10 years (and assign a near 0% probability to IRDM's ability to earn a return on the $3 billion investment in Iridium NEXT above their cost of capital).

Company Overview and Background – Iridium is the second largest wholesale provider of mobile voice and data communications via satellites (second to Inmarsat; LSE: ISAT). End-users include governments (~22% of total Revenue), commercial users (maritime, oil and gas exploration companies, hospitals, etc) and recreational users. IRDM was acquired by a Greenhill sponsored SPAC in 2009.

Summary Financial Projections

	2007A	2008A	2009A	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Revenue										
Consensus / Bull Case	$260.9	$320.9	$318.9	$351.0	$375.7	$386.2	$419.8	$458.3	$500.8	$549.7
Base Case	$260.9	$320.9	$318.9	$351.0	$342.1	$337.7	$345.2	$353.4	$362.9	$373.5
EBITDA - Maintenance Capex										
Consensus / Bull Case	($123.8)	($91.8)	($76.9)	($43.6)	($15.1)	$1.5	$28.0	$58.9	$93.3	$133.5
Base Case	($123.8)	($91.8)	($76.9)	($43.6)	($38.4)	($39.7)	($38.3)	($36.3)	($33.7)	($30.3)
Leverage (Net Debt / EBITDA)										
Consensus / Bull Case				1.0x	1.8x	3.0x	3.7x	4.4x	5.0x	4.7x
Base Case				1.0x	2.1x	4.0x	5.9x	8.1x	10.8x	12.0x

The "Bull" Case – The bull case is predicated on IRDM holding a monopoly position that will enable the Company to grow EBITDA 15%+ for the next 20 years. However, IRDM is fully valued today (at 16x "Bull Case" 2016E EBITDA-Maintenance Capex) even if IRDM can increase EBITDA from $156M in 2010E to $333M in 2016E . Based on my research, I believe the Company will be 12x levered and unable to meet the $257 million mandatory principal payments plus ~$100 million in interest expense beginning in 2017. After careful analysis and consideration of the "Bull Case," I believe the bull investment thesis is predicated on at least 7 investment "myths."

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Iridium Communications (Continued from previous page)

Myth #1: Iridium is the Dominant Market Player with Limited Competition – Iridium has operated as the monopolist player in the MSS voice market for the past 3-4 years and has consequently enjoyed pricing power and subscriber growth. Importantly, Iridium's monopoly power was created as a result of the failure of Globalstar's satellites and Inmarsat's competitive decision not to enter the North American MSS voice market prior to 2010 – not Iridium's superior business model.

With the entry of Inmarsat's IsatPhone in June 2010 and the recent launch of Globalstar's new satellite constellation (October 2010), Iridium's monopoly position has ended. The increased competition will have a material negative impact on IRDM over the coming 3-5 years, during a period in which IRDM is relying on an increase in cash flow to fund NEXT.

- **Inmarsat** – Inmarsat entered the North American MSS voice market in June 2010 (IsatPhone Pro).

  Half the Price – Inmarsat's phone is priced at $500-$600 to end users vs. Iridium's 9555 Satellite Phone, which is priced at $1,249 for the basic phone. Inmarasat's monthly service is $15 per month plus $0.99 per minute of usage (vs. Iridium's $39.99 per month plus $1.39 per minute).

  Plus: Comparable Service – Inmarsat and Iridium provide comparable service to ~95% of the potential market. Inmarsat only lacks coverage in the Polar Regions, a service area that very few users require.

  Equals: A Superior Value Proposition for Inmarsat: Based on conversations with numerous satellite phone retailers and the largest Value Added Reseller of MSS phones and services, the IsatPhone has been very well received by the market. Representative comments / data points are below:

  - "The initial response to the IsatPhone has been more positive than expected."
  - "IsatPhone orders are pouring in, and I am currently backordered."
  - "IRDM currently represents about 65-70% of our total sales vs. ~100% previously."
  - "Inmarsat has the long-term competitive advantage in term of both price and scale."
- **Globalstar and Terrrestar** – Globalstar has invested $1.3 billion in its next generation satellites and launched 6 new satellites in 2010 (18 scheduled in 2011). TerreStar has partnered with AT&T and entered the market in 2010 as well. Terrestar is currently operating under in Chapter 11 protection.

Facts: (1) Iridium's monopoly position has ended. (2) Iridium must grow CFO at least 10% per year over the next 20 years in order to earn a return on capital above the Company's cost of capital. I believe the current competitive dynamics make this very difficult.

Myth #2: Strong Industry Growth – Iridium grew commercial voice subs at a 16.5% CAGR from 2007–9/30/10 vs. a 5.5% CAGR for the MSS market (due to market share gains). However, the total dollar value of the Commercial voice market declined from 2007-2010 as ARPU declines outpaced sub growth.

Myth #3: IRDM's Equipment Margins are Sustainable – Approximately 25% of Iridium's FY 2010E Operational EBITDA is expected to come from profits on equipment sales. In order to remain competitive with Inmarsat's phones priced at $500-$600 to the end user (vs. $1,295 for Iridum's phone), Iridium will likely be forced to reduce its hardware prices. Inmarsat sells their hardware at costs (vs. Iridium's 40%+ margins on equipment). Iridium also announced in December that they expect equipment revenue to decline 15-30% in 2011.

Myth #4: Iridium NEXT is Fully Funded – Iridium secured $1.8 billion in debt financing through a debt facility guaranteed by COFACE, the French export credit agency (avg. interest rate of 4.5% and will be repaid over 7 years beginning in 2017). The remaining $1.2 billion is dependant on cash flow from operations, warrant proceeds (2/3 of which are struck at $11.50 per share, a 43% premium), and hosted payloads.

Myth #5: Iridium will Generate High Returns on Capital From the NEXT Investment
Facts: The current operations ($120 million of FCF) cannot support a $3 billion investment for satellites with a useful life of 12-15 years. In the unlikely scenario that IRDM can grow FCF by 10% per year through 2030, IRDM will generate a modest 17.9% ROIC (relative to high risk proposition of building and launching satellites).

Myth #6: The $3 billion of capex to be spent over the next 4-5 years is growth capex
Fact: IRDM must replace its satellite constellation every 12-15 years (or $200 of annual maintenance capex).

Myth #7: Spectrum Value – Iridium holds licenses to use 8.725 MHz of continuous spectrum in the L-Band. Fact: At $0.50 MHz POP, Iridium's spectrum would be worth ~$1.2 billion, still much less than the Company's future net debt levels. NEXT satellites will also only support data speeds of up to 128 kbps to mobile phones (4G data speeds are over 20x faster).

Potential Catalysts – (1) Leverage becomes visible on a reported basis as IRDM borrows $1.8 billion and will not generate any FCF until the satellites are launched in 2017; (2) Growth slows / earnings miss in 2011 will force the sell-side and investors to extrapolate a slower growth rate (and acknowledge the resulting liquidity problems); (3) Liquidity constraints in 2017 as the Company has to make $257 million in principal payments per year plus $80-$100 million of interest expense; (4) Expiration of lockup period as 50% of the Company's shares outstanding were encumbered by a lockup that expired 9/29/10 (including 30% of shares held by shareholders who invested in 2000 following the Chapter 11 reorganization); and (5) a possible satellite failure as the current constellation was designed to last through 2008.

Investment Risks – (1) There is no current cost to borrow IRDM shares, but the 12.4% short interest poses a potential risk to the short investment; (2) Insider buying - Scott Bok (Greenhill CEO) has purchased $7.8 million of IRDM shares since June 2009. Although clearly concerning, he received cash compensation of $43.7 million from 2005 – 2009 in addition to total GHL stock sales of approximately $110 million since 2005.

"With the entry of Inmarsat's IsatPhone in June 2010 and the recent launch of Globalstar's new satellite constellation (October 2010), Iridium's monopoly position has ended... during a period in which IRDM is relying on an increase in cash flow to fund NEXT."

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"I began to learn about value investing and attended the two day value-investing course taught by Bruce Greenwald. I realized that while I knew a lot, there was a lot more that I didn't know and decided to go back to business school..."

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to financial statements and financial information and was always interested in investing, although upon graduating from college, my path was predetermined. I went into our family business which operated convenience stores and truck stops throughout the Southeast. I worked in that business for twenty-plus years, but was always investing on my own and eventually I decided that I wanted to do something else with the rest of my life. I guess you could say I retired, although I was too young to retire.

I began to learn about value investing and attended the two day value-investing course taught by Bruce Greenwald. I realized that while I knew a lot, there was a lot more that I didn't know and decided to go back to business school to get the formal training that I could couple with my business experience to help me become a better investor. Warren Buffett often says, "I am a better businessman because I am an investor and I am a better investor because I am a businessman." I think of myself as a businessman who has transitioned into being a professional investor.

I applied to Columbia because it is the birthplace of value investing. In my business life, we were value investors. We didn't know how much we could sell our business for. We really didn't really care. There wasn't an active market for the business. We concentrated on operating efficiency and cash flow. We wanted to know how much cash we had at the end of the year, and how much cash we had to reinvest to maintain our competitive situation, and if it was wise to deploy cash into new markets, which were new locations. We managed for cash flow, period. I took that mindset as I went into business school and have kept it as an investor.

G&D: Jenny, how did you find the calling to value investing?

Jennifer Wallace (JW): I am a graduate of the first value-investing class that was offered when Professor Greenwald reintroduced it. Several people have said, you either get value investing in the first five minutes or you never do and I think that is right. I absorbed the concepts that Bruce taught and I read Seth Klarman's book *Margin of Safety* and then never looked back.

After graduating from business school, I joined McKinsey & Company, Inc. I knew that ultimately I wanted to end up as an investor, and I spent a few years gaining hands-on business experience as a consultant to complement the investment training I received at Columbia. I left McKinsey when I was introduced to Bob Bruce, who became my mentor, and we managed money for members of the Bass family. In Artie's case, he ran a business and then went back to business school. I went to business school and then decided to work inside some businesses before migrating to investing. I had known Artie through our association with Columbia Business School and when Bob decided it was time for him to retire, Artie and I decided to start our partnership.

G&D: How did your experience working with Bob Bruce influence your investment approach?

JW: My first day on the job, Bob put me in an office without a computer, Bloomberg, or phone. I had nothing but a big desk and a stack of Value Line reports. He told me not to come out until I had found a couple of good businesses to talk about. Bob taught me to focus on a company's financial characteristics to determine whether it was a high quality business. It may sound obvious, but many people focus on stories and short-term price movements instead of fundamental financial information when judging a company. Bob also taught me about the risks of illiquidity and the perils of getting stuck in a value trap of a low priced, low quality business—that there is usually no price low enough to justify buying an overly leveraged or low-

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margin business. While working with Bob I learned that successful investing boils down to answering two basic questions: "Is this a good business?" and "Is it trading at a discount to what it is worth?" And those are the two questions that we seek to answer each day.

I had been an investment banker in the late 1980s and started investing around the time of the Asian meltdown and Russian debt crisis and then the dot-com buildup and subsequent bust. Going through periods when value was recognized in the market and when value was ignored, and seeing how the financial markets can move and react has shaped my thinking about investing. These experiences have reinforced for me the importance of consistency in a research and investment process and to not let the short term whims and fluctuations of the market throw you off. The challenge in investing is that decisions are not black or white. There is always a tradeoff between price and quality and we have constructed our process to help us weigh that tradeoff.

AW: You can't determine what value to put on a business unless you know the quality of the business. Higher quality businesses are worth more than the lower quality businesses. The two are really intertwined. Buffett says value and growth are joined at the hip; we agree and add that the quality component is an important element of value.

"Going through periods when value was recognized in the market and when value was ignored, and seeing how the financial markets can move and react has shaped my thinking about investing."

G&D: Judd, you co-authored a book with Professor Greenwald.

Judd Kahn (JK): I came to the investing business through my academic connections to Bruce Greenwald. He and I were colleagues in the 1970s at Wesleyan University and after Bruce had moved to Columbia Business School, we began collaborating on a corporate finance textbook. During the course of that project, there was a write-up in the *New York Times* about the two-day Value Investing seminar that he taught and that small article led to phone calls from three publishers. By the following week, we had put aside the corporate finance book and began writing *Value Investing from Graham to Buffett and Beyond*. We followed it later with *Competition Demystified* and then *Globalization*. So my introduction to Artie and Jenny was through Bruce and the work that we did together on those books.

G&D: Can you tell us a little bit about Summit Street?

JW: We invest in well-capitalized, high-quality companies when they are available at attractive prices. We look for mispricings across a wide universe of stocks and then, drawing on our investment and business experience, we try to determine whether the market is offering us a genuinely attractive investment opportunity or just a stock that is deservedly cheap.

We are active managers in the classic stock-picking sense of the word. We do not construct our portfolios to match the sector alloca-

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tions of an index. Rather we look at every potential investment on its individual merits and own the stocks that we believe offer the highest sustainable quality at the most attractive valuations.

JK: Equities have traditionally played an important role in the total return expectation of most investment portfolios. The question now is how best to get those returns. Over the long bull market that began 1982 and ended in 2000, the S&P 500 index compounded at over 16% a year and a raft of academic and popular literature argued that markets are efficient. During this time, individual stock selection came to be seen as both pointless and expensive and investors were lulled into believing they could capture high equity returns by simply owning index funds. That strategy fell apart over the next ten years when people were burned by owning "the market" as a whole as the S&P 500 had negative returns over the decade of the 2000s.

Our clients get the equity returns they require without exposing themselves to owning the whole market.

G&D: Your fund is defined by a process. Can you give us an overview of what the process is?

JW: Conceptually, our investment process is the melding of business fundamentals into a financial and valuation framework. We refined our investment methodology and process based on our business and investing experiences as well as our own (primary) research and other published secondary research. We begin by identifying the characteristics we want in our investments and we evaluate companies in a disciplined and comprehensive way to make choices along the continuums of business quality and attractiveness of valuation.

"Conceptually, our investment process is the melding of business fundamentals into a financial and valuation framework."

AW: We have fundamental and pricing data on over twelve thousand companies that we receive daily. Right off the bat, we eliminate about nine thousand companies from our investment universe as either too small or too illiquid. Out of the remaining three thousand companies, there are roughly fourteen to fifteen hundred that we would not own at any price because the companies do not have sufficient financial strength or a history of profitability. So we eliminate those as well, which leaves roughly fifteen hundred companies, many of which we would be willing to own at the right price. And these we rank from one to fifteen hundred, based on valuation and sustainable profitability. In that group you have great businesses at good prices and good businesses at great prices, and our evaluation reflects both aspects.

JW: It is worth pointing out that we invest alongside our clients. Therefore, we are interested in absolute returns and we think very carefully about capital preservation. What that means in practice is that we are discriminating about the investments we make and we will hold cash when we do not find enough sufficiently attractive investment opportunities.

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G&D: What are some of the characteristics you look for?

JK: We need to see strong balance sheets, a history of adequate returns on capital, and sufficient size and trading liquidity to be able to get in and get out of a position. After we have confirmed that our minimum requirements for these characteristics are met, we are willing to invest across all capitalization sizes if the price/quality tradeoff is right. The mid-cap space usually presents us with more opportunities than others, but we own small and large cap names as well. We invest where we find the value.

G&D: So you have touched on the quality of the business. Now, from a valuation standpoint, what are some of the main criteria that you use to evaluate companies?

JW: The measure that we find to be most useful for assessing valuation is what we call "demonstrated earnings yield," which is normalized cash earnings divided by enterprise value.

AW: The reason we use enterprise value is that it allows you to compare companies with different capital structures, and it also answers a question that a strategic buyer would ask—if you bought this company in its entirety, what would you pay? You would buy the entire capital structure. You would buy the equity, you would buy the debt, and you would own the cash and the other assets.

G&D: How do you normalize earnings?

JW: We normalize over several years. We start with a simple average and then make adjustments in order to estimate the normal earnings power of a company. This is very similar to the methodology advocated by Bruce and Judd in their book. Normalizing does two things from an investing standpoint. First, it allows us to identify companies that might be trading at a high multiple of current earnings but at a low multiple of normalized earnings. By doing this, we identify prospective investments that may be temporarily under-earning their norm, and our job then is to determine the probability that they will earn something close to normal again. The other benefit of normalization is that it helps us to avoid companies that might be at peak earnings, unsustainable in the future at that level, but which look cheap relative to recent earnings. By normalizing the earnings, you see that some of these companies are not interesting from an investment standpoint. In our experience, failing to adjust for a company's normal earnings power can lead to mistakes on both ends, ignoring some stocks that deserve investment consideration and including some that don't.

AW: We calculate normalized earnings in a consistent way for all the stocks that we evaluate. If a company looks potentially interesting to us based on this first pass valuation, we then look at it in greater detail. So when we start our company-specific research, we already have a pretty good idea why it may be an attractive investment. But we don't take the initial calculation at face value. We adjust for any nonrecurring events that may be skewing the numbers. And then after we make the adjustments if it still looks interesting, we determine whether the revenues and margins are defensible. So our normalization process has three steps, history, history adjusted, and estimates going forward.

G&D: You are touching upon the fact that reported GAAP financial statements often do not reflect the economic earnings power of the company.

JW: We focus on operating cash flow as opposed to GAAP earnings. We start with published financial statements, and then we make systematic and company-specific adjustments to understand each unique situation. Obviously there are strengths and weaknesses to any method of evalua-

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"The measure that we find to be most useful for assessing valuation is what we call "demonstrated earnings yield," which is normalized cash earnings divided by enterprise value."

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tion, whether it is earnings, book value, cash flow, etc. It is old news to talk about the ways that management teams can inflate GAAP earnings. For this and other reasons, we find operating earnings more useful than net. Given current accounting standards regarding impairment tests and write-offs, book value has also become more of a moving target and is less stable than it once was. Also, it doesn't capture the potential value of investments in R&D, customer relations, or other expensed items that are essential to the valuation of service businesses. In our experience, the cash generating history and future potential of a company is the best indicator of value. We do make adjustments, but we begin with reported financials.

G&D: So part of your research process is determining whether that normalized earnings power is sustainable. In a way, are you forecasting the future earnings power as well based on your qualitative assessment?

AW: Yes, to some degree we are, but we have not found that building ten-year DCF's down to three decimal points is ever very helpful in developing our investment theses. Our primary focus is on what a company has earned in the past, and when making investment decisions we rely on whether we believe a company can return in the next few years to a demonstrated level of earnings, or whether the market may have correctly identified a likely future decline but perhaps over-penalized a company's valuation. We buy at a significant discount to normalized earnings, and if we get it right and the earnings do recover, we know that the stock price will follow and that the investment will probably work out well for us.

"We buy at a significant discount to normalized earnings, and if we get it right and the earnings do recover, we know that the stock price will follow and that the investment will probably work out well for us."

JW: Because investing is about looking forward not backward, all investors make forecasts. We use past demonstrated performance as the starting point to inform our judgments about the future. Our research process is like a sieve with increasingly finer gradations on the mesh. The initial cut is a systematic, comprehensive fundamental look at the universe by which we weed out companies that we do not want to own. Then, on the remaining companies, our next pass is an evaluation to assess valuation and quality. If after that, we become interested in a particular company, we do more research.

In the course of our company-specific research we focus on three questions. First, are the numbers right? That is, is there anything misleading in the history that is like a mirage, making the company look on first blush like a good potential investment, but maybe not. For example, one company we looked at recently had significant liabilities that were not reflected on the balance sheet. Based on the company's financial statements, enterprise value looked low, but once the liabilities disclosed in the footnotes were added, in

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fact it was much less attractive—it had a much higher valuation.

Second, are the demonstrated earnings sustainable? Is it likely that recent earnings will recover to a past level, or is a company temporarily over-earning and therefore not a bargain? We are looking at the fundamentals, and that is when we construct our model. We look two to three years out—no more. Our decisions are based on rational, business judgments about the future for a company. Is the company trading at a discount to its fundamental value based on its likely earnings power?

Third, are there potential problems we call the "unquantifiables?" I always joke about Murphy's Law as it applies to investing - everything that can go wrong will go wrong with a stock, most likely the day after you buy it. So we try to minimize that. We look at governance, ownership structure, historical capital allocations, and management incentives. Anything that could be a barrier to value realization increases the risk with an investment. Depending on how serious, it may be a good reason not to invest in an otherwise attractive opportunity.

AW: We buy stocks when they are undervalued but after we own them, we obviously want that value-gap to close. As you know, for value names to become fairly priced, either there has to be a change of perception in the market or some sort of outside force comes in, an activist investor, or strategic partner, or a financial buyer. We do not necessarily invest with the expectation that this will happen, but it is one way that value can be unlocked. If there are significant impediments to any method of value realization, we won't invest. We want low bars. We want companies that have demonstrated profitability, that are trading at attractive valuations and if the market doesn't recognize the intrinsic value, we want the bar low enough so that somebody else can come in and unlock it.

"We look at governance, ownership structure, historical capital allocations, and management incentives. Anything that could be a barrier to value realization increases the risk with an investment."

G&D: You have mentioned financial strength several times. Specifically what do you mean when you say you like financially strong companies?

AW: We like companies with low or no debt and excess cash because that gives them strategic flexibility and the wherewithal to withstand a temporary downturn. They can run their businesses without worrying about meeting payroll, they can return cash to shareholders, or they can reinvest for growth. The strategic options created by the presence of excess cash add to our margin of safety in an investment. This is how we ran our family business and I think most well-run companies operate for long-term financial stability as well.

JW: Many of our companies do generate excess cash and have meaningful accumulations of cash on their balance sheets. It is worth noting that capital allocation risk is a risk that goes along with investing in cash-rich

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companies. As Artie says, it can add to our margin of safety but that is only if the management team uses the cash wisely. We look quite carefully at the capital allocation decisions the management team has made. We like to see a documented history of wise decisions. Conversely, big expenditures on questionable projects turn us off.

G&D: One thing you touched upon is the tradeoff between price and quality. There are great businesses at a good price, and there are good businesses at a great price and everything in between. After all the quantitative work is done, how do you make that tradeoff?

JK: Actually, we make this trade off in a systematic fashion as part of our quantitative work and rankings. This allows us to objectively compare apples and oranges. We then focus our company-specific research on the situations that we think offer us the best combination of low price and high quality. In practice, we screen out low quality stocks right from the start. So even though we weigh valuation more heavily than quality, in some ways it's almost equal, not mathematically, but conceptually, because the pool in which we are looking already consists of high quality companies. The names we own are in the top three-to-five% of all companies that we evaluate.

G&D: The initial part of your process is designed to eliminate many of the emotional or distracting behavioral patterns exhibited by investors, but there is a step later on where you reintroduce your human element. How do you compensate for your personal biases?

"We track every name that we look at, whether we buy it or not. For the names that we research but don't buy, we keep a record of the specific reasons we passed."

JW: As you point out, our process is designed to counteract the detrimental effects of behavioral biases whether stemming from human nature or personal experience. We cast a wide and unbiased net and look at all companies in an objective and systematic way. One of the many virtues of a good partnership and a comprehensive and consistent process is that they act as helpful counterbalances to preconceptions and subjective judgments. For example there are certain companies and industries that based on prior experience each of us is predisposed against. But we know the financial characteristics that we are looking for and we respect the story that is told in a company's documented financial performance. Every company that hits our radar is subject to the same kind of research. Are the numbers right? Is there a reason to expect sustained profitability? What are the barriers to value realization? That is a long answer to a tough question. Maybe a better (and shorter) answer is that we compensate by being aware. It is certainly not easy or cut and dried, but I do believe that being aware of potential risks goes a long way to helping protect against them.

AW: Incidentally, we track every name that we look at, whether we buy it or not. For the names that we research but don't buy, we keep a record of the specific reasons we passed. We obviously know the outcomes for the names that we own, and we look at

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those—both the successes and failures. We also keep records of whether there was something that we missed that we should have known. Sometimes things happen that are outside of your control, but what we are most concerned with is making sure that in the course of our research process we stay focused on the things that matter.

JW: As Artie says, we do behavioral documentation every day. And in our company-specific research which is the step that I think you are specifically asking about, we try to be very clear in the distinction between business judgments based on numbers and evidence versus gut reactions. An example of this kind of judgment-based decisions is some work we did looking at a company that makes H1N1 vaccines. The company has had terrific earnings over the past couple of years which is not surprising in light of the 2009/2010 swine flu outbreak when demand was high and the company was operating at full capacity. When it hit our watch list, the stock was trading at a very low multiple of its recent earnings. But when we haircut next year's earnings to reflect the significantly lower demand that the company was projecting, it was just not cheap enough to be an attractive investment. We are making business judgments about the probabilities of various likely outcomes. We are not in the business of making emotional decisions.

G&D: You talk about quantitative analysis – would you say you are 'quant' investors?

JW: No, we would not characterize ourselves as quants in any way. People talk about black boxes and I have also heard people talking about glass boxes (meaning they can see how a model works). But these descriptions do not apply to us. We are fundamental value investors and we use technology to help us be more efficient in finding the kind of investments that we like. Some people have asked if we are afraid that we miss things because of the systematic nature of our search approach. In my experience, everyone in this business starts with a search strategy that includes some things and excludes others. There is a limit to the number of things one can look at. Time is the biggest constraint facing all investors. Our search strategy reduces down to a set of sensible ways to eliminate companies that do not meet our basic threshold and then to evaluate those that do. It is a powerful first step. Some investors start by looking at events or catalysts that might cause a stock to become mispriced. We cut right to the chase and look for actual mispricings first, and then do our research to determine if the mispricing is genuine. Our process allows us to be very effective at finding a host of opportunities, and applying our capital and our client's capital towards the most attractive ones available.

G&D: Would you mind elaborating a bit on what you see as the major source of your investment returns and perhaps tell us about a specific investment you've made?

JW: Our investment returns come from a combination of three things. The first is, the "trend reversion of earnings". We have found that the earnings of cash generating, financially strong companies are powerfully trend reverting. A company may temporarily under-earn its historic norm, or have a blip and then go back to a steady industry rate of return. In many cases, the market suddenly realizes that the company will eventually be earning closer to its norm and the valuation gap closes before the earnings actually improve. That's a very powerful double effect, where you see earnings improving and valuation expanding at the same time.

The second source of our investment returns is the "mean reversion of multiples." We have found that companies which are trading at low valuations relative to a sustainable earnings level are likely to see their multiple recover. Typically, this is

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"In many cases, the market suddenly realizes that the company will eventually be earning closer to its norm and the valuation gap closes before the earnings actually improve. That's a very powerful double effect, where you see earnings improving and valuation expanding at the same time."

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a situation where a company is being priced at a very low multiple relative to its current earnings because the market doesn't believe that those earnings will be sustained. So our job is to figure out whether these earnings are likely to continue. Are they being fairly penalized? Perhaps earnings will decline, but will they fall as much as the market is expecting?

The third source of our investment returns come from the "high grading" of the quality of our portfolio companies. The quality overlay adds meaningfully to returns because by avoiding losers we improve overall results. This final point is very important from a capital preservation standpoint.

An example of a high quality company whose valuation we believed would recover is Research in Motion, the maker of BlackBerry handheld devices. In late September 2010, RIMM's price essentially reflected the market view that it was a declining business and that it could not sustain its past earnings level. Here was a company that consistently has earned high 20s to low 30s% return on equity. It had 5% of its market cap in cash and generated nearly $8B in free cash over the past 4 years trading at an enterprise value of 6x normalized earnings, which is a 16% demonstrated earnings yield. At 2.5x book, we were essentially offered the opportunity to invest for north of 13% on our equity. The market was saying that current earnings were not sustainable, but on the surface the numbers were very interesting to us. After doing our research we concluded that at $47 with almost $3 per share of cash, not very many things had to go right for RIMM for the investment to work out well for us.

"An example of a high quality company whose valuation we believed would recover is Research in Motion, the maker of BlackBerry handheld devices."

AW: In fact, we thought that a lot had to go wrong to justify the then current valuation.

G&D: Were there any specific expectations that the market had which you disagreed with, or was there just a lot of negativity already priced in?

AW: Both. It appears that the market is fixated on RIMM losing market share, but the pie itself is growing, and that is something we focused on. RIMM may be losing some share, but I would rather have 20% of a large and growing market than 50% of a small and stagnant one. The really good part of RIMM's business is the Enterprise business where it has security advantages that have allowed it to keep its grip on the Enterprise. The story has been that the iPhone and the Google OS Android will meaningfully encroach on RIMM's share in the Enterprise but we see that part of their business as potentially more defensible. International growth is accelerating and Enterprise is not dead.

JW: An interesting point is that RIMM is selling more Blackberry devices worldwide today by orders of magnitude than it was before the iPhone was introduced.

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Then there's the notion of bandwidth capacity limitations for wireless providers. RIMM has a proprietary ability to compress data so that is very efficient for the providers to transmit. Companies that do not have this compression technology use more bandwidth to transmit the same information. For years this has been part of many bull scenarios for RIMM but it has not materialized as a quantifiable economic benefit. Maybe that's because there has been no shortage of bandwidth. But we are now approaching some real capacity limitations. There is talk about who should pay the price for bandwidth-use and by extension, who can secure the benefit of efficiency. If any of this materializes into an actual economic story, one of the key beneficiaries should be RIMM. I can't tell you what that would be worth in terms of RIMM's stock price; it is one of several good things that could line up for RIMM. By our analysis, more negativity and bad news, and more earnings degradation was priced into the stock at $47 than was justified.

G&D: What would make you think about selling a company like that?

JW: We think RIMM is still attractive, though obviously less so above $60 than it was at $47. We are happy to own it as long as the fundamentals of our investment thesis are still in place. Generally we expect to hold our positions for a year or more, but sometimes prices appreciate quickly and a stock approaches our estimate of intrinsic value sooner than that. In that case, of course we sell.

"Generally we expect to hold our positions for a year or more, but sometimes prices appreciate quickly and a stock approaches our estimate of intrinsic value sooner than that. In that case, of course we sell."

G&D: Talking about selling, do you have specific sell rules?

AW: As Jenny said, we sell when a stock's price reaches our estimate of its value. We also have position limits and we trim names that hit those limits. As we have described, we buy companies with a specific financial profile but sometimes due to a corporate action the financial characteristics change such that the company no longer meets our desired profile. For example, a company with excess cash on its balance sheet may announce that it's going to spend the cash and take on debt to make an acquisition. In this kind of situation, we will typically sell. Additionally, there are times when we uncover material new information about a company that we own - this requires new analysis and may lead us to sell. We also have a fair number of companies that get acquired. We're not in merger arbitrage though, so when a company we own announces that its board has approved a sale we generally look to redeploy the funds. The final reason that we sell, which is the hardest one to explain, is if there are better opportunities. Because we have the benefit of the first step of our research in which we look at all companies with the same disciplined evaluation of valuation and quality, we have an objective way of comparing what is available in the market against the stocks in our portfolio.

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G&D: Do you want to walk through another example?

JW: Sure—we can talk about King Pharmaceuticals. It was recently acquired but it is a good example of a company we bought because we expected its earnings and its valuation to recover. KG has an excellent franchise in pain medications but its sales were under pressure and it was earning less than it had in prior years because of increasing generic competition. As a result, it was trading at a low multiple of demonstrated earnings, but at a higher multiple of last year's earnings. So KG hit our interest-list because of our normalization process, when it might not have if we were looking only at trailing twelve-month results. The company had a pipeline of potential drugs leveraging off of their pain franchise, many of which are near approval.

When we bought it, it was trading at 10x free cash, and with a 20% demonstrated earnings yield, meaning an enterprise value of 5x normalized cash earnings. We paid about $10 per share for it in April, and in October Pfizer announced that they were buying it at a 40% premium. We did not invest expecting a takeover, but rather we were willing to bet on the likelihood that the company's earnings would recover if one or two of the many drugs in its pipeline were approved. This is the kind of situation where, because of our normalizing and our research to determine whether normal was a reasonable expectation, we see things that a strategic buyer may also find quite attractive.

"Having a longer term focus is a big advantage. Rather than obsessing about whether a company is going to make its next quarterly numbers, we look at what a business does in a normal environment."

G&D: Did you have a view on what would cause it to get back to normal.

JW: They had a deep pipeline of potential new drugs – we were getting current (albeit declining) earnings at a very low price and essentially any new drugs for almost nothing.

AW: There are very few people with a consistent long-term record in accurately predicting the future and we have a healthy dose of realism about our ability on that score as well. Meaning, we do not presume to have a crystal ball and therefore are cautious about investing on the basis of a multi-step, catalyst-by-catalyst timeline. Instead, we try to eliminate as many potential risks up front, and then make our investments in companies with as many potentially good things lined up to happen as possible.

AW: Having a longer term focus is a big advantage. Rather than obsessing about whether a company is going to make its next quarterly numbers, we look at what a business does in a normal environment. As long as you buy at a good price and the company has the runway and wherewithal to get to that point and there are no major impediments to value being realized, you are not likely to lose money.

G&D: You are long only. What are some of the rea-

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sons that you don't consider adding shorts to your portfolio?

AW: One would think that you could take what we do and simply add a short book of stocks with the opposite characteristics of what we own on the long side, but it just doesn't work that way. We have looked at it extensively and as a rule we do not like the risk reward profile of short selling. When a short goes against you it becomes a bigger problem. The most you can earn if you are right is 100% and your downside is unlimited.

JW: We are quite interested in downside protection, but we do not believe that shorting stocks would necessarily give us that protection and instead it could add significant risk to our portfolio. We believe that we can deliver superior returns by focusing on what we consider to be alpha generating long opportunities. There's a notion of a circle of competence and a circle of comfort. We do what we do well, and we stick to that.

G&D: Artie, you're an adjunct professor with Columbia's Value Investing Program. How did you get involved?

AW: After I had graduated, a couple of professors I had in school asked me to come and talk to their classes which I did, and teaching a course was a natural outgrowth of that. About eight years ago Bruce Greenwald asked me to co-teach a class alongside him and two other portfolio managers. Everybody who was teaching was a value investor but we all go about it in a different way. I think Bruce liked the interaction between multiple styles and the class benefited from seeing different people's point of view. That's when the Applied Value Investing course evolved to what it is today with more of a team approach and all the sections having two professors. For the past three years, T. Charlie Quinn and I have taught together. It is a real pleasure.

G&D: How have you seen the program evolve over the years?

AW: Well, the number of applicants has mushroomed and the program has grown from two sections to four to accommodate some of the increased interest. More importantly, the quality of the students is much higher. What has not changed is that students get out of the program exactly what they put in. AVI is a lot of hard work, but if you put in the effort, the payoff is invaluable.

G&D: Jenny, you mentioned that you were in the first Value Investing class with Professor Greenwald. Can you describe the experience?

JW: As I recall, there were about thirty people in the class, and Bruce had to recruit some of the people to take it because value investing was still somewhat under the radar. The course was taught by Bruce and Roger Murray, who had started teaching it after Ben Graham retired. There were additional contributions from some legendary value investors who came in to speak. I've watched it go from that one course offering to the current program but I agree with Artie—it was the same when I took the class as it is today. Some people got it and put in the work and were rewarded. Some people did not.

G&D: Any parting words of wisdom for our readers?

JW: Value investing is a broad way of thinking and there are many effective ways to apply it. Develop an approach that suits your personality and your skills and then stick with it.
AW: Be sure that the mindset and time horizon of your investors are compatible with your investment strategy. Committed capital allows a value strategy to work.

G&D: Thank you so much for speaking with us.

JW: Our pleasure.

"Value investing is a broad way of thinking and there are many effective ways to apply it. Develop an approach that suits your personality and your skills and then stick with it."

Second Annual Moon Lee Prize For Excellence

Pictured: Paul Orlin, Alex Porter, TJ Carter '11, Bruce Greenwald, Inder Soni, Aaron Kuperman, and Jon Friedland '97.

Over 100 alumni of the Applied Value Investing (AVI) Program gathered on January 28, 2011, for a reception and final presentations for the second annual Moon Lee Prize for Excellence.

The award is given in memoriam of Moon Lee, a dedicated value investor with Porter Orlin, LLC. In his honor, his friends at Porter Orlin initiated this competition for outstanding students in the AVI Program. The students competed for cash prizes of $15,000 and $5,000 and the submissions were judged on the quality of their research and the concise presentation of a strong investment thesis.

The Moon Koo Lee Prize is given as a tribute to a respected colleague and a remarkable person. Moon worked at Porter Orlin from 2003-2008 and demonstrated a tireless ability to identify and analyze deep value opportunities where few could see.

Moon graduated Magna Cum Laude from Harvard College and received his MBA from Harvard Business School. During his MBA studies, Moon received the prestigious Dean's award for co-founding a Junior Achievement mentoring program at a local public high school.

The program grew to 70 students and 60 MBA volunteers and impacted numerous lives. Moon loved to laugh and built strong ties to so many people. He is survived by his wife Martine, his parents, his sisters and countless devoted friends.

Finalists of the Moon Lee Prize For Excellence		
1st Place	TJ Carter	Long WMB
2nd Place	Patrick Sullivan	Short IRDM
Runner-Up	Todd Brunner	Long BLT
Runner-Up	Eric Hagemann	Long OPAP SA

The four finalists, Todd Brunner, TJ Carter, Eric Hagemann, and Patrick Sullivan were selected from a group of nearly 40 contestants. At the reception, each student presented their analysis to the judges from Porter Orlin, including Alex Porter and Jon Friedland '97.

Following a sequence of insightful presentations and vibrant Q&A, the judges awarded first place to TJ Carter for his long recommendation on The Williams Companies (WMB) and second place to Patrick Sullivan for his short on Iridium

Heilbrunn Center for Graham & Dodd Investing

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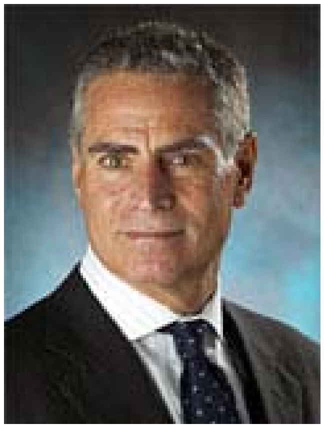
Bill Ackman & Michael Ashner Presentation



On November 9, 2010, Columbia Business School students and faculty were privileged to have Bill Ackman, Founder and CEO of hedge fund Pershing Square Capital Management, present in the Columbia Faculty House on the topic of "Finding Value in Real Estate." Prior to starting Pershing Square, Ackman was Co-Founder and Chief Executive Officer at Gotham Partners Management, a hedge fund he started in 1992 and ran until 2003. Presenting with Mr. Ackman was Michael Ashner, CEO of Winthrop Realty Trust, a publicly traded Real Estate Investment Trust. The event, which was sponsored by the Paul Milstein Center for Real Estate, the Heilbrunn Center for Graham & Dodd Investing, and the Columbia investment Management Association, drew a large crowd of students and faculty, leaving standing room only.

Mr. Ackman began the evening by discussing Pershing Square's successful investment in General Growth Properties, the Chicago-based REIT with interests in approximately 200 regional shopping malls across the U.S.. Ackman described how Pershing Square began accumulating shares in General Growth after the Lehman Brothers bankruptcy and the near collapse of AIG triggered the company's precipitous decline from a $23 billion market capitalization to $100 million in just a few months. "We started buying every share we could buy, using total return swaps," Ackman said. "After buying up 25% of the company's shares we asked them to file for chapter 11." He then provided a detailed description of the exciting few weeks which followed, including Pershing Square's subsequent $400 million dip loan to the company, its $1 billion purchase of outstanding debt, Simon Property's attempted acquisition of the business and Ackman's ultimate reorganization of the overall company. "If there's someone fighting on behalf of shareholders," he explained, "you'll have a good outcome when the assets are worth more than the liabilities."

Ackman and Ashner then discussed Pershing and Winthrop's recent investment in Stuyvesant Town, the 80 acres of condominium, retail and office space between 14th street and 23rd in New York City. Tishman Speyer had bought Stuy Town for $5.4 billion in 2006, putting only $12 million of equity into the deal. "They bought the property thinking they could just throw people out and raise rents," explained Ackman, "but these tenants were very politically set-up and would not go out easily." After Tishman defaulted on its loan in January 2010, Ackman and Ashner decided to buy the first three tranches of Stuy Town debt, and the two now collectively own about $300 million of debt in the property. Ackman and Ashner then described the series of subsequent events which made the Stuy Town deal one of Pershing Square's least successful investments to-date.

A question & answer session followed. Students asked Mr. Ackman and Mr. Ashner a series of questions ranging from their opinion on the health of the American consumer, their view of the future of the CMBS market and Ackman's recent investment in apparel retailer JC Penney.

"We started buying every share we could buy, using total return swaps. After buying up 25% of the company's shares we asked them to file for chapter 11."

Get Involved:

To hire a Columbia MBA for an internship or full-time position, contact Bruce Lloyd, assistant director, outreach services, in the Office of MBA Career Services at (212) 854-8687 or valueinvesting@columbia.edu . Available positions also may be posted directly on the Columbia Web site at www.gsb.columbia.edu/jobpost.

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Please also share with us any suggestions for future issues of *Graham and Doddsville*:

Graham & Doddsville 2010 / 2011 Editors

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