July 23, 2003

Paying Dividends: A Paradigm Shift

The 2nd Quarter was a busy, but rewarding time on many fronts. SCHACHT VALUE successfully completed our move to a new office. Yours truly delivered a much-needed message to managers at the Coastcast annual meeting in Los Angeles. And our portfolio performed exceedingly well (up 20+ percent in the last 3 months). Clearly, the key to success is making sure I'm out of the office!

In all seriousness, investors are beginning to see the beneficial effects of the dividend tax cut as it ripples through America's boardrooms. Every firm seems to be reevaluating its capital structure in light of the new environment.

The Bush administration sold the dividend tax cut on issues of fairness and economic stimulus. Both arguments, while valid, are not the most powerful issue: a massive change in incentives. Corporate managements can no longer use taxes as an excuse to horde capital. They are now under immense pressure to effectively put capital to work or disgorge it via dividends to shareholders. This shift in thinking may indeed lead to the government realizing more dividend tax receipts than in the past. In any case, it can only be a good thing for the economy, short- and long-term.

Many companies have already responded to this paradigm shift in corporate incentives by increasing dividends. Countless more are being pressured to follow suit.

On June 26, 2003, **The Topps Company, Inc. (TOPP)** announced that its Board of Directors declared a quarterly cash dividend of $0.04 per share. Arthur T. Shorin, Chairman and CEO of Topps, stated, "Given our strong financial position and recent changes in the tax treatment of dividends, the Board has concluded that a dividend is an advantageous way to create additional value for our stockholders." And just like that, Topps begins sending $16.5 million a year to its shareholders. All management needed was a little push.

On July 14, 2003, **Citigroup Inc. (C)** announced that its board of directors had approved a 75 percent increase in the quarterly dividend on the company's common stock to 35 cents a share from 20 cents a share. Sanford I. Weill, Chairman and Chief Executive Officer said,

> "The recent change in the tax law levels the playing field between dividends and share repurchases as a means to return capital to shareholders. This substantial increase in our dividend will be part of our effort to reallocate capital to dividends and reduce share repurchases. We have demonstrated our commitment to stockholders by consistently increasing our dividend since the inception of our predecessor company in 1986. Our Board's authorization of a 75 percent increase in our dividend, the largest increase in our company's history, further underscores our desire to enhance returns to our investors."

Mr. Weill framed the issue well. Dividends are no longer at a disadvantage to share repurchases.

If anything, it seems corporations now have a slightly greater incentive to pay dividends because short-term capital gains are still taxed at the ordinary income tax rate. If you own a stock for 6 months and it pays a dividend during that time, you only pay the 15% rate on the dividend.

From the shareholders' perspective, dividend payments have always been a cleaner transaction compared to share repurchases. When a company repurchases its shares, the value created or destroyed should be reflected in the price of the remaining shares over the long run. The effect of a company buying back stock is just one of many economic events that is reflected in the capital gains/losses realized by shareholders. I don't wish to belabor the point, but company managers can play games with stock repurchases that are not possible with dividends. With a dividend, you get a check, plain and simple.

Simply put, the Bush dividend tax cut has helped us realize our investment goals. We knew that Citigroup and Topps had excess capital and that it would benefit us. The tax law changes just accelerated things and in the process have changed the financial landscape for the better. Our portfolio currently yields nearly 2 percent from dividends, far better than the rates on money market funds. And there are more dividends to come.

It is highly likely that we will see several more portfolio companies initiate a dividend or increase existing payouts before year-end. **Travelers Property Casualty (TAP.A)** raised their dividend 33 percent just this week. Sears may soon follow.

When we first bought **Sears, Roebuck & Co (S)** in November, I felt like calling each client and apologizing for the embarrassment they would have to endure. I mean this is not a company with cachet. You won't hear it mentioned over cocktails. It's, in a word, boring!

In a recent conference call, analysts spent about 30 minutes probing management about how Sears sees itself. Is Sears a retail company that happens to own a credit card portfolio or a financial company that has a retail division? Truth be told, both of Sears' main businesses were struggling and the company seemed to lack direction. Retail sales were sagging and the quality of its credit card portfolio was deteriorating. At the time, investor pessimism was high and (surprise) the stock was falling. Word on the Street was that Sears was on the road to extinction.

Reality check. Sears may be a company in decline, but with revenues at $40 billion and reported net income at $1.3 billion last year, it is far from extinct.

SCHACHT VALUE started buying shares at around $26 a share, valuing the entire company at roughly $8 billion. Our conservative intrinsic value estimate was closer to $12 billion (or $36+ a share). A significant disparity existed between price and value. After our initial purchase, Sears continue to nosedive. We continued to add shares as the stock bottomed out at $19 a share. Something had to give.

On March 26th, Sears CEO Alan Lacy cried, "Uncle!" He announced that Sears would evaluate strategic alternatives for its credit card business, including a possible sale. The company telegraphed numbers like $7 billion as a possible value for the division, but these assertions were openly questioned by most on Wall Street. Many analysts questioned whether Sears would even recover the $3 billion of equity it had in the business. Others said the business might have to be broken into pieces because parts were so undesirable no company would buy them. Oops!

Last week, Sears announced that it had agreed to sell its credit card business in its entirety to Citigroup, one of the savviest acquirers in the financial world. Sears proceeds: $6+ billion and $400 million or more over the next 10 years. It seems Sears' appraisal was accurate and that many have underestimated the value of Sears. The fog has begun to lift. After the deal closes, Sears will have several billion dollars after taxes with which to pay off debt, repurchase shares, and (yes) increase its dividend.

I'm pleased to say that our investment thesis has been proven correct. Sears is currently trading at $40 a share. This values the company at nearly $12 billion, an increase of almost 70 percent since January 1st. No need to be embarrassed about that!

Dividend tax changes are also likely to affect **Furniture Brands International (FBN)**, a recent addition to our portfolio. As you may have guessed, FBN manufactures furniture. The company owns brands like Thomasville, Broyhill, Lane, Henredon, and Drexel-Heritage. In fact, the company says that of the 8 major brands in the furniture business, they own all but two, Ethan Allen and Lazy-Boy. CEO Wilbert G. "Mickey" Holliman is an impressive CEO with a deep knowledge of the business and clear managerial discipline. This attitude has helped FBN thrive in past years amid an industry slump. The housing boom has not rubbed off on the furniture business. Despite this Furniture Brands has remained solidly profitable, making $118 million after selling 9.8 million pieces of furniture in 2002.

All this aside, we were drawn to Furniture Brands by its price. We began buying shares at $21 a share in April. With approximately 56 million shares, Furniture Brands was valued at only $1.2 billion or about 10 times earnings. The firm throws off an impressive stream of excess cash ($100 to $125 million a year). In recent years, this cash was used to pay off debt accumulated during a recent acquisition binge. But things are about to change.

Furniture Brands' debt load is approaching $300 million, which the company says is its target. Once debt gets to this level, management plans to switch gears and start paying out excess cash flow to shareholders. Currently, FBN does not pay a dividend or repurchase stock, but the company has thrown the door wide open to both possibilities. A definitive announcement is due by year-end.

FBN is up almost 15 percent since our first purchase 3 months ago. With or without a recovery in the furniture industry, we should make even more in the coming months. Cost cutting and solid management of the business should bring cash flow to between $125 and $150 million per year. A significant chunk of that money should find its way to shareholders. The market has started to take notice, but we think it has a long way to go. Our estimate of intrinsic value is $35 a share, representing a significant upside to current levels.

It may take a miracle for Steve Jobs of **Apple Computer (AAPL)** to get the message that dividends are good for investors. Apple is still sitting on $4.5 billion cash with few major investment prospects on the horizon. In my conversations with company representatives, they maintain that the cash is there in case an attractive acquisition comes along. I reminded them that Apple's track record in that area is miserable. If the money was paid out to shareholders, we could easily put it to work. At this point, Apple seems content to hold the cash and collect the paltry interest payments.

Nonetheless, AAPL stock is up nearly 40% year-to-date on renewed interest in the company's products and services. We have used the opportunity to reduce our position. There is still a (remote) possibility that management will have a Eureka moment and reward its shareholders with a dividend using the excess capital it has piled up over the years. The stock price would no doubt benefit. In any case, we won't hold our breath!

Lastly, the saga of **Coastcast (COCA)** continues. The company held its annual meeting on June 12th and we were there, much to the surprise and dismay of company management. It seems that in years past shareholders have not bothered to attend COCA's annual meeting. This might explain why the CEO (Hans Buehler) and his board of directors had no qualms about arriving in a stretch limousine! They obviously assumed that this year would be no different than any other. I must say that I enjoyed a degree of satisfaction in making this Coastcast annual meeting a memorable one.

SCHACHT VALUE has been actively communicating with other like-minded COCA investors in past months. In response to our call, a small group of outside shareholders showed up for the annual meeting. When management realized this, the meeting was quickly moved to a conference room. Apparently, it was originally scheduled for Mr. Buehler's office!

The official meeting lasted only minutes. As expected, all the directors were reelected, despite our votes to the contrary. Our chance to speak came during the question and answer period, which ultimately lasted about an hour and a half. Unable to hide behind press releases and minions, the leaders of Coastcast were forced to face the music.

We started by questioning board members about their independence and reminded them that their duty is to all shareholders, not just their friends in management. It was made clear that if the board sells COCA to insiders for a fraction of its true value, then legal action may be an option.

We asked Hans Buehler to justify his recent statements. On September 12, 2002, Mr. Buehler declared in a letter to shareholders that:

> "As our fortunes improve and we resume to report good news and earnings we hope that our stock price will reflect it. At present, we have free cash of $2.21 per share, and a book value per share of approximately $5.70."

Just over 7 months later, on April 24, 2003, we were told that:

> "Mr. Buehler advised the board that, if the board determines that it is in the best interests of stockholders, he (perhaps together with others) would be interested in pursuing an acquisition of the Company. The exact structure and pricing of such an acquisition would depend on numerous factors, but in response to board inquiries Mr. Buehler indicated that, based on preliminary considerations, he anticipated that the purchase price per share would be in the range of $2.05 to $2.20."

We told Mr. Buehler that this change of heart seems convenient at best, given his interest in buying the company. He seems to sing different tunes depending on which hat he is wearing: CEO or possible acquirer. Did COCA's value drop $3 a share (or $21 million) in 7 months? No! To accept this proposition, we would have to accept that the underlying business of Coastcast (in liquidation or otherwise) is worth less than zero. This is absurd. If nothing else, the company owns some very valuable real estate.

The debate over Coastcast's value was lengthy. SCHACHT ALUE argued that the Coastcast should yield over $3.50 per share if liquidated in an orderly fashion. Board members obviously wanted to distance themselves from Mr. Buehler's estimates, continually reiterating that no formal offer is on the table. But we made our point.

Finally, we impressed on board members that they must not accept an anemic offer from Mr. Buehler and friends. If no other offer materializes, there are numerous other alternatives, including complete or partial liquidation. Many strategic alternatives are open to Coastcast, despite the fact that certain insiders have an interest in only one.

SCHACHT VALUE and other interested shareholders sent a very clear message to the leadership of Coastcast simply by attending the meeting. A sign of progress: my letters to the company do not go unanswered any longer!

We believe that our patience with Coastcast will be rewarded. The value proposition is that compelling.

Overall, while we still do not believe that the overall market is cheap given current fundamentals, we continue to find attractive investments. As was the case during the Internet Bubble, we see a bifurcated market. We see huge pockets of excess concentrated in the technology and biotech areas while many "Old Economy" companies remain unpopular with investors. Apparently, investors have not learned anything from past mistakes.

Our portfolio remains well positioned to take advantage of the inefficiencies that exist in the market. This coupled with the changing incentives in Corporate America, accounts for my optimism as we move forward.

With my dividend checks in hand,

Henry W. Schacht, CFA
President and Chief Investment Officer