

SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

April 19, 2007

www.schachtvalue.com

Headline Heaven

Despite the volatility in the markets, Schacht Value is having a very good year. The average client account is up over 7% year-to-date, double the return of the overall market. Our holdings are responding to the very catalysts we were hoping to see. Buyouts, breakups, and other value creating transactions are occurring throughout the portfolio to the benefit of our clients.

We are very enthusiastic about these developments, but we refuse to allow hubris to take over. Schacht Value has maintained price discipline and we continue to find value. For proof of this, one needs only to look at the portfolio changes below.

Portfolio Changes (since February 12, 2007)

Additions

Allied Irish Bank plc ADR (AIB)
Ingram Micro A (IM)
Imperial Tobacco Group plc ADR (ITY)
Kraft Foods (KFT)

Eliminations

iShares US Homebuilders (ITB)
Jo-Ann Stores (JAS)
News Corp (NWS)
Unilever NV ADR (UN)
UST (UST)
Wabash National (WNC)

Schacht Value has been in headline heaven since the start of 2007. It seems like every company in our portfolio is involved in some high-profile activity that reflects well on the stock price. In the not so immortal words of Martha Stewart, that's a good thing.

ABN Amro (ABN), our favorite Dutch bank, is our best performer of 2007. Schacht Value first purchased ABN shares in November 2005 at \$24 a share. We were attracted by a unique set of assets, a cheap valuation, and the 4.5% dividend. Today, ABN trades at \$49.15 a share, a gain of over 100%. In fact, the shares are up over 50% since January 1st. Why? Several activist hedge funds with large stakes in ABN have publicly stated that the bank is undervalued. They are pushing for a breakup or a sale of the company. These investors contend (and Schacht Value agrees) that ABN's assets could be better utilized by others. Feeling the heat, ABN entered exclusive talks with **Barclays (BCS)** about a possible merger.

Ironically, Schacht Value owns Barclays as well. It's our favorite UK bank. This puts us in an interesting quandary. We want ABN to get bought out, but NOT by Barclays! ABN shares have gone up nearly every day since this process began and the company has gotten so pricey that Barclays can ill-afford to buy it. The magnitude of the numbers is staggering. ABN Amro's market value was \$60 billion in January. It is over \$90 billion today. Barclays has a \$98 billion market value. Any deal would be the largest banking deal ever.

The purchase and integration of ABN Amro would be risky for Barclays even in a best case scenario. Fortunately or unfortunately, any valuation benefits that Barclays saw are long gone. ABN is now selling at a premium price of 14-15x earnings, while Barclays remains cheap at 9-10x earnings. Barclays should repurchase its own shares and leave ABN Amro to others. Luckily, other potential bidders are coming forward. It's gratifying to see investors clamoring for ABN shares that were so unloved just a year ago.

The value approach to investing works and we still see value in the European banking sector. Schacht Value is building a position in **Allied Irish Bank (AIB)**, one of Ireland's top banks. In comparison to its continental competitors, AIB is tiny, with a market value of \$26 billion. The company pays a sizable dividend (3.2%) and is currently valued around 10 times 2007 earnings. Along with a strong position in Ireland, the firm has stakes in Poland and the United States. In addition to Allied Irish, we continue to add to Barclays as prices warrant. As we mentioned above, Barclays is still cheap and it is a world-class operation. The company may become a buyout target itself if a deal with ABN fails. **Bank of America (BAC)** is just one giant that has considered buying Barclays in the recent past.

Banks aren't the only ones getting in on the action. **Dow Chemical (DOW)** has been a constant topic in the financial press lately. There have been rumors of a buyout by India's Reliance Industries, private equity, and/or a group of Middle Eastern investors. Two top Dow executives were just fired for "unauthorized" discussions with potential buyers, so someone is interested. What sounds like a soap opera is actually a \$45 billion global chemical business. Could Dow really be a buyout candidate? The sheer size of private equity pools means anything is possible. The market is convinced, as the stock is up 13% since January 1st. The mere fact that people are discussing the idea speaks to Dow's strong fundamentals. The company has over \$3 billion in cash on hand. It pays \$1.5 billion in annual dividends and retains at least another \$3 billion in earnings each year. Dow is valued at around 10x free cash flow and management is working hard to ensure stability in cash flow going forward. Pressure is building on CEO Andrew Liveris to build shareholder value one way or the other. Buyout or not, we like Dow Chemical. Our price target is \$55 per share, 20% higher than the current price.

In technology, **Palm Inc. (PALM)** is also thought to be a buyout candidate. It's up 22% year-to-date on the news. Again private equity is a prime suspect, but Motorola, Nokia, Dell, Hewlett Packard and others have been mentioned. Palm has all the right characteristics. Firms wanting to increase or establish their presence in smart-phones should take a look. Palm's Treo cell phones are very well regarded. Financially, Palm is underleveraged with zero debt and over \$500 million in cash. And cash flow is sizable and relatively stable.

Schacht Value looks for catalysts that will force investors to rethink the value of our holdings. One such catalyst is a buyout (or the rumor of one). Restructurings that simplify and/or strengthen a company are another.

On March 30th, **Altria Group (MO)** distributed its remaining ownership in **Kraft Foods (KFT)** to MO shareholders. One day MO was the majority stockholder of Kraft and the next it didn't own a single share. Some 1.5 billion Kraft shares hit the market in one massive wave. Like most spin-offs, investors often sell first and ask questions later. To make matters worse for KFT shares, Altria shareholders have been itching to get rid of Kraft for years. Tobacco is the better business. It is not a shock that investors overreacted. In anticipation of this, Schacht Value decided to hold our Kraft

shares and add to the position as selling pressured the stock. Someone else was buying too! Kraft's chief financial officer (CFO) said, "We said we would be actively taking advantage of the opportunity that the distribution of shares afforded us and we have in fact been in the market doing that." He declined to say how many shares have been purchased, but the company's board has authorized stock repurchases of up to \$5 billion. Kraft may not be a long-term holding, but we'll take advantage of market inefficiencies like this any day.

Lyondell Chemical (LYO) has continued its makeover recently also. After buying out its refining partner Citgo, Lyondell management explored the sale of its titanium dioxide (TiO₂) business in February. The goal was to exit a troubled business and reinvest elsewhere. They succeeded. On February 26th, LYO announced the sale of its TiO₂ division to The National Titanium Dioxide Company Ltd. for \$1.2 billion. To put this in context, Lyondell's total 2006 operating income was over \$1 billion. By breaking out each division's operating income (or loss), the black hole is apparent.

Ethylene	\$867 million	Propylene	\$403 million
Refining	\$383 million	Titanium Dioxide	– \$567 million

LYO would have reported \$1.637 billion in operating profits (an increase of 53%) if not for its titanium dioxide business. Lyondell has a market value of only \$7.8 billion (\$31 a share) and its only unprofitable business sold for \$1.2 billion. What a country! Our target for LYO is over \$40 a share.

Not all of our companies made the news because of buyouts or major restructurings. Perhaps the most exciting headline this quarter graced the cover of Forbes magazine on February 26th. The article was entitled "High on Loews". The premise was that **Loews Corporation (LTR)** is still too cheap despite a tripling of the company's share price in the last three years. Thank you for noticing, Forbes.

We've owned Loews for years. Recently it has grown into the 2nd largest holding in our portfolio. As long as this conglomerate continues to trade at a substantial discount to the value of its parts, we'll keep buying. The value of LTR's ownership stakes in offshore drilling, insurance, tobacco, hotels, and pipelines are simply not being reflected in the price of Loews' stock. It gets better. Dividends from subsidiaries, record insurance earnings, and asset sales, have left Loews awash in cash. It has \$5.3 billion in the bank. Our capitalist hearts swell with pride!

The market value of Loews is \$26 billion (\$47 per share x 550 million shares) and cash represents fully 20% of this value. Every \$47 share of LTR stock is a claim on about \$9.60 worth of cash and a pro rata share in the underlying businesses. The key question is: What will management do with all that excess cash? It's certainly not burning a hole in the company purse. The Tisch family members who control Loews are careful with a buck. Past performance proves this, but the following excerpt(s) from their annual "Letter to Our Shareholders and Employees" should further explain our confidence.

(At Loews), we seek out undervalued opportunities to create value, whether through cash flow generation or asset appreciation, and we focus on identifying and managing downside risks.

***Value investing** in the traditional sense consists of purchasing businesses or assets at substantial discounts to the present value of the returns they are expected to generate. We use this approach in assessing every potential acquisition.*

As a result, each company in the Loews portfolio has at least one thing in common: it was acquired at an attractive price. Markets are cyclical, so at times there are many investors willing to pay more than we are. Today is one of those times. The marketplace is crowded, making it difficult to buy good businesses at attractive prices.

We feel no pressure to invest at any given moment and we are comfortable maintaining a large amount of liquidity, which allows us to move quickly when the time is right. But, as the saying goes, just because you're on a diet doesn't mean you can't read the menu! Loews continually evaluates business opportunities, seeking out potential value-creating acquisitions.

Loews views each business it acquires as a long-term holding, a perspective that sets us apart from a private equity firm's conventional "five years and out" timetable. Accordingly, Loews still owns most of the businesses it has bought over the years. We have historically acquired companies with substantial capital or financial assets that offer products and services for which there is enduring, if sometimes cyclical, demand. To date, we have not invested in cutting edge technologies or emerging consumer trends, but we keep an open mind and will consider any kind of acquisition if it is in the interests of our shareholders. What we refuse to do is overpay. We believe strongly that if a good business is purchased at a good price, downside risk will be minimized. The converse is equally true, which keeps us from straying from our core principles.

When we examine potential acquisitions, we are drawn to companies with the ability to generate cash flow to fund internal growth and the payment of dividends. We are equally drawn to companies with undervalued assets. Good businesses come in various shapes and sizes – just look at our subsidiaries. We focus on adhering to our core principles while maintaining the flexibility to pursue any opportunity that will benefit our shareholders.

At Loews we focus on capital allocation at the holding company and at each of our subsidiaries. We believe that if we allocate Loews's capital for long-term value creation, it will ultimately be reflected in the value of Loews common stock. We pursue this goal not only by acquiring businesses at attractive prices and managing them for the long term, but also by repurchasing Loews common stock in the open market. Share buybacks have become a popular practice in recent years, in part because many companies repurchase shares to counter the dilutive effects of stock options and other employee incentives. Such is not the case at Loews. We repurchase shares only when they are selling at prices we regard as favorable and when repurchases create value for our shareholders.

While we are pleased with Loews's results in 2006, we are determined to maintain financial discipline and the flexibility to deal with any change in the business climate that may lie ahead. With our strong balance sheet and focus on finding undervalued assets, we are equally well positioned to continue enjoying healthy market conditions or to use a downturn as an opportunity to make new acquisitions on favorable terms.

We could not have said it better ourselves. Schacht Value is stacking the deck with Loews: one value investor buying stock in another value investor. There should be a law!

Schacht Value has found plenty of opportunities to deploy capital at attractive prices. Loews is chief among them. After a great 2006, Schacht Value was cautiously optimistic about 2007. Hopefully this newsletter shows that our optimism is warranted.

Thank you for your continued support and confidence.

Henry W. Schacht, CFA
President and Chief Investment Officer

Circle of Competence ◦ Intrinsic Value ◦ Margin of Safety ◦ Catalysts ◦ Active Ownership ◦ Sell Discipline