

SCHACHT VALUE INVESTORS, LLC

Capital Management in the Graham and Dodd Tradition

June 5, 2009

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Question Debt, Not Capitalism

On June 30, 2006, a joint-venture between Cintra Concesiones de Infraestructuras de Transporte of Spain and Macquarie Infrastructure Group of Australia paid \$3.8 billion to lease the Indiana Toll Road for 75 years – 3 times what the State of Indiana expected. The transaction was valued at 40 times revenue and 60 times cash flow on an annual basis. If a “cash flow” yield of 1.7% wasn’t bad enough, the consortium financed the purchase with \$3.5 billion in loans due in 2015. Refinancing this debt will be a problem and the interest costs ensure that the deal will not be profitable. So why did they do it?

Aggressive growth assumptions combined with cheap money led many to make irrational decisions in recent years. From Main Street to Wall Street the story of too few assets backing too much debt is all too common. From the house flipping crowd to people using home-equity lines to overspend and so-called sophisticated investment groups, the destructive power of too much debt is being felt by many.

It’s an old story. Economist John Kenneth Galbraith wrote a great little book some 20 years ago called *A Short History of Financial Euphoria*. His timeline runs from the Dutch tulip mania in the 17th century to the spread of junk bonds. It is time for a new chapter that starts with the tech bubble and the Greenspan Federal Reserve and ends with a credit bubble and real estate collapse. The extent of the contagion is shocking.

It is clear that human nature does not change and can’t be regulated. It is the “drama of mass insanity”. Galbraith effectively states that “all financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets.” He correctly points out that “all crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment.” This recurring behavior is attributed to “the brevity of the financial memory.”

Finally, Galbraith states that “whatever the reason (and it is unimportant), the absolute certainty is that this world ends not with a whimper but with a bang.” 2008 was such a bang – one that still rings in our ears.

Schacht Value has always focused on the financial health of its portfolio companies. We specifically look for underleveraged balance sheets and sustainable cash flows; but none of this mattered in the panic of 2008. When residential real estate rolled over and credit markets seized up, saint and sinner got pulled into the vortex together.

Unlike an empty house that is leveraged to the hilt, our portfolio is full of companies that generate cash and have intrinsic values that are calculable. The unrelenting stock price drops strained credibility. Did the economic value of **Berkshire Hathaway (BRK.b)** really fall over

40% in 2008? We think not. Nonetheless, seeing account balances drop precipitously drove us to distraction and many investors simply threw in the towel. It didn't matter that they were giving away an undervalued asset for the privilege of owning a depreciating asset, namely US dollars. We continually counseled against this action, regardless of how stupid we looked in the short-run. The recent rebound in the markets has allowed a measure of redemption. Only now is discrimination returning to the market.

Nonetheless, the fear of 2008 caused many to question the markets and, in some cases, the future of the free enterprise system. Capitalism is not the culprit. Again, we quote John Kenneth Galbraith:

“The final and common feature of the speculative episode . . . is what happens after the inevitable crash. This, invariably, will be a time of anger and recrimination and also of profoundly unsubtle introspection There will also be scrutiny of the previously much-praised financial instruments and practices that have facilitated and financed the speculation. There will be talk of regulation and reform. What will not be discussed is the speculation itself or the aberrant optimism that lay behind it. Nothing is more remarkable than this: in the aftermath of speculation, the reality will be all but ignored.

Count us among the unabashed supporters of capitalism and free enterprise. More regulation and a move toward a more controlled economy will create more problems than it solves. That said, Schacht Value did a great deal of introspection, during and after the debacle that was 2008. We reevaluated our valuation methods and metrics. We reviewed our overall approach to the market. Our conclusion was (and is) that the approach is solid. Reading and interpreting financial statements and differentiating between various types of businesses still matters. This ultimately will dictate our long term investment results. We intend to earn back the money we lost in 2008 and we thank all who stood with us through this crisis of confidence.

Energy and persistence conquer all things. - Benjamin Franklin

Per usual, a number of changes have been made to the portfolio since our last communication. In many cases, we traded cheap stocks for cheaper stocks of higher quality. Sometimes we did something by doing nothing. In short, we held on to what we owned and concentrated on keeping our head while others were losing theirs.

Just knowing that the economy is “bad” is not a sufficient reason to sell a company. Honestly, it is mastery of the obvious to say the economy is bad. As the old market adage goes, “if it's in the headlines, it's in the price.” And price is the fulcrum upon which all investment decisions hinge.

The prices of many companies got so low that despite all the bad news, an enormous margin of safety existed. Schacht Value did not need an ironclad earnings estimate to justify the holding, or indeed purchasing, shares. Given how far prices fell, sometimes all we needed was the knowledge that a company had the financial wherewithal to simply survive in order to justify a purchase. The virtue of a strong balance sheet has always been a hallmark of our investment approach, which is why the declines of 2008 were so disheartening. Nonetheless, many of our

portfolio firms are using their financial strength to capitalize on the misfortune of others. Time will reward these firms kindly.

The essential point is that security analysis does not seek to determine exactly what is the intrinsic value of a given security. It needs only to establish that the value is adequate - e.g., to protect a bond or to justify a stock purchase - or else that the value is considerably higher or considerably lower than the market price. For such purposes an indefinite and approximate measure of the intrinsic value may be sufficient.

- Benjamin Graham

Low prices didn't prevent many investors from indulging the urge to sell. The urge to buy didn't seem to exist. This is a reaction that we think will prove costly. We actually got calls (in March) from people convinced that the Dow Jones Industrial Average was headed to ZERO. We don't think that it is a coincidence that these panicked calls coincided with the market's lows. Anyone who sold at these levels has permanently locked in those losses and given Mr. Market more credibility than he deserves.

In a recent television interview, Warren Buffett put it succinctly when he said: "It's a big mistake to say that business is bad; therefore, I shouldn't buy stocks. That usually is the time to buy stocks, and when everything is wonderful, it is not usually a good time to buy stocks." Schacht Value did buy shares throughout the downturn. The resulting portfolio is somewhat more concentrated and remains full of valuable goodies!

Probably the most amazing holding has been **Ternium (TX)**, a dog that is now having its day. The company is based in Luxembourg, but owns steel plants in Mexico and Argentina. Last year Venezuela (yes, Hugo Chavez) announced that they would be nationalizing Sidor, a Venezuelan company in which Ternium held a 59.7% stake. TX shares got killed on the news and have never fully recovered. Investors expected a painful nationalization process and were uncertain about how much Ternium would get for Sidor, if anything.

Last month, however, Ternium announced that it would be receiving nearly \$2 billion from Venezuela in installments payable through October 2010. Some \$400 million has been received already. The market value of Ternium prior to this announcement was just \$2 billion. So the cash payment from Venezuela effectively accounted for the entire value of the firm. Happily, Schacht Value nearly doubled our TX holding when the shares were floundering. We may not be experts in the steel industry, but we know how to count. We are now reaping the rewards. Today, the market value of TX is some \$3.5 billion. We still think it's cheap. Year-to-date Ternium shares are up over 100% and it has catapulted to become our 2nd largest holding. Valuation matters!

Economic fears and general selling pressure drove **Arkansas Best (ABFS)** shares below \$16 a share this spring. That translates into a market value of just \$400 million for this long-term Schacht Value holding. We think this is the best run trucking firm around, yet the market had it

priced for death. This is a company with over \$200 million in cash and less than \$2 million in debt. That's right: cash represented over 50% of the company's market value at this absurd price. At this level, Arkansas Best probably could have sold their trucks for scrap and still not lost money for investors. We bought more shares at this level, but few others did. They didn't care that ABF has been profitable for the last 10 years and regularly earns between \$35 and \$75 million per year. The valuation made no sense to us. Rather than panic and sell, Schacht Value added to our position and held on. The result: ABF has nearly doubled to over \$30 per share. Valuation matters!

At its recent lows, **Kyocera (KYO)** sported a market value of just \$10 billion. Many clients heard the story of KYO when they called us, but it warrants repetition. You see, Kyocera owns around \$10 billion in cash and securities and has a miniscule amount of debt. At one point, the market was actually assigning a negative value to the underlying business of Kyocera. This is absurd for a business that generated \$800 million to \$1 billion in free cash flow in recent years. In the panic of 2008-2009, few investors cared despite the obvious undervaluation. But economic vacuums don't persist forever. Again, we added to our Kyocera holding. The result: KYO is up 75% from its low late last year. Valuation matters!

In March, we picked up a few shares of children's clothing retailer **Gymboree (GYMB)**. The move didn't seem very bright given the outlook for the American consumer. That said, Gymboree was trading at \$18.50 a share giving it a market value of \$535 million. For this, we got a company with \$140 million in cash (26% of our purchase price) and zero debt. This is a firm that is also capable of making \$70 to \$90 million in a really tough environment. Based on the lower earnings estimate, the company was trading for 8 times earnings before adjusting for the cash and around 5 times earnings excluding cash. For a company that is completely debt free, we thought this was a steal. The result: It took GYMB about 6 weeks to hit our price target after a gain of 50+ percent. We sold, only to see the shares go even higher. Great things happen when you see value where others don't. Yes, valuation matters.

Not all of our holdings have rocketed skyward in recent months. **Forest Labs (FRX)** is down slightly year-to-date, but it deserves a few words in these pages. FRX is perhaps the most undervalued company in our portfolio. With a market value of \$7.5 billion, the company holds excess cash and securities of nearly \$3 billion or around 40% of the current market value. If that was not enough, FRX is expected to generate over \$1 billion of free cash flow this year. That's a free cash flow yield of about 14% before adjustments for cash and 21% after. Wow! Worries about patent expiration have held Forest Labs back, but at this price it hardly matters. The company is run by thoughtful managers and should perform well going forward.

Schacht Value was founded after the tech bubble burst and we generally haven't owned too many genuine dot-coms. But recently we could not resist. At its peak in 2004, online auction giant, **eBay (EBAY)** had a market value of around \$80 billion (\$59 a share) and earned about \$800 million. That's 100 times earnings or around a 1% return for anyone who paid such an absurd price. Fast forward to January 2009 and poor old eBay is down to \$13 a share or around \$17 billion. The company is bigger than it was in 2004, but has fewer shares outstanding. It earned \$1.8 billion in profits and generated \$2 billion in cash. eBay is a cash machine for its owners, if not those auctioning Beanie Babies on the website. On the surface, in January eBay

was trading at 9 times earnings and a free cash flow yield of 12%. That's a far cry from its 2004 valuation.

A closer look revealed that eBay was even cheaper. The company has a pristine balance sheet with over \$2 billion in net cash (cash minus all debt). eBay also owns the online communications service Skype, which previous managers bought for a ridiculous price. Skype loses money and current management is planning to sell it via an IPO next year. Estimates of its "value" run as high as \$3 billion. Some think that a mainstream telecom company may even buy Skype before the IPO. Trust us, any time you can sell a money-losing business for billions, do it! Without Skype, eBay's valuation looks even better, because they are essentially subtracting a negative. Management clearly wants to focus on the auction business and online payment service, PayPal. Investors are starting to appreciate this story. eBay shares are up over 35% since our initial purchase, and we still like it. Did we mention that it's a cool Internet company!?!

The common theme is that all of these companies have rock solid balance sheets and valuations that don't hinge on one year's earnings outlook. With companies like **Coca-Cola (KO)** and **Disney (DIS)**, it is self-evident that they have an economic value that transcends a particular calendar year due to their assets and long-term earnings power. Likewise, our portfolio companies will survive this turmoil.

Like many others, Schacht Value makes mistakes in valuing individual holdings, but our approach and portfolio are sound. In aggregate, our portfolio was undervalued going into 2008 and even more undervalued coming out with Price to Value (P/V) ratios as low as we have seen.

At the risk of repeating ourselves, a company's balance sheet and structural earnings power still matter. From **Boeing (BA)** and **Northrop Grumman (NOC)** in defense to **Utah Medical (UTMD)** and **Stryker (SYK)** in medical supplies, we own companies with unique positioning and real staying power. These along with other favorites, like **Dr. Pepper Snapple Group (DPS)**, should also provide a wonderful hedge against inflation, should the Fed's printing presses continue full tilt. Expect it.

In a panic nobody stops to ask directions. 2008 was proof that emotions betray us at precisely the wrong time. If one recognizes the pattern (market up = I feel good vs. market down = I feel bad), it is easier to break and avoid a cycle of buying high and selling low.

With the market falling earlier this year, one financial columnist wondered if "Ben Graham's approach (value investing) once again (is) relevant?" Our answer: Yes. It always has been. Valuation always matters!

Have a good summer,

Henry W. Schacht, CFA