Schacht Value Investors, LLC

Capital Management in the Graham and Dodd Tradition

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South Beach via Detroit

The English economist Arthur Cecil Pigou (1877-1959) once said, "*The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born, not an infant, but a giant.*" One such newborn giant was 2009.

Born out of panic, the S&P 500 gained 26 percent for the year. Schacht Value outperformed this by a significant margin. Our average account was up over 40 percent. At the lows in March, these equity returns were a distant hope with nearly every listed company camped out on the 52-week low list. But this is precisely <u>why</u> returns were so high.

Conventional thinking says that the economy is bad and therefore stock prices must fall. Taken to the extreme, this logic would see equity prices eventually reach zero in an extended period of economic weakness. At that point, we'd all pick up (what's left of) our marbles and go home.

Laugh if you want, but a year ago we heard predictions of Dow ZERO! That's right. The value of the 30 Dow Jones Industrial Average companies was headed for zero. Such was the panic that existed in late 2008 and early 2009.

True, American Express, Bank of America, and General Electric had their issues. But what about Coca-Cola, Kraft, Johnson & Johnson, and McDonalds? Zero? In fact, the profitability of these (and many other) companies is largely unchanged despite very real macroeconomic issues.

Then again, headlines are easier to read than annual reports and SEC filings.

It was the late Sir John Templeton who counseled investors to buy at the point of maximum pessimism. If 2009 didn't prove the point, nothing will. Trough to peak, the US equity markets gained approximately 70 percent.

A poor economic environment does not mean that a company's stock must go down. Put another way, a company can be severely undervalued even if the outlook isn't rosy.

Schacht Value doubled an existing position in steel manufacturer **Ternium (TX)** at $9 a share early last year. By year-end, the stock was up over 300 percent, our best performer. If not for worries about steel pricing/demand and the nationalization of the company's Venezuelan holdings (see July 2009 newsletter), TX never would have experienced such gains. The stock price never would have gotten so low without this pessimism. There were plenty of reasons to dislike Ternium, but when its market value dropped to $1.8 billion, none of them mattered. By December, investors had changed their collective minds. $7 billion seemed more appropriate.

Lexmark (LXK) is another company elite investors love to hate. They say it's a second tier company whose best days are behind it. We agree. Thanks to the Tech Bubble, shares of the printer maker hit $135 in the year 2000. With 130 million shares outstanding, the market value was over $17 billion. Reported net income was $300 million, meaning investors were willingly paying 56 times earnings for a company playing in **Hewlett Packard's (HPQ)** sandbox.

By the summer of 2009, Lexmark shares had fallen to $16 a share. This fall from grace is all the more dramatic considering the company has 40 percent fewer shares outstanding than it did 10 years ago. With 78 million shares, the "new" market value was barely $1.3 billion.

In recent years, LXK's profits have fallen to $150 - $200 million annually. Free cash flow is substantially higher and profitability has stabilized at current levels. The slim market value more than discounts the problems Lexmark faces. While LXK will probably never be "worth" $17 billion again, $1.3 billion was a ridiculously low price. At the time of Schacht Value's first purchase, the company was trading around 8 times earnings. And it gets better.

Lexmark holds $1 billion of cash and securities on its balance sheet that could be used by any acquirer in a potential takeover. Liabilities, including $650 million of debt and a pension liability, are more than covered by this mountain of excess capital. In any case, they are long-term obligations. In the meantime, Lexmark managers continue to use excess cash to repurchase shares. They apparently know a bargain when they see it.

Schacht Value was confident that these numbers eventually would attract attention, that investors would revalue Lexmark. And they did. Just 9 months after our initial purchase, Lexmark shares have gained over 100 percent to $33 a share. Not bad for a second rate company!

We still like Lexmark and believe that **Dell (DELL)** could be a likely suitor.

Whether it was household names like **Boeing (BA)** and **eBay (EBAY),** or lesser known (or regarded) companies like Lexmark and Ternium, finding dollars masquerading as quarters was easy in 2009.

The question going forward is one of sustainability. The rebound in equity prices has done little to address underlying concerns. Most of these concerns relate to "big picture" issues like budget deficits, interest rates, inflation, the dollar, commodity prices, etc. Fear remains the prevailing emotion, creating opportunities as well as pitfalls.

Here's an example: The Department of the Treasury announced recently that 2009 cash outlays ($3.5 trillion) outpaced cash receipts ($2.1 trillion) by $1.4 trillion. A record deficit that is almost certain to rise. Ironically, as individuals and businesses cut spending and debt levels, government at all levels keeps spending (and borrowing). In fact, total debt in the United States has actually risen as new government debt more than replaces private sector debt reductions.

Which is more sustainable?

Yet largely due to investor fears, demand for Treasury securities is still robust. So much so that James Grant of *Grant's Interest Rate Observer* says Treasuries at current prices offer investors "return-free risk". The bursting of the credit bubble and the associated drop in asset prices has laid the groundwork for yet another bubble, this time in the world's "safest" asset class.

A January 26th *MarketWatch* report put an exclamation point on this belief. It reads (in part):

> *The Treasury Department sold $10 billion in 1-month bills on Tuesday* ***at a rate of 0%****, the fourth time since December that the government has sold the short-term securities for* ***no yield at all****. Bidders offered to buy 5.55 times the amount of debt being sold.*

Want to loan money to your Uncle Sam? Get in line. And pray interest rates don't go up.

If the paltry yields weren't enough, the Federal Reserve continues to hold down interest rates by purchasing Treasury securities with newly-printed money, somewhat akin to a grocer with his finger on the scale. This makes an investment in Treasuries even riskier. As for the Fed, they're hoping to spur a recovery.

A recent cartoon in *Barron's* magazine seems to capture the thinking perfectly. One besuited man (presumably a government official) tells another: "*Somehow, we've got to give consumers the confidence to start spending unwisely again.*" Sadly this seems to be the prevailing policy driver. We're steering clear and apparently others are too.

One money manager actually made the financial news this week by stating he'd rather own **Coca-Cola (KO)** shares than Treasuries. We agree that KO is cheaper (and safer) than Treasuries at their respective prices.

At Schacht Value, we prefer **Dr Pepper Snapple Group (DPS)**. The risk/reward relative to Treasuries isn't even close. It is no accident that DPS is our largest holding. Strong brands give the company pricing power, which protects us against inflation. In lean times consumers think twice about a kitchen remodel, but most continue to drink their favorite beverage. By industry standards, the company is tiny, with a current market value of $6.8 billion (or $26.80 a share).

To put this in perspective, DPS just received $900 million (13 percent of the company's market value) after renegotiating some bottling contracts with Pepsico, a $95 billion company. It is just the latest move by CEO Larry Young and his team, who have been busy since Dr. Pepper became an independent company following a 2008 **Cadbury (CBY)** spin-off. Since then, DPS has reduced debt, initiated a dividend, and expanded the Dr. Pepper brand into all **McDonald's (MCD)** restaurants. Despite a 77 percent gain in 2009, Dr Pepper Snapple Group is still cheap, with an 11 percent free cash flow yield. The company's big brands and small size also make it a potential takeover target. As a standalone company, Dr. Pepper is worth at least $10 billion (or $40 a share). A buyout could bring $14 billion.

Schacht Value doesn't have to be sanguine about the macroeconomic picture or the government response to like Dr. Pepper.

To take the argument one step further, our largest foreign exposure has been Japan, a country that is arguably in worse shape than the United States. Whether you look at economic growth or national debt to GDP, Japan (the country) is having problems. These same issues, however, don't translate into problems for companies based in Japan, especially companies with large international exposure. In the last year, Schacht Value has owned **Honda Motor (HMC)**, **Kyocera (KYO)**, **Nippon Telephone (NTT)**, and **Nintendo (NTDOY)**. All enjoy strong balance sheets and substantial free cash flow.

A current Japanese favorite is no different. **Takeda Pharmaceuticals (TKPHY)** sells drugs that combat diabetes, cardiovascular disease, and other disorders related to urology, oncology, gastroenterology, and the central nervous system.

The company has a beautiful balance sheet with almost $9 billion in cash and a multi-billion dollar securities portfolio. The list of holdings reads like a mini Japanese mutual fund with exposure to other pharmaceutical companies, chemicals, banking, insurance, and even tires (Bridgestone). And while the Japanese government is addicted to debt, the nation's companies generally shy away. Takeda's debt balances are practically nonexistent. Over one-third of Takeda's market value ($34 billion) is sitting on its balance sheet in the form of cash and securities.

Even before adjusting for these excess assets, Takeda is valued at less than 10 times free cash flow. Combine this with a gross dividend yield approaching 5 percent and (again) we prefer Takeda to Treasury securities. Besides TKPHY was founded in 1781. We're not sure what they were selling back then, but they clearly know how to survive.

Another Treasury/cash alternative is **NutriSystem (NTRI)**. Schacht Value started buying shares in May 2009 at $15 a share. With 30 million shares outstanding, its market cap hovered around $450 million. The balance sheet sported $70 million in cash and zero debt. Free cash flow in recent years has easily topped $60 million a year. As consumer demand fell in 2008-2009, cash flow remained high due to a flexible business model that uses very little capital. A 4.5 percent dividend yield didn't hurt either.

NutriSystem signed new distribution deals with the likes of Walgreen's, Sam's Club, and Wal-Mart last year. The prospect for renewed growth did wonders for NTRI shares. December saw NutriSystem shares trade between $25 and $33 a share. Our price target was $28, so by year-end NTRI was gone.

At $450 million, NutriSystem was a bargain with no expectations of growth. With a $1 billion market value, it was a bargain no more. Growth had become a foregone conclusion, a necessity. At $20 a share, we'd happily buy NTRI shares again.

We used the NutriSystem proceeds to buy shares of **Weight Watchers (WTW)**. More leveraged than NTRI, it nonetheless enjoys the same operational benefits: high margins, strong free cash flow, and low capital expenditure requirements.

Weight Watchers has 77 million shares outstanding, with nearly 60 percent of these shares owned by Luxembourg-based Artal Group. At $29 a share, the current market value of WTW is $2.2 billion. Given the free cash flow generating ability of this firm, fair value is closer to $3 billion, perhaps more. Free cash flow should approach $3 a share this year. In these lean times (pun intended), Weight Watchers is doing just fine.

Barnes & Noble (BKS), however, is struggling. Schacht Value started buying shares last summer and there has been precious little good news out of the company. That said, we see an undermanaged company in a fragmented industry with great potential and unrealized financial virtues. We're not alone.

This month, billionaire Ron Burkle sent a letter to the BKS board of directors and, by extension, to the Riggio family, controlling shareholders of the company. In the letter, Burkle's company (Yucaipa) expresses a desire to increase its current 18.7 percent stake to 37 percent. This would effectively match the Riggio ownership level. It is a fight for future control of the company.

Schacht Value noted Yucaipa's growing ownership last summer. It is one of several catalysts we identified that could drive the stock price materially higher. Nonetheless, most investors say Barnes & Noble is a dying company, a dinosaur. Why? In a word: **Amazon.com (AMZN)**.

The assumption that Amazon will eventually kill Barnes & Noble is exactly why BKS shares are so cheap. Warren Buffett says to "buy when others are fearful". He didn't say it was easy. The company's market value is a paltry $1.1 billion despite $150 million or more in free cash flow and a 5 percent dividend yield.

Schacht Value believes there is room for a physical alternative to Amazon.com (AMZN). Brick and mortar retailing isn't dead. The possible demise of Borders Group (BGP) only makes the competitive landscape more intriguing as Barnes & Noble has the financial strength to survive.

As for Amazon, its market value is $52 billion or 52 times its $1 billion (plus or minus) of annual free cash flow. That works out to an implied yield of 2 percent. Clearly Amazon's shareholders believe their company is going to grow at an accelerated rate for years to come. If not, they'd be better off getting in line for some long-term Treasuries. While Amazon is a better company than Barnes & Noble, we think BKS will be the better investment at its current price.

Sir John Templeton (Mr. Pessimism) would be skeptical of **Apple (AAPL)**, **Google (GOOG)**, and Amazon, especially at current prices. But we're told these are great companies, worthy of purchase at almost any price. The wider investment community (and financial press) has created its own version of the Nifty Fifty, the lucky few that garner constant attention. Interestingly, the anointed ones are often technology-related and are frequently "virtual" (meaning no physical locations), considered the nirvana of business models. All these positive attributes make it easier to build pie-in-the-sky valuations.

And 52 times free cash flow qualifies as one huge pie in the sky.

Not being in the cool crowd is just one of the sins committed by Barnes & Noble and other Schacht Value holdings. Then again most great investments don't come with a choir of angels. Warren Buffett bought Geico when others thought it was headed for bankruptcy.

It is not a surprise that the most extreme real estate prices (of the recent past) were seen in popular, desirable places to live like San Diego, Las Vegas, and Miami. The same is true of fast-growing companies like Amazon, which has legions of affinity shareholders. This is in stark contrast to places like Detroit and companies like Lexmark that have no such fan club.

So whether it's an unknown steel manufacturer, a company playing second fiddle to Hewlett Packard, an old fashioned brick and mortar retailer, or a purveyor of late-night weight-loss infomercials, it often pays to venture beyond the informal "approved" list.

Worries about Chinese monetary policy or possible debt defaults in Greece make good headlines, but they are a distraction from (and no substitute for) in-depth company-specific analysis. Neither will dictate the future value of Weight Watchers.

Schacht Value stays focused on the relationship of price to value.

Buying expensive property in San Diego is not a riskless bet (Amazon and Google). Distressed assets in Detroit (at the right price) can be very rewarding (Barnes & Noble and Lexmark). But really we'd prefer to buy San Diego at Detroit prices (Dr. Pepper Snapple). Or lakefront property in the middle of nowhere (Takeda Pharmaceuticals & Ternium)!

Thank you for your continued trust and support,

Henry W. Schacht, CFA