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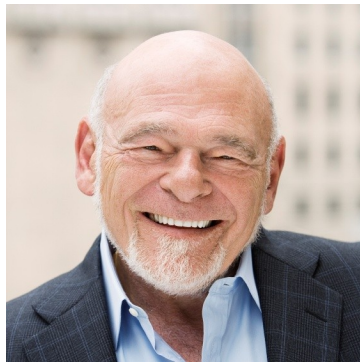


COLUMBIA STUDENT INVESTMENT
MANAGEMENT ASSOCIATION

Issue XIV

Winter 2012

Sam Zell — “Going for Greatness”



Sam Zell

Sam Zell is Chairman of Equity Group Investments (EGI), the private, entrepreneurial investment firm he founded more than 40 years ago. Mr. Zell holds a bachelor's degree and a J.D. from the University of Michigan.

G&D: Could you tell us a little about your life growing up and what impact that may have had on your future career as an investor and businessman?

SZ: I was born 90 days after my parents moved to this
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William von Mueffling — “Financial Productivity At a Discount”

William von Mueffling '95 is President of Cantillon Capital Management, an investment firm with more than \$8 billion under management. He was previously a Managing Director at Lazard Asset Management, where he was responsible for hedge funds. Prior to joining Lazard, he was with Deutsche Bank in



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William von Mueffling

Michael Karsch — “Be an Editorialist Not a Journalist”



Michael A. Karsch is the Founder and Portfolio Manager of Karsch Capital Management, LP (“KCM”), a global long/short equity investment manager located in New York City. Mr. Karsch founded KCM in July of 2000 and currently manages approximately \$2.3 billion in assets across several investment funds and separately managed accounts. Prior to founding KCM,

(Continued on page 11)

Michael Karsch

William Strong— “Outstanding Assets at Distressed Valuations”

Mr. Strong and his partner Sean Fieler manage Equinox Partners, Kuroto Fund, and Mason Hill Partners. He began his investment career in 1970 with Ruane Cunniff & Co., manager of the Sequoia fund. In 1986 he started his own investment firm, Mason Hill, and in 1994 launched the global

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William Strong



Pictured: Bruce Greenwald at the Columbia Student Investment Management Conference in February 2011.

The Heilbrunn Center sponsors the Applied Value Investing program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners.



Pictured: Heilbrunn Center Director Louisa Serene Schneider at the CSIMA conference in February 2011.

Louisa skillfully leads the Heilbrunn Center, cultivating strong relationships with some of the world's most experienced value investors and creating numerous learning opportunities for students interested in value investing. The classes sponsored by the Heilbrunn Center feature guest lectures by legendary investors, and are among the most heavily demanded and highly rated classes at Columbia Business School.

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Welcome to *Graham & Doddsville*

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

We have been privileged once again to speak with some of the world's most renowned investors, and are excited to bring you a piece of their wisdom.

Famed investor William von Mueffling '95, a proud graduate of Columbia Business School and chairman of the advisory board of the Heilbrunn Center for Graham & Dodd Investing, shared with us Cantillon Capital Management's strategy of investing in companies with high sustainable financial productivity. We found his discussion of the different business "moats" particularly insightful. Mr. von Mueffling outlined the thesis behind his firm's investments in Bank Rakyat, Royal Vopak, Oriflame Cosmetics, and others.

Michael Karsch, founder and Portfolio Manager of Karsch Capital Management, described his firm's intense focus on conducting thorough diligence and finding a point of differentiation, while evaluating companies in a lifecycle framework. Mr. Karsch also provided valuable advice on the skills critical to becoming one of the best in the profession and discussed the thesis behind his firm's investment in Viacom.

William Strong of Equinox Partners reflected on his early career at renowned value investing firm Ruane Cunniff, and the subsequent founding of his firm. Equinox Partners' strategy of investing in high quality assets at distressed valuations in emerging economies has led to many years of strong returns. Mr. Strong discussed some of his current investments in HDFC and Bunas Finance.

We were thrilled to get a chance to speak with legendary investor Sam Zell, who shared his investing philosophy and reflected on the path of his phenomenally successful ca-

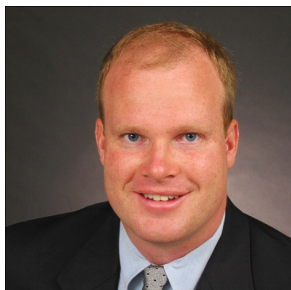
reer. We found Mr. Zell's discussion of adapting and investing through different business cycles particularly interesting. We also enjoyed learning about his innate and consistent ability to recognize, and then capitalize on, supply and demand imbalances in different markets that other investors had overlooked.

Finally, we are pleased to introduce you to William C. Martin, an entrepreneur-turned-investor, whose highly successful investing record and unique background caught our eye. Mr. Martin outlined his strategy of investing in companies with compelling growth prospects in conjunction with shorting some of the most overvalued and corrupt companies.

We deeply thank these investors for sharing their time and insights with our readers. As always, we welcome your feedback or ideas about the newsletter. We hope that you find it to be as useful a source of information about these great investors as we do!

- Editors, *Graham & Doddsville*

William C. Martin — "Think Like An Entrepreneur"



William C. Martin

Mr. Martin is the Chairman and Chief Investment Officer of Raging

Capital Management, an investment firm he founded in 2006. Prior to Raging Capital, he co-founded a number of financial information and media companies, including Raging Bull in 1997, Indie Research in 2002, and InsiderScore in 2004. He served four terms on the board of Bankrate (RATE) until it was acquired by Apax Partners in 2009. He

has also served on the boards of CallStreet (acquired by Factset Research (FDS)), ByteTaxi (dba FolderShare — acquired by Microsoft (MSFT)), and Salary.com (SLRY—acquired by Kenexa (KNXA)). Mr. Martin attended the University of Virginia.

G&D: How did you first

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William von Mueffling

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Germany and France. He earned a BA from Columbia College and an MBA from Columbia Business School in 1995. Mr. von Mueffling is chairman of the advisory board of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School.

G&D: Could you tell us a little about your background and how you first became interested in investing?

WvM: I was very lucky because between my junior and senior years at Columbia College I interned at Shearson Lehman Hutton in investment banking. After doing that for the summer I realized that there was nothing more miserable than doing it for two years as an analyst, so I thought about other areas of finance that would be interesting, and research jumped out at me. I didn't want to do it in New York City, so I ended up doing research with Deutsche Bank in Frankfurt. In the early 1990s working in sellside research in Europe for a German bank was not considered a glamorous job, but it created a great opportunity for me. No one in my office wanted to cover any stocks outside of Germany, so at a very young age I was able to do research on big companies that were listed in Europe. To be able to write, publish, and meet executives so early in my career was a unique opportunity, which I would not have had if I had

stayed in the US.

G&D: What led to your move from the sellside to the buy-side?

WvM: I realized I loved researching and investing in companies, but felt that the job of the sellside analyst was constrained in the sense that you typically had a sector or small group of companies to follow. I found this boring and wanted to broaden the number of companies I followed. I recognized that the only way I was going to make the jump from the sellside to the buy-side was to get my MBA. This is how I ended up at Columbia Business School.

G&D: What do you think you got out of your time at Columbia Business School that made a difference later in your career?

WvM: I got much more out of business school than I ever thought I was going to get. There are two main areas where I really improved. First, I gained an understanding of business cycles. I had read a lot about business cycles in the past but my own understanding of them really developed during business school. Second, a real "light-bulb" moment for me was taking Bruce Greenwald's value investing class and hearing some of the best investors in the world speak. Things started to click for me in terms of developing my own style of investing. What many of

these investors were doing really resonated with me.

The overriding theme of value investing is buying a dollar for fifty cents and therefore investing with a margin of safety. This principle is one of the most important things I took away from Columbia. It wasn't so much about a particular style or strategy, as there are many different styles under the value investing umbrella.

G&D: Can you talk about your specific style of investing at Cantillon?

WvM: One can broadly divide value investing into two camps. The first camp is the Graham & Dodd style which is buying assets at a discount or cash at a discount. The second camp is the Buffett style, which I characterize as buying financial productivity at a discount. We fall into the second camp. We believe that there are many different types of moats to be found, and that a moat around a business should allow it to produce outsized margins and wonderful returns on capital. The trick is being able to buy this stream of cash flows at a discount. Unlike Graham & Dodd investing where you might look at low price-to-book value companies or net-net companies, we are trying to buy high financial productivity at a discount to its intrinsic value.

G&D: Can you talk about

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"We believe that there are many different types of moats to be found, and that a moat around a business should allow it to produce outsized margins and wonderful returns on capital. The trick is being able to buy this stream of cash flows at a discount."

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William von Mueffling

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some of the companies you own and the moats that make them attractive?

WvM: Bank Rakyat is an Indonesian bank that has one of the highest ROAs for a bank in the world because it specializes in micro lending. If you think of Indonesia and the geographic area that you have to cover, micro lending means going to outer islands and remote parts of the country. Bank Rakyat has several thousand small offices, often as small as a kiosk, in such remote locations. Such a network would be very hard for a company like Citibank to replicate. This is a huge moat that results in high returns on capital. In Indonesia today, just having the infrastructure for a business is a huge moat. It may not be forever, but it is today.

Another company we own is Royal Vopak. Vopak is the world's leader in the storage of liquids at terminals. Finding the space for these terminals and getting all of the regulatory approvals is a long and complicated process. In addition, multinational companies that are shipping highly volatile chemicals or gas want to work with reputable companies. The terminals that Vopak owns or has long-term leases on represent a huge moat that is hard to replicate. Vopak is global and can offer terminals all around the world. This enables the company to have extraordinarily high

returns on capital and very high visibility. What is interesting is that both Bank Rakyat's and Vopak's moats are based on significant tangible assets, yet they still have very high returns on equity. Not all high ROE

“What is interesting is that both Bank Rakyat's and Vopak's moats are based on significant tangible assets, yet they still have very high returns on equity. Not all high ROE businesses are like ours in asset management where you have few assets. You can have great returns if your physical asset is truly unique.”

businesses are like ours in asset management where you have few assets. You can have great returns if your physical asset is truly unique.

Then there are a group of companies where the moat is a network. Names we own in this area are Rightmove, the leading property website in the UK and OpenTable, the dominant restaurant reservation website in the US. OpenTable is a destination website without physical assets. One of the things happening on the internet now is that verticals are being owned by dominant portals. People do not go to multiple websites for things like travel, dinner reservations, and real estate. If there is a dominant portal then there is a winner-take-all phenomenon. For example, Priceline is the dominant portal for travel in Europe. Similarly, Rightmove “owns” real estate in the UK. The stronger these portals get, the bigger the network effect and the higher the profits.

G&D: The Graham & Dodd vision of investing in underfollowed, obscure companies might say that the companies you look at are over-followed and that there are too many eyes looking at them. How do you think about this?

WvM: The true cigar-butts and underfollowed companies in the classical G&D sense are now few and far between. You can't manage a large amount of money and play in that space, and I would argue that you can earn very good returns in

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“...the best place to be in high-ROE investing is in names that are neither super-expensive nor super-cheap, where the market has a hard time trying to figure out what the right price is. This is where the best investing returns can be made.”

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Pictured: Benjamin Graham.

William von Mueffling

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the space that we play in. Our job as analysts is to spend the entire day asking ourselves: "what do we get and what are we paying for it?" There is a reason why large cap pharmaceuticals trade at low PE multiples and a reason why Amazon.com trades at a very high PE multiple. We all have to work very hard for our keep. The market understands the strengths and weaknesses of various companies. You have to pay more for a company with a great moat. Tano Santos, Columbia Business School's David L. and Elsie M. Dodd Professor of Finance and Economics, has done some great work on high-ROE investing recently. His work indicates that the best opportunities are not in the high-ROE companies with the lowest PE multiples – these companies usually have some structural problem such as a lack of growth, or in the case of large cap pharmaceuticals, patents that are expiring. Tano's work suggests that the best place to be in high-ROE investing is in names that are neither super-expensive nor super-cheap, where the market has a hard time trying to figure out what the right price is. This is where the best investing returns can be made. This is where we are generally most successful finding opportunities. What typically happens is that the market pays a very high multiple for fast growing companies with the best

moats and a very low multiple for high-ROE businesses that have structural issues – neither of these places is the best area to search for ideas. Rather, the best place to look is in the middle of the pack and to figure out which of these companies is mispriced.

G&D: Do you tend to use price-to-earnings multiples

"... when we set our price targets on companies, we use PE multiples because, at the end of the day, we are equity investors and we are valuing businesses based on the earnings a company can deliver."

more than others? Is this how you screen for new ideas?

WvM: For cyclical companies and turnarounds, price-to-sales is a much better ratio than price-to-earnings. Using price-to-book multiples makes sense if you are looking at companies that are losing money. From a

screening prospective it makes sense to use all of the tools that are out there. But when we set our price targets on companies, we use PE multiples because, at the end of the day, we are equity investors and we are valuing businesses based on the earnings a company can deliver. Even if we are looking at a company that has temporarily depressed earnings, we will still be pricing it off of the potential earnings power.

G&D: Could you illustrate that with an example?

WvM: Oriflame, a manufacturer and marketer of cosmetics, has been in existence since the 1960s, so there is a long-term operating history that we can look to in order to gain some comfort. This is a perfect example of a company where there is a disconnect between what you get and what you pay for. The company's share price is the same as when it went public in 2006 despite the fact that sales and profits have grown and the company is in more markets now than it was then. The company has suffered from three things that have not been in their control. First off, Russia accounts for approximately 30% of their sales. They manufacture their products outside of Russia, and therefore there is a currency mismatch between part of their revenues and costs. This has hurt their margins in the past few years as the

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Russian Ruble has been weak. But the company is now taking steps to address this issue by building production capabilities in Russia. Second, the Russian market for cosmetic products has been weak this past year. Lastly, the company was kicked out of Iran, a country which accounted for only 1.4% of sales. This spooked investors, although given the repressive regime in Iran, this should not have been so much of a surprise. Oriflame's multiple has historically been quite high as the company is perceived as an emerging markets growth company given that it is the leading player in Indonesia, Russia, and India. The market has historically paid a high multiple for the company, so you didn't have a margin of safety. But today, you pay only 10x earnings for the company. You don't have to put a high multiple on those earnings to have a lot of upside. Additionally, the co-founder of the company recently took 8 million euros of his own money to buy shares, and other members of the executive team also bought shares. This is the type of situation we look for – a company with a very depressed share price, but which has a leadership position in a number of emerging countries and therefore solid and sustainable earnings power going forward. Oriflame's moat is in the 3.5 million reps that promote and sell the company's products each day, in addition to its brand.

tion to its brand.

G&D: Some investors have discomfort investing in direct selling companies given the high rep turnover characteristic of the industry and multi-level marketing scheme. What would you say to the critics?

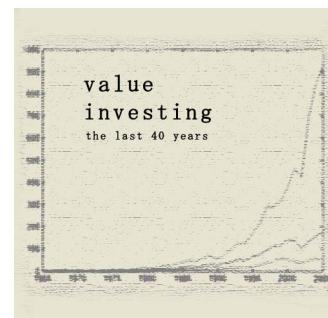
WvM: In the senior levels of these organizations, generally there is little turnover. The most senior reps are very loyal to the company. The high turnover occurs with the lower-end reps, typically because a lot of them are buying the products for themselves. There are a few reasons that investors do not like the direct selling model in the US. First, it is in a secular decline in the US. Direct selling has historically been an emerging markets business – as the market gets more mature, people go to a store to buy things. Second, if you look at the companies listed in the US, every so often one of them will blow up, which has tainted the overall industry. In emerging markets like India and Indonesia, direct selling may be the only way that many people have access to these products. So I differentiate between direct selling companies in the US and in emerging markets. Part of the reason that Oriflame is so cheap right now is that mainly Western investors own the name, and their judgment has been clouded by US companies that have had issues.

G&D: When investing overseas how do you think about the risk foreign governments might pose to companies you own?

“You also have to remember that your benchmark is the United States, a country with huge problems. We were recently looking at Thai banks, though we don't own any, and we compared Thailand to the United States on a piece of paper. If I covered the names and asked you which country would you would rather invest in, you would be shorting the US and going long Thailand. Thailand has a current account surplus, full employment, low inflation, and other advantages.”

WvM: There is no black and white answer. It mat-

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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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ters what country you are in, what's the domicile of the company, how big the company is, and a whole

"The single biggest thing that has changed from when I started my investing career to today is that the macro environment has enormous risks that are now coming to a head. As a result, I think that there are many more value traps today."

host of other factors. You also have to remember that your benchmark is the United States, a country with huge problems. We were recently looking at Thai banks, though we don't own any, and we compared Thailand to the United States on a piece of paper. If I covered the names and asked you which country would you would rather invest in, you would be shorting the US and going long Thailand. Thailand has a current account surplus, full employment, low inflation, and other advantages. One of the things we can't forget is that the world we

live in today is very different from the world 20 years ago.

G&D: How does your macro view shape how you invest today?

WvM: The single biggest thing that has changed from when I started my investing career to today is that the macro environment has enormous risks that are now coming to a head. As a result, I think that there are many more value traps today. Until the financial crisis, every company seemingly was growing. In the aftermath of the credit bubble and in the years ahead, one thing we can say with some confidence is that we will not have much growth in the West for some time. If a company has a lot of Western exposure, you have to be able to explain why they are going to grow even if Western growth is zero. OpenTable and Google don't need Western growth to be bigger companies five years from now, even though both are primarily exposed to Western economies. Another perfect example is a Spanish security service company called Prosegur that we have owned for many years. Prosegur's management realized about ten years ago that to be able to grow, it needed to expand outside of Spain and began making the right investments. Today its cash-in-transit business has leading position in many Latin American countries and is growing rapidly,

and therefore the company has been a great investment for us despite the fact that the Spanish business has been stagnating. Part of the reason that high ROE strategies have had more difficulty in recent years is that there are plenty of high ROE companies that are primarily exposed to the West and cannot grow.

"Going to the pond of low ROE stocks is like going to the pond with only one fish. You may get lucky and catch that one fish, but why would you ever waste your time doing it. A low ROE business will do poorly over time in the stock market so we don't bother looking at it."

G&D: How do you feel about situations where the founding family is a major shareholder in a company?

WvM: I think it depends who the founding family is

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William von Mueffling

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and how involved they are. There are some great companies, such as chemical company Wacker Chemie based in Germany, where the founding family is heavily involved. I don't think you can make a general statement about founding families. We own a company, Aalberts, where the founder, Jan Aalberts, refuses to allow any of his children to work for the company. He thinks that if you have your children work in the business then it's not a meritocracy.

G&D: How does Cantillon maintain large global coverage with a small team of analysts? Are your analysts sector specialists or generalists?

WvM: Our analysts are generalists. The problem with specializing in sectors is that you tend not to have your eyes open to other sectors. We don't have to cover the world of stocks for our strategy; we only have to follow the world of high-ROE stocks. We do not own McDonald's, but given that it's a very high-ROE company, we have a price target on it. For us there is no point in following low-ROE companies, as it is a fact that low ROE companies will underperform the stock market over time. It is like if you are going fishing for the day and there are two ponds, one that is stocked full of fish and the other has one fish in it. Going to the pond of low ROE stocks is like going

to the pond with only one fish. You may get lucky and catch that one fish, but why would you ever waste your time doing it. A low ROE business will do poorly over time in the stock market so we don't bother looking at it. Sure we will miss the low ROE companies that become high ROE compa-

"The most common mistakes that people make in high-ROE investing is confusing high operating margins and high ROEs with a moat. If it smells like a commodity business but the returns are higher than a commodity business, it is likely still a commodity business."

nies, but we would waste a substantial amount of time trying to find these companies.

G&D: What is your diligence process like?

WvM: It is different with every company. Since we know who the high ROE companies are around the world, we try to visit them and talk to them over time. Take Oriflame for example – we have met with them many times over the years although we only recently began investing in the company. Even if we don't invest with some companies initially, we get to know the different industry players well, and knowledge accumulates over time.

G&D: Can you talk about your sell discipline?

WvM: In high-ROE investing your time horizon really should be infinite. The fantasy is that you never ever sell any of your holdings. If a company generates very high ROEs and does good things with its cash flow such as reinvesting in the right projects or buying back stock, they will continually grow earnings. Your price target, which you base on next year's earnings, will always be increasing so you will reset your price target and continue to hold the stock. The poster child for this is Swedish Match, a company which I first invested in 1995 at Lazard Asset Management, and later when I founded Cantillon. It has been one of the most amazing stocks in Europe during that time. The multiple never gets higher than 17x, but every krona of free cash

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Pictured: Tom Russo at CSIMA Conference in February 2011.

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William von Mueffling



Pictured: Howard Marks, key note speaker at CSIMA conference in February 2011.

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goes to buying back shares. They have actually had to change the rule in Sweden on having negative equity as a result of Swedish Match's share repurchases, because companies weren't allowed to have negative equity. So that's the fantasy that you will never have to sell these stocks. The reality is that companies do get to be too expensive. The best example of this is Coca-Cola. In 1999 or 2000 it traded at 60x earnings – if you bought it then you haven't done too well even though over that time Coca-Cola has grown sales and earnings. The PE multiple has gone from 60x at the peak down to where we bought it at 13x. We have price targets for all of our companies and we say that we hope we never have to sell any of our companies, but as companies approach our price targets we sell them and put proceeds into names that are far away from their price targets.

G&D: Can you talk about some common mistakes that investors tend to make?

WvM: The most common mistakes that people make in high-ROE investing is confusing high operating margins and high ROEs with a moat. If it smells like a commodity business but the returns are higher than a commodity business, it is likely still a commodity business. Mistakes I've made have been situations where I have not adhered to this advice and I've fallen in love

with the returns generated by a company and failed to pay attention to the nature of the business. There used to be three listed companies that made sausage casings: Devro in the UK, Viscofan in Spain, and Viskase in the US. Devro had 40% operating margins and generated unbelievable ROIC, and the

"I call our portfolio today the "dream team of high ROE investing" because it consists of some of the best moat businesses in the world."

market for sausage casings was highly consolidated. When I first looked at it I thought it was a commodity business that was not difficult to replicate. I hopped on a plane and went to Glasgow to take a factory tour and learn how sausage casing is made. What I learned confirmed my pre-suppositions – this is a simple, easy business. Still, I walked away thinking that the companies had such incredible margins because this was an oligopoly and convinced myself this was a good business because the returns were so good. Very shortly after we invested in Devro,

one of the competitors started to go after market share by cutting prices and the whole industry just collapsed. This is one of the reasons that we work on ideas in teams at Cantillon – we don't want to fall in love with returns.

G&D: Has your strategy of focusing on high return companies changed during your investing career?

WvM: The one thing that has changed is that we keep raising the bar around what constitutes a good company. I remember one time I met with the chairman of Hunter Douglas - a great company that manufactures window blinds - and he asked me about our strategy. I told him that we invested in high-ROE businesses like his. He asked me what a good ROE was and I told him 15%, and he responded that a minimum ROE for a great company was 20%. Over time, we have come to be more in tune with his way of thinking. I think that there are enough amazing companies out there where you can create a portfolio of 60 names with an average ROE in the mid-20% range. I call our portfolio today the "dream team of high ROE investing" because it consists of some of the best moat businesses in the world.

G&D: Are there any situations where focusing on ROEs can be misleading?

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WvM: ROE can be misleading if the ROE is not sustainable. Technology can disrupt an ROE. At the same time, you can have industries that go from low ROE to high ROE through consolidation. A good example of this is the US aluminum can industry, which was highly fragmented in the early 1990s. The industry went through rapid consolidation during the 1990s until there were two main players remaining, Ball Corporation and Rexam. ROEs went from very low levels to roughly 20% after the consolidation. However, for every example like this I can give you another where an industry goes through consolidation but the return profile does not improve. The way many companies destroy high ROEs is through making expensive acquisitions. Heineken's core business is an amazing one, but in the late 1990s and early 2000s, it was paying very high multiples for many low-quality brewers. This drove Heineken's ROE down and destroyed shareholder value. All of the companies we own throw off a ton of cash, so you have to know what management is going to do with it. We spend a lot of our time getting comfortable with what management will do with the cash their businesses generate.

G&D: What makes a great investment analyst in your mind?

WvM: If it was just about

"If someone tells you that 'we buy eyeballs' and that a stock is cheap based on price to eyeballs, ask the question 'is buying something based on eyeballs a valid investment strategy?' The great news is that all of the successful investment strategies are known and haven't changed since the efficient market hypothesis was first put out there. The problem is that many firms don't pursue these strategies, and that these strategies require a lot of patience."

being smart and having an MBA, there would be a lot of great investors. So there must be some other quality that is necessary to be a great investor. I think that quality is good judgment. An analyst needs the judgment to determine that businesses, moats, and management teams may not be as good as they seem. The problem is that this is a very tough thing to interview for.

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

WvM: Only follow back-testable investment strategies. If someone tells you that "we buy eyeballs" and that a stock is cheap based on price to eyeballs, ask the question "is buying something based on eyeballs a valid investment strategy?" The great news is that all of the successful investment strategies are known and haven't changed since the efficient market hypothesis was first put out there. The problem is that many firms don't pursue these strategies, and that these strategies require a lot of patience. When you see so many mutual funds with 100% turnover, you know that they are not following a robust strategy. Most importantly, find someone that you enjoy working with. And read a lot.

G&D: It was a pleasure speaking with you, Mr. von Mueffling. Thank you for your time.

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Michael Karsch



Michael Karsch

“Sometimes you learn things explicitly... and other times you learn things implicitly, just through experience. My education involved both of those things and the key is figuring out how to properly integrate them.”

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Mr. Karsch was a Managing Director at Soros Fund Management and was one of four investment professionals at Chieftain Capital Management. Mr. Karsch began his career as an investment banking analyst at Wasserstein Perella & Co. Mr. Karsch graduated Phi Beta Kappa with a B.A. from Tufts University in 1990. He obtained his Master of Arts in Law and Diplomacy from Fletcher School of Law and Diplomacy in 1991 and obtained his M.B.A. from Harvard Business School in 1995.

G&D: Can you tell us a bit about how you got interested in investing?

MK: As a teenager, I started investing in gold. This was during a very volatile time in the late 1970s, and I probably did all of the wrong analysis, but it worked out...and then it didn't work out. But the experience got me hooked in terms of thinking about how to make money in the markets. Subsequently, I started reading about and following some stocks. At the time I probably didn't have the right reasons for investing in these stocks, but nevertheless I thought I had a method for it. Later, my investment banking experience at Wasserstein Perella & Co. helped to formalize my opinions about stocks. I found a company

called Timberland, and for the first time I was able to marry my own personal view on the stock with some of the more systematic valuation techniques that I learned in investment banking. With Timberland, I noticed it had been more of a suburban brand but that it was increasingly gaining traction among urban kids as well. I realized this could breathe new life into the brand. At the time the company wasn't making much money but I saw its potential. I started spending a lot of time checking out their shelf space at places like Foot Locker, cold calling the company, etc. I ended up paying for business school with profits from that investment as the stock went from about \$14 per share to \$80. I remember running in between classes at Harvard Business School calling the Charles Schwab phone number to find out where Timberland was trading. A bunch of my classmates and family then ended up owning Timberland because of my research. I was really hooked at that point.

At business school, I got to hear Seth Klarman speak. I had been more interested in "Growth at a Reasonable Price" investing up to that point, but Seth's emphasis on value investing with a margin of safety made a lot of sense. Seth actually asked me to interview, but I wanted to be in New York, so he graciously sent my

resume to Chieftain Capital. The three main principals at Chieftain were all Columbia MBAs. I was very excited about joining Chieftain because, unlike many hedge funds at that time, it was structured to really teach an analyst. At Chieftain there were ten stocks and four people, and I felt like it was a great way to get an education. I stayed there for three years and afterwards got an opportunity to work at Soros Fund Management for two and a half years before starting my own fund.

G&D: Could you tell us about a few of the key things that you learned along the way?

MK: Sometimes you learn things explicitly, such as being told something by a colleague, and other times you learn things implicitly, just through experience. My education involved both of those things and the key is figuring out how to properly integrate them. Chieftain taught me that you have to figure out what your point of differentiation is. They felt their point of differentiation was to know their names better than anyone else and have a lot of discipline. Most of all, what they taught me is that you need to know your stocks cold. We'd sit down to lunch together and they'd ask many questions, like "What's the growth rate in this company been the last

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three years? What's the trend in margin? What's the ROE? How will they be able to expand that ROE going forward? What is the company's competitive advantage?" So I learned from them that there's a methodology to analyzing and thinking about stocks. And I think sometimes people forget that – they just want to talk instinctively without a methodology behind it. Having this methodology clear in my mind made me more thorough and objective in analyzing different investments.

What I learned later from Stan Druckenmiller at Soros Fund Management was to be more creative, to think about the industry before the company, and to be more thematic, because stocks are not just a mathematical exercise. There's a whole group of people who just focus on how cheap a company is, and there are others who gravitate to finding a "great company." In my own view these things are relevant, but they're hugely overestimated. From Stan I learned to think more creatively about a secular theme and then how to fit it into the overall systematic way of thinking about companies that I learned at Chieftain. Then over time, you learn many life lessons. I keep some of these notes on a board in my office to remind me of them all the time. Stan used to say, "Everyone's a long-term

investor until they start los-

"Simplistically at Karsch Capital Management, we seek to invest on the long side in stocks which are ascending the lifecycle and short stocks which are descending the lifecycle. Our area of greatest strength has been to invest on the long side in stocks which might be classified as value and GARP and to short stocks which are either "broken momentum" or "value traps." Our area of discomfort lies in investing (long or short) in momentum stocks, primarily because these stocks and businesses attract and encourage speculation which overrides traditional analysis."

ing money." Once you start living through volatility, you understand what that means. People have in their own mind how they would like to see themselves as an investor, but often this view isn't consistent with the duration of their capital or their own temperament. For instance, everyone wants to be Warren Buffett. But very few people have the temperament, the stomach for the investment duration, the capital, or the conviction of Warren Buffett. Mike Tyson has a similar quote that I like: "Everyone has a plan until they get punched in the mouth." So those are just some examples of the many things I've learned.

G&D: Could you talk a bit about the lifecycle of investing approach that you write about in your letters and how that applies to the checklist that you use in evaluating companies?

MK: The lifecycle of investing is a framework that states that markets, industries, companies and stocks typically move through 5 stages over time. These stages are: 1) distressed, discarded and/or undiscovered, 2) value, 3) growth at a reasonable price (GARP), 4) growth, and 5) momentum. The lifecycle analysis and an appreciation for a company's evolution through the cycle often lead us to ask whether a company will be perceived as

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better (up the cycle) or worse (down the cycle) over a reasonable investment horizon. Simplistically at Karsch Capital Management, we seek to invest on the long side in stocks which are ascending the lifecycle and short stocks which are descending the lifecycle. Our area of greatest strength has been to invest on the long side in stocks which might be classified as value and GARP and to short stocks which are either “broken momentum” or “value traps.” Our area of discomfort lies in investing (long or short) in momentum stocks, primarily because these stocks and businesses attract and encourage speculation which overrides traditional analysis. The lifecycle framework is premised on microeconomics, reflexivity and human behavior. Determining where an investment resides in the lifecycle is more art than science and requires debate about which variables are most relevant. So, when thinking about the lifecycle, we consider who is on the other side of the trade and what their argument is. We ask ourselves why the stock is trading at its current price, whether it can be impacted by reflexivity in any way, whether we expect an acceleration or deceleration when it comes to earnings beats, and whether this is consistent with where we think the company is in the cycle. Finally, we try and think about how far in the lifecycle each company can go and what

this means for our exit strategy.

The key is figuring out what your point of differentiation is with each idea. Are you

“The lifecycle framework is premised on microeconomics, reflexivity and human behavior. Determining where an investment resides in the lifecycle is more art than science and requires debate about which variables are most relevant. So, when thinking about the lifecycle, we consider who is on the other side of the trade and what their argument is. We ask ourselves why the stock is trading at its current price, whether it can be impacted by reflexivity in any way ...”

an innovator, an imitator, or an idiot? As an example, when activist investors first pitched Deutsche Börse, they spoke about management change, cost cuts and share repurchase. All of these initiatives were intriguing to value investors, especially because the stock traded at less than 12x forward FCF. The stock had already appreciated by the time we analyzed the Company, so we pondered whether we could still find a point of differentiation. We concluded that existing investors understood the cost cutting and capital allocation story being pitched, but were not focusing on the revenue growth story. In other words, investors saw Deutsche Börse as a solid company, but not a growth company. We have followed Chicago Mercantile Exchange since its IPO and we strongly believed in derivative exchanges as strong secular growth businesses. Therefore, we believed investors would reward Deutsche Börse by allowing it to move up the lifecycle to GARP and growth. Timberland was another example of the importance of understanding where a company is in the lifecycle as well, as people thought things were going very badly for them and were bearish on the company, but in fact the brand was being revitalized. There were a number of mini lifecycles going on within the company, but its cycle ended on an upswing

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Pictured: John Spears of Tweedy, Browne Company at CSIMA Conference in February 2011.

“Apple is the ultimate lifecycle stock. We started writing about our interest in the company almost seven years ago, and we talked about what a great opportunity there was for the iPod if it addressed the market that Sony’s Walkman had addressed.”

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“Just identifying great companies with large moats around them isn’t enough. In my opinion, you’re a journalist in that case and you will probably be a solid role player, not a superstar. ... You become a superstar by developing and using your own judgment, rather than what textbooks tell you, to figure out what’s a great stock and why.”

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because Nautica took them over. Now, related to looking at where a company is in the lifecycle, we use our checklist to evaluate all of the components of the business, the industry, the management team, potential catalysts, valuation, and many other factors.

G&D: Given that you focus a lot on mid-cap and large-cap stocks, do you still find many companies that are in the earlier stages of the lifecycle? And does a company like Priceline fit the bill?

MK: Priceline is a fantastic example of a lifecycle stock. It was a 1999 darling. Everyone thought that they were the geniuses of the world. They had this interesting notion of how to do a reverse auction. It turns out that there was a very limited niche for it and the CEO was a big spender who got reckless. We started looking at it again when the stock had declined almost ninety percent from its peak. The attraction of the company at that point had to do primarily with its large NOLs, with optionality on the operating business, rather than any good operating metrics. The company subsequently got rid of the old CEO, was able to turn the business around, and buy Bookings.com for about \$300 million. Bookings.com was a phenomenally successful acquisition, as it now represents two thirds of

their profit. And Priceline has around a \$25 billion market cap!

Another example is Apple. Apple is the ultimate lifecycle stock. We started writing about our interest in the company almost seven years ago, and we talked about what a great opportunity there was for the iPod if it addressed the market that Sony’s Walkman had addressed. At that time, you were basically getting the company for cash, and the iPod presented optionality for the company. The big debate around Apple now is: could a technology products company really be worth \$700 billion to \$1 trillion dollars? Or, is it just trading at 10x earnings? You could argue that many of the financial companies in 2009 represented lifecycle opportunities.

G&D: At Columbia we are taught to look for companies with sustainable moats around the business. But you tend to be more of a “growth at a reasonable price investor.” How do you try and blend the two together?

MK: I’ve always asked, “Do you want to be a journalist or an editorialist?” Just identifying great companies with large moats around them isn’t enough. In my opinion, you’re a journalist in that case and you will probably be a solid role player, not a superstar. I don’t think you’re going to

get rich figuring out whether Porter’s five forces fit into a given company or not. The value-add is on the editorial side. You become a superstar by developing and using your own judgment, rather than what textbooks tell you, to figure out what’s a great stock and why. You can start by identifying and learning from great stock pickers. Obsessively try and figure out what they’re doing. And it’s not just, “oh, I’m going to follow XYZ investor, and do exactly what he does.” You have to try to understand why they are investing in a particular company and what their point of differentiation is.

G&D: How do you think about the macro picture these days?

MK: We certainly have to take the macro picture into account in our thinking, and that’s disappointing because that’s not what is most fun to me about the business. The fun for me is finding a creative new idea and realizing that the company has transformed but the market hasn’t caught onto the transformation yet. Unfortunately, in this type of environment you need to give extra thought to all of the issues affecting the investment landscape. For the first time, I’ve considered hiring a macro analyst who could help synthesize all of the data points that are affecting the markets. I don’t

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know when all of this focus on the macro issues relating to the US recovery will end. The recovery has been so weak that any improvements seem like a big deal. Are we on a sustainable path to recovery, or not? What will the impact of the presidential election be? There are elections all over the world this year. There is a new regime coming in China. I never fully understood what people meant by kicking the can down the road, but when you look at the U.S., we're just growing our deficit every year. So while corporate balance sheets look better and such, is all of this superseded by the fact that our debt to GDP keeps growing? It's hard to know.

G&D: Your fund significantly outperformed your peers back in 2008. Are you seeing issues in the macro environment that are similar to that time, and if so are you positioning your fund defensively?

MK: The current U.S. picture does not feel like 2008. For one thing, the jobs picture seems to be improving. Credit has not gotten worse, which is a big difference. The banks are better capitalized and rail volumes are going up. During 2008, the stock market was still going up and up but the rail volumes had fallen off a cliff and no one seemed to care. Capacity utilization now is at a level about where we were right before the collapse of Lehman Brothers. The unem-

ployment rate is already pretty high, so how much higher can it really go? There are a lot of other areas, like housing starts and auto sales, where it's starting to feel now that we're operating at more of a base level. The only question is:

"I think analysts spend too much time building models and being myopic in that regard and they don't spend enough time trying to take a broader perspective. That's why we try to stress focusing on an industry before a specific company."

do we have a looming time bomb that will eventually manifest itself in some way like in Italy? We all want to believe that our debt market is safe because the US 10 year Treasury yield didn't go up even with the rating downgrade in August 2011. The temptation is to say that these things won't happen. But we may just be in the middle of a tempo-

rary respite because the state of many foreign economies is so poor that plenty of capital is coming towards the U.S. dollar. Four years from now, it could be very different.

G&D: Could you talk about some of the common errors that you see young analysts make?

MK: Well, one thing we already talked about is that too many analysts just try to define a "good company" or "bad company" without taking a more sophisticated view. Too many analysts have not experienced a lot of failure and can be ill prepared to deal with it. They have incentive to convince themselves that they are doing great and avoid constructive, objective feedback. Good analysts realize you have to fail and have setbacks in order to eventually succeed. Most of the people I know who are successful have a great deal of perseverance, and they learn from their problems. Most analysts are too money-focused early-on. At Chieftain, I knew I would be giving up plenty of money compared with some of my friends who went to other places. But that job was worth an enormous amount to me. A lot of young analysts have no idea how to behave in a performance review, and they often focus on a very small amount of money rather than seeing the big picture. This tends

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to alienate people who would otherwise become their mentor. Some analysts aren't good at managing upward and aren't skilled at cultivating relationships with people who are senior to them. Good analysts show a desire to continuously learn. Professional athletes are amazing continuous learners and are so much better at that than stock pickers, and yet, the education level of the stock pickers is supposed to be exponentially greater than the athletes.

G&D: With all the data out there and all the reading material, what do you ask analysts to focus on and what do you tell them to avoid?

MK: I think analysts spend too much time building models and being myopic in that regard and they don't spend enough time trying to take a broader perspective. That's why we try to stress focusing on an industry before a specific company. This has become a more complex business over time. It used to be enough for a professional football player to be over 300 lbs or a professional basketball player to be over 7 ft. Now you have to be 7 ft. and fast, or 300 lbs and quick. Stock-picking is the same way. You need to be very good with the computer and going through the documents but you also need to be creative.

G&D: Could you talk about a particular name that you

like right now and why?

MK: We started buying Viacom stock in the high thirties. We believe it is in the value stage of the lifecycle. People have made the assumption that cable programming isn't a great business anymore because there isn't much room for penetration for multi-channel distribution in American cable. Viacom doesn't have a tremendous international business either, although that existing business is growing. People are worried that multi-channel penetration will actually decrease over time due to Netflix, or better antennas, or people moving into their parents' home. Some believe that the cable operators or Congress will come up with an a la carte service, meaning that you won't need to buy 50 channels all at once. Instead, you could decide to just buy Disney and MTV. Some think that unbundling would kill the business model since not everyone wants all of these other channels. This has been brought on by the fact that everyone is basically paying \$7 or \$8 per month for ESPN. So, obviously, if you're not a sports fan and it's a tough economy, that sounds terrible. But the reality is if a la carte happens, it will be many years from now. These companies have five year contracts with cable operators. These contracts actually call for price increases, not price decreases. Netflix and

the various threats are real, but they are hitting Viacom at a rate of 1% or at most 2% per year, and I'm not convinced it's going to accelerate dramatically in the next five years. You can already see Netflix having some problems with their model in terms of the business not scaling as much as they expected. You also have some people who are worried about advertising and things like ratings. Ratings at Nickelodeon right now are weak and people extrapolate that kids are too busy playing on their iPads and therefore don't watch Nickelodeon. I tend to think ratings just bounce around. When ratings are bad, people make up excuses and reasons for why that will persist, but I think it just fluctuates. In terms of advertising, 35% of cash flows come from predictable subscription fees. Yes, there could be some volatility in the advertising, but the impact on cash flow won't be dramatic. The changes that are taking place now, like Netflix, etc., won't really dent the free cash flow. So, the perception and reality are quite different.

The company has also said they are going to redistribute \$20 billion in free cash flow back to their investors over the next five years. This basically means \$2.5 billion in dividends and \$17.5 billion in buybacks. So you're talking about a

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“Good analysts show a desire to continuously learn. Professional athletes are amazing continuous learners and are so much better at that than stock pickers, and yet, the education level of the stock pickers is supposed to be exponentially greater than the athletes.”

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Pictured: Marty Whitman, Adjunct Professor, Heilbrunn Center for Graham & Dodd Investing, at Graham & Doddsville breakfast in October 2011.

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company that is basically buying itself back over the next five years. Despite the buyback announcement, the stock is flat. So people either don't think that free cash flow will come through, or they are being too myopic... I don't really know what their reasoning is. My view is, if advertising gets worse and cash flows go down, they will have less cash for buybacks but they will buy back a similar percentage of shares because the stock price will be lower. I actually think the free cash flow will grow from \$2.5 billion to \$3 billion to \$3.5 billion over the next five years. In five years, if the stock is flat, you will have a company with a market cap of \$7.5 billion down from \$25 billion because of all the repurchases. At that point, the market would be saying that they will only generate \$700 million in free cash flow when I think they can generate \$3 billion or so. Therefore, there's an incredible margin of safety.

You could say, well, if the stock goes higher they won't be able to repurchase all of those shares. But that's fine. In that case I'd just sell the stock and make a nice profit. If the price doesn't rise, you're talking about a stock that in five years is probably trading at 2.5x P/E. Maybe the world will be different at that point. Maybe it will be worse, maybe it will be bet-

ter. We think there is still value in the MTV and Nickelodeon brands. Maybe the industry will go to a la carte pricing like what's happened in the music industry. In this industry, however, you

“Great analysts see bumps in the road as sources of pride and necessary situations because they understand that this is a business where the best-case scenario is that they'll be right 60% of the time.”

still have contracts in place for five years, and you don't even know if they'll be able to do an a la carte scheme after five years. There are plenty of forces fighting against it. Finally, a lot of people still watch Nickelodeon and MTV. It's not as if everyone is paying lots of money for these channels and not watching them. In terms of a status quo view, let's say that the company has flat free cash flow over the next five years instead

of the growth in free cash flow that I expect. If you go to a 10x multiple on that, the stock is a triple or quadruple, with optionality for a takeover. So I just look at it and I think people are misguided and myopic in terms of worrying about the short term ratings.

Right now they actually benefit to a degree from Netflix because Viacom owns Paramount. All of those shows and movies they've licensed to Netflix have actually provided some very nice cash flows. One could say, well what happens if that cash flow stream from Netflix goes away? If that goes away then by definition Viacom's core business must likely be still thriving. I'm not saying that the business won't change ten years out, but investing is a probability business, and in my opinion, the probability of their cash flow going down by half to two-thirds over the next five years instead of going up by 30% is very low. I haven't heard a realistic, convincing argument yet as to how that will happen.

G&D: In our remaining moments, could you finish the following sentence? A great analyst...

MK: A great analyst is a continuous learner. A great analyst knows how to get the best out of everyone they work with. There's a tendency for analysts to say,

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"That investor is so great! I'm going to do what they're doing" and they look solely at outcomes instead of using their own brain. In other words, "don't worship false gods." A great analyst recognizes that this is a mentoring business and actively seeks out mentors in order to become successful. They also understand it's a non-linear progression business. When an analyst understands that, they're able to think about their game plan very differently. They understand that the market is always improving and their skill set needs to also. You can't just rely on investment banking exercises or Porter's five forces to help you truly understand what's going on at a company. Great analysts see bumps in the road as sources of pride and necessary situations because they understand that this is a business where the best-case scenario is that they'll be right 60% of the time.

G&D: Any parting words for our readers?

MK: In order to be good at anything, you need to figure out how and where you can absorb pain. I have a friend who is a professional football player. I always say, "I don't know how you are willing to be tackled by 300 pound people." But he feels that football is where he is at his best. Where else would he be able to make the kind of money he makes

and be that famous? It is his choice, and he is willing to overcome whatever pain it

"A great analyst recognizes that this is a mentoring business and actively seeks out mentors in order to become successful. They also understand it's a non-linear progression business. When an analyst understands that, they're able to think about their game plan very differently. They understand that the market is always improving and their skill set needs to also."

takes in order to win.

I have chosen this industry where the pain is acceptable for me. That is not to say that this is an easy business. There is rejection from the market, from clients, from peers. I've taken whatever pain I've needed to for 16 years in a row now in order to continually grow and persevere, because this is my equivalent to his football. But my impression is that most young people have a sense of entitlement. They've been told how great they are by their parents. They've gotten into a great school, and then a great business school and they think that everything will come their way. I think people felt that way when the economy was doing great. Factset just said they lost subscribers for the first time in their history. There's a high probability that the world is only going to get tougher than it has been for the last ten years. I haven't seen young people change their attitude to reflect this more difficult environment, and I already felt they weren't tough enough to face the previous environment. To be good in this business, you must carefully cultivate the important relationships that will get you to where you want to go. To be successful, you have to be resilient.

G&D: Thank you very much for your time Mr. Karsch.

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William Strong



William Strong

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long/short hedge fund Equinox Partners. Mr. Strong graduated from Williams College with a BA in Economics in 1971 and received his MBA from Harvard Business School in 1979.

G&D: When did you first become interested in investing?

WCS: When I was ten years old, my mother belonged to an investment club. I talked about investing with her and soon decided I wanted to buy a stock. My uncle suggested that I buy one share of Blackwell Oil & Gas Co. So I did... and then it went bankrupt. That was the beginning of my investment career.

I've always been interested in investing as well as history and economics. I earned a degree in economics from Williams College. After a brief stint in the Army, I worked as a municipal bond underwriter for Loeb Rhoades & Co. This was in the early 1970s when interest rates went up a lot and New York City defaulted on its debt. So I had an interesting initial experience in the financial markets. I went back to business school and they actually taught Graham and Dodd investing at Harvard Business School for a week. This was probably the last year they ever did that because, of course, they then

decided that markets were perfectly efficient and these classes were a total waste of everyone's time. But the Graham and Dodd approach to investing made sense to me. To make a long story

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We spent most of our time analyzing

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period of time.

That's the basic orientation of how I started."

short, a small New York value investing firm, Ruane Cunniff, was looking to hire somebody out of our business school's investment class, and they hired me. That job opportunity turned out to be possibly the luckiest thing that's ever happened to me. I remember interviewing with Bill Ruane and recall him saying, "I'm a

friend of Warren Buffett." At the time, I thought to myself: "Who is Warren Buffett? I've never heard that name before." I worked at Ruane Cunniff for seven years and then I started my own business in 1986.

Bill Ruane had taken Benjamin Graham's course in business school and had met Buffett while in school. So Ruane had something like the Buffett approach to value investing, which I would define as preferring better quality businesses and managements and willing to pay a bit more for them. We were drawn to businesses that had strong competitive positions and sustainable, high returns on capital. We spent most of our time analyzing companies' competitive positions and if they could generate high ROEs for a long period of time. That's the basic orientation of how I started. One of the first things I worked on at Ruane Cunniff was Ginnie Mae bonds yielding 18%. Those were the days of the 15% 30yr non-callable treasuries. We also looked at high quality US companies. I remember I worked on Gillette and tried to figure out if 7x earnings wasn't cheap enough. Ruane wanted me to focus on big name US stocks when I started. I moved from there onto smaller cap US stocks as well as some European companies in the latter part

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of the 1980s.

G&D: Could you talk about your style of value investing and what you focus on today?

WS: At Equinox Partners we apply the Graham style

recently promoted Daniel Gittes, who's been at Equinox for seven years, to join Sean and me as a Portfolio Manager. We have 7 analysts who are generalists yet have focused industry expertise as well. As you can imagine, this kind of work requires a lot of travel: we



William Strong at a CSIMA conference in Feb'2011

of buying businesses cheaply but with a preference for better quality businesses. What we've done over the years is to take that approach global. After looking at Asian companies and resource companies in the '90s, the last step in our development was in 2008 – when we made a big foray into Brazil and in Asia after the world fell apart. At this point our scope is basically the whole world. We look everywhere to find outstanding businesses and managements that are really undervalued. In terms of our investment team and process: in addition to my partner of 17 years, Sean Fieler, we've

each travel about two months a year and in total see about 1,000 companies a year, though not all are unique visits. We think we've met and monitor some of the best businesses and managements in the world and our team is constantly on the hunt.

We do two other things, which I'll mention briefly. One is short-selling, which almost put us out of business in the '90s because we were short during the tech bubble. The other thing we've done is take on a large exposure to precious metals because for a long time we have been concerned about the value of fiat currencies.

G&D: Could you describe the types of businesses you target for investment?

WS: What we're really trying to do is find businesses that have a sustainable competitive advantage. Bruce Greenwald talks about the power of a franchise. He talks about how only businesses that can invest sustainably at high returns are adding value when they grow. That's a really good point. We've seen lots of companies that have grown while destroying value. So we're looking for companies that have a strong franchise and a strong competitive advantage. And, in the last 10 or 15 years, we've come to understand and appreciate that if you have such a franchise in the context of growth – maybe not specifically in a growth business but in the context of growth, which takes us to the emerging markets – then you have a really powerful investment. The combination of a strong franchise that generates high returns on capital and the possibility of reinvesting a large portion of retained earnings and cash flow back into that high return franchise is a fabulously valuable business. That's really what we're looking to find.

G&D: Don't these great businesses trade at higher multiples? If so, how do you get comfortable as a value

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“So we’re looking for companies that have a strong franchise and a strong competitive advantage. And, in the last 10 or 15 years, we’ve come to understand and appreciate that if you have such a franchise in the context of growth – maybe not specifically in a growth business but in the context of growth, which takes us to the emerging markets – then you have a really powerful investment.”

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investor investing in these businesses?

WS: Most of the time they do trade at higher multiples, but we are getting paid to find such businesses that are attractively priced. Rick Cunniff used to call it an “Easter egg hunt”. They’re really hard to find. Sometimes you find a really great business that’s buried in these other businesses that aren’t so great. Sometimes you find a really great business in a country that’s out of favor. Sometimes you find a really great business in a bad environment, like 2008, where investors had a lot of great opportunities. There are a number of ways in which we can find these paradoxes, where you have a great asset that’s selling at a really low valuation. Obviously, this doesn’t happen very often, so when it does, we try to buy as many shares as we can and own them for a long period of time. That’s the nature of the challenge we’re faced with. We’re trying to find outstanding assets at distressed valuations.

G&D: Given the importance of emerging markets to your investment strategy, are you concerned about corruption?

WS: I have some bad news for you. Corruption is everywhere. It’s a little more sophisticated in Europe, and if you go to Washington, it’s not a pretty picture. At

Equinox, we make a tremendous effort to try to understand where corruption is, how it works and how to avoid it. Corruption is a big problem, not just in emerging markets, but everywhere.

G&D: In these emerging economies, do you tend to utilize partnership structures or other arrangements to position you better?

“We try to look ten years down the road... we’re really trying to look at the structural trends in the country and in that business, which will help translate the investment into success.”

ments to position you better?

WS: We’ve been investing in emerging markets for a long time – we first went to Asia in 1994. We’ve been going to Brazil for ten years. We’ve developed relationships in a lot of places, some of which are with other investors. For example, we have a good relationship with a small value investment firm in Sao Paulo. We

know them well and we actually have owned some of the same positions. They’re helpful in that they can help us see the local landscape from the ground level and they know the people and their backgrounds. We have brokers locally that we’ve known for 15 or 20 years. We know a few brokerage firm research folks here and there that can help us. Additionally, managements of companies that we’ve known for years will opine about other management teams. There’s a lot of work that needs to be done but we’ve got a long record and a pretty good set of relationships now that helps us sort through a lot of this.

G&D: What is one aspect of your investment process that distinguishes you from other firms?

WS: I think one thing that distinguishes us is our long-term investment horizon. We try to look ten years down the road. That translates into a four to five year holding period. For instance, there’s a tech company in India that we have met with several times. The CEO of this company said after one of our more recent meetings that, based on some of the questions we had asked, it reminded him very much of their last board meeting. Whereas some other managers may have a two or three year outlook, or maybe even

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next quarter as an outlook, we're really trying to look at the structural trends in the country and in that business, which will help translate the investment into success. Fortunately for us, our investors understand and agree with our long-term perspective.

G&D: Could you talk about some of your major successes over the years?

WS: Another thing that we've done really well is meld together good company-specific, bottoms-up research with a thematic overview of what's going on in the world. For example, we've owned precious metals since the late '90s based on the idea that there are major financial imbalances in the world that are not being addressed. Those imbalances will ultimately cause stress in the financial system and that should take gold from the depressed levels of the late '90s to much higher levels. So we've had success with gold mining stocks and gold itself over the last decade, although that theme didn't work in 2011.

One of the other major successes we've had is to avoid places in the world that are just problematic to invest in. We spent a lot of time over the years looking at Japanese companies and had a really difficult time getting comfortable with managements. They just don't seem to be interested

in the shareholders' well-being. The ROE for an average Western company over the years has been around 12-13%. Now, if you look at the ROEs of Japanese companies since 1928, it's 400-500 bps below that of the Western companies. The last 20 years have particularly been a disaster for Japanese companies. What's shocking is that you had these companies with very low profit margins and extremely low

"...we apply over-arching themes to investment ideas while being very focused on finding good bargains. We narrow down the set of the universe of stocks.

About 95% of the universe we don't even bother to look at.

We're really trying to find great businesses that are cheap."

ROAs leveraged six or seven to one. That's three or four times what the leverage ratios would be in the US or in Europe. This is a business model we're not comfortable with. We think about these types of large

issues or themes. We are global investors but, with few exceptions that have been painful, we've stayed away from Japan.

On the other hand, we have gone to India, which offers businesses that have produced much stronger returns compared to companies in Japan. This is not to say India doesn't have its problems. It has lots of problems: big, political problems. But in India, you have a company like Sun Pharmaceutical, which is growing at 15-25% per year and generating net cash while growing that fast! We don't own Sun, but this is a great business in an environment where you can reinvest in a business with really high returns. So we apply over-arching themes to investment ideas while being very focused on finding good bargains. We narrow down the set of the universe of stocks. About 95% of the universe we don't even bother to look at. We're really trying to find great businesses that are cheap.

G&D: How would you define "cheap"?

WS: We look at P/E ratios, Price/Book, EV/EBITDA – we use many valuation techniques. We're trying to find businesses that we think can generate 15-20% returns, so one can work backwards from the valuation to see if a particular investment would translate into that

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Pictured: Professor Roger Murray and investor Robert Heilbrunn with their wives, Agnes Murray and Harriet Heilbrunn.

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type of return. In a rapidly growing business, one can pay a double digit multiple and still enjoy a 20% return. We look at all these metrics and then think about what we can expect to earn from this business if it continues to operate as it has been operating.

G&D: Could you share some specific ideas with our readers that you find compelling?

WS: We own an Indian company called HDFC. It has been in the mortgage origination business for a long time. It is a very successful company and generates 20%-plus returns on equity. With financial companies in general, it's hard to create a competitive advantage because interest rates are what they are and demand for money is what it is. HDFC has grown its mortgage book by 24% per year over the last ten years and they've grown their earnings and book value at 20% for the last ten years. We've owned this company on and off for five or six years and we've known for a long time that the management here is key. The management has developed a very low operating cost business. They have a nationwide network of branches and have a bank subsidiary that they use to help originate mortgages. They borrow money in the marketplace and price their mortgages with a spread of

2.25%. Their reputation is very strong – because their service is so good people are happy to pay them 10 or 20 bps extra on a mortgage. They seek to match the durations of their assets and liabilities and thus avoid the “borrow short lend long” game that many of their peers play. The company has done extremely well on its operational and credit risk management side.

HDFC has an unbelievably low cost-to-income ratio of 7.7%, whereas most banks average 40%-50%. They are incredibly efficient. Assets per employee have grown from \$500,000 in 1990 to \$18,600,000 today. Employee count has slightly more than doubled in the same time frame. Average loan size is very small at \$40,000 per mortgage and loan losses are four basis points since inception! The low costs translate into an incredibly high ROE. HDFC has such a good operating ratio that we are always trying to figure out how they are able to do this. My partner Sean Fieler was in India a few years ago and met with the senior general manager for their Mumbai region, who explained to him how they get these low costs. The company approves something like 99% of all loan applications. They figured out years ago that they wasted time and money rejecting people, so they only let people apply who they will accept. They have all these ways they

screen out people who wouldn't qualify – they profile all potential applicants based on profession, history, and where they come from. They know the kind of applicants they want and don't even take applications from anyone else. So they have virtually no loan losses whatsoever. In 2008, when the subprime mortgage crisis hit the US, HDFC didn't have an asset problem. They had funding problems as the capital markets froze up, but they had almost no loan losses. HDFC also tries to minimize their interactions with each customer. One way they do this is through agreements they have with large employers where the employers allow HDFC to take an employee's mortgage payment from a paycheck before the employee even sees the money, or they accept post-dated checks from borrowers once at the beginning of the mortgage.

HDFC is a company that has been growing at a nice clip for a long time. Rapid growth does not exist forever, but one of the nice things about emerging markets is that there is a long fairway before the slow-down point. This contrasts with America where a company can only enjoy a rapid growth phase for 3-5 years. Mortgages as a percentage of GDP in India have grown from 4% to 9% in the past four years, and I would guess could likely grow to

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“Everyone else hates volatility, but volatility is our friend. We like volatility.”

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30% before growth starts to slow down.

G&D: Emerging market stocks tend to be volatile. How do you explain to your investors that volatility isn't always bad?

WS: Everyone else hates volatility, but volatility is our friend. We like volatility. We had sold HDFC in late 2007 when the valuation had gotten rich, but HDFC declined along with the market in 2008, so we were able to buy back the shares. HDFC is owned 70%-80% by foreigners, so the panic selling in 2008 was due to international fund managers selling the stock. If we get another bad period in the market, we could see a similar situation with the stock.

Another idea we really like right now is a small finance company in Indonesia, Bunas Finance, started as a JV with Manufacturers Hanover Corporation, formerly a NYC-based bank. The senior management has been with Bunas for a long time and has a solid track record. The business has very big spreads because the underwriting process is very difficult to duplicate, as they lend money to small business owners using collateral which other finance companies consider imperfect: used cars and motorcycles. It is not hard to value a new car, but oftentimes it is difficult to value used vehicles. These vehicles, consisting of

trucks, minibuses, motorcycles and Jeeps, are generally used for productive purposes, which makes borrowers more likely to pay back the loans because they need the vehicle to run their business. Most of the underwriting effort is spent evaluating the borrower and the borrower's business rather than the collateral – agents are sent out to assess the borrower's business and its cash flow. There is not much competition from large banks because the banks cannot underwrite like this, so Bunas is able to earn very high interest rates on their assets. Competition consists of pawn shops and loan sharks. Blended net interest spread is currently around 9.3%, which is huge. Because the collateral is hard to value and the process is messy, management maintains a very conservative balance sheet. Bunas has a negative duration mismatch – in other words, their assets mature quicker than their liabilities. The company has virtually no leverage – banks are often leveraged 12 – 15x and other financial companies are levered at 5 – 7x. Bunas is only leveraged at 2x. So they are able to generate very high returns – 20%+ ROE – without using much leverage.

G&D: Given the fact that the business had been growing but that Bunas' stock was flat until approximately a year ago, was it frustrating

as an investor?

WS: It's a two-sided coin. If you have a perfectly efficient market, where business values are always reflective of business fundamentals, then we are out of business. If you have a perfectly imperfect market, where the stock market never reflects fundamentals, then we are out of business. Markets generally value fundamentals properly. Our job is to find exceptions to this and take advantage of it. This is what value investing is all about.

G&D: How many positions do you hold and what is the geographic breakdown?

WS: We have 51 long positions, 14 of which are in the mining space. Our principal operating business holdings are in Brazil, India, Indonesia, and other emerging markets. We don't own anything based in the US and have a few small positions in Japan and China. Russia and China have been difficult for us to get comfortable with management teams, though there are exceptions. Russia also has some bad demographics. In China we have a hard time trying to understand why a business is like it is and where it came from. We've seen similar things in Russia – one company we looked at has a majority owner who is Vladimir Putin's judo partner. We try to avoid these types of situations.

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"In our mind the relative risk equation has changed a lot of in the last few years, but it still has a way to go. Emerging equities, at the valuations that we see today of high-single digit and low-double digit P/Es, are very attractive."

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Pictured: Panelists Mario Gabelli '67, Charles Brandes, Jan Hummel, and David Winters at the "From Graham to Buffett and Beyond" Omaha Dinner in April 2011.

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On the short equity side we have very little right now. Where we see a real asymmetry of risk/reward is sovereign debt. We are shorting low-yielding sovereign debt in developed markets, which is an expression of our thematic observations.

G&D: Can you go into some detail on your thoughts on Europe?

WS: We are not surprised with how events have transpired. We have had a negative view of the management of fiat currency in the West for some time. Europe is an example of what we have been worried about. We don't have any great insights other than the fact that there are fundamental issues that are not being addressed. This is true for the whole developed world – we have too much debt. This is unlike Brazil, Indonesia, and India. We think the risk in the developed world is finally being properly perceived as being much higher than it used to be, and the risk in emerging markets is properly being viewed as having been reduced. In our mind the relative risk equation has changed a lot of in the last few years, but it still has a way to go. Emerging equities, at the valuations that we see today of high-single digit and low-double digit P/Es, are very attractive.

G&D: How surprised are you about where US treas-

uries are trading given the amount of debt that the US has?

WS: We are not only surprised, we are short treasuries, so we are losing money. The irony of the S&P downgrade of US debt was the rally in the price of treasuries. This is similar to

“One of the things that is really important is the ability to think independently. So much of the value in what we do is disagreeing with the consensus, so you want someone that is comfortable doing that.”

what happened in Japan where Japanese bonds rallied every time there was a downgrade.

G&D: What advice would you give to students interested in a career in investing?

WS: My strong advice is to do what you like to do. I think there are too many people going into the investment business because of outsized compensation which I don't believe can

last.

G&D: What do you look for when hiring an analyst?

WS: One of the things that is really important is the ability to think independently. So much of the value in what we do is disagreeing with the consensus, so you want someone that is comfortable doing that. Also important is the ability to be rational and have good quantitative skills.

G&D: What is the competitive advantage that sets you apart from others in the industry?

WS: What we do different from others is to maintain a very long time horizon. In our industry this is a luxury, as many other investment firms have clients that do not let them do this. As a result of having a very long time horizon, we can sit back and try to logically imagine a very different financial environment than the one we are in today. We are looking for larger themes that will produce epic investment results. We think about the themes that we want to be in, and in those themes, find different great businesses that we want to own. We look for jurisdictions where there are maximum misconception and extreme valuation anomalies.

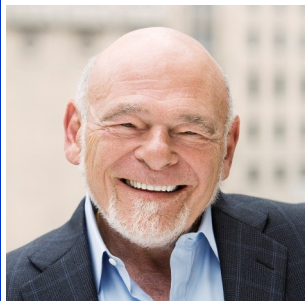
G&D: Thank you very much Mr. Strong.

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Sam Zell



Sam Zell

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country, so I grew up in an immigrant household with a very strong father and a supportive mother. My parents placed an emphasis on achievement and had little regard for time spent on fun. That orientation distinguished me from my peers. I operated under different rules and different expectations than most of my friends. Initially, that was very difficult for me. I wasn't very adept at becoming one of the "in-crowd". Everybody wants to belong, but I didn't feel that being a part of "the team" fit my personality. Eventually, I gained the self-confidence to trust my instincts rather than be influenced by my peer group or by conventional wisdom.

I had several businesses in grade school and high school. The most notable developed when I was 12 and going to Hebrew school in Chicago and living in the suburbs. I discovered these newsstands underneath the elevated train tracks that sold magazines that didn't exist in the suburbs. In 1953, this new magazine called Playboy was published and I saw a terrific opportunity. I would buy the magazine for \$0.50 and re-sell it to my friends for \$3.00. That was my first lesson in supply and demand.

Other businesses I had over the years included selling book-holder straps to my friends in grade school, tak-

"My parents placed an emphasis on achievement and had little regard for time spent on fun. That orientation distinguished me from my peers. I operated under different rules and different expectations than most of my friends. Initially, that was very difficult for me. I wasn't very adept becoming one of the "in-crowd". ... Eventually, I gained the self-confidence to trust my instincts rather than be influenced by my peer group or by conventional wisdom."

Michigan. Then, during my junior year at Michigan, my friend told me the owners of his apartment building planned to tear down the building to construct a new 15-unit apartment building. I said to my buddy, "We are students. We understand what students want. Let's pitch him an offer to manage the building and maybe we can get a free apartment out of the deal." We did, and our pitch worked. We took over management of the building, helped to design it and rented out the units. In exchange, the owner gave us two one-bedroom apartments in lieu of a fee. We were so good at it that the building owners soon gave us the opportunity to manage another building, and then another. By the time I graduated law school four years later, we managed something like two or three thousand apartments.

During law school, we also started buying buildings. Raising capital wasn't even an issue. The first asset was a three unit apartment building that cost \$19,500 and required only \$1,500 down. That was all it took for me to become a landlord. My simple premise was that I thought I could do something better with that building. I repainted the apartments, bought new furniture and doubled the rents.

G&D: How did you transi-

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ing photos of the kids at prom, and selling party favors to fraternities and sororities at the University of

Sam Zell

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tion from managing a three unit building to managing a substantial amount of real estate a few years later?

While I was in law school, my father was a jeweler, but he was also a passive investor in real estate. After I had bought my first building, I came home from school one year and I asked him about his property investments. He said he was getting about a 4% return. Well, I was getting about a 16% return in Ann Arbor, MI, from my 3-unit building. Our conversation made it clear to me there were two different investment worlds out there – major metropolitan areas like Chicago, New York, Los Angeles and San Francisco, which would always attract a lot of real estate investment from wealthy investors — and second-tier cities and university towns, which received little or no investment. I developed the thesis that if I was willing to go to these second-tier cities, particularly cities with growth, I could generate significantly greater returns because, frankly, there was no competition.

After law school, I raised capital to buy my first major building, which was a 99-unit building in Toledo, OH. That's really where it all started. On that first major deal, we produced a 19% return (as opposed to the 4% my father was earning) and I discovered that I

could continue to duplicate double-digit returns in these ancillary markets. So in the first phase of my career, I invested in Orlando, Tampa, Jacksonville, Arlington, TX, Reno, NV, and Ann

Arbor MI, buying mostly apartment buildings. If you are successful in the first deal, it's not too hard to raise the money for the second deal. Pretty much after that first investment in Toledo, I never really had trouble raising money again.

"I start by not paying much attention to the market. I think the Street reflects the value of the last share, but the true value of the asset may be more or less than what's indicated publicly. In the same manner, I don't make investments predicated on the assumption that there's a greater fool out there who's going to buy it from me for more than I paid for it. I look for situations that logically make sense to me."

G&D: How do you think about valuation, whether it's a real estate or a non-real estate asset, and could you perhaps give us an example of your approach?

SZ: I start by not paying much attention to the market. I think the Street reflects the value of the last share traded, but the true value of the asset may be more or less than what's indicated publicly. In the same manner, I don't make investments predicated on the assumption that there's a greater fool out there who's going to buy it from me for more than I paid for it. I look for situations that logically make sense to me.

As an example, in 1985 I took over Intel Corporation. At the time, Intel had been the largest bankruptcy in the history of the United States. Coming out of Chapter 11, the company still owned a subsidiary that leased 17,000 railcars. Business had been so terrible that utilization of the railcars was 32%. While others might have considered this a really horrible situation, I looked at it and said: "These railcars are almost new be-

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Sam Zell

“I reminded myself that everything is about supply and demand. I knew that when the supply and demand curves for boxcars met, I could make a fortune. So I went out and bought all of the used railcars in America. ... We did extraordinarily well because we had bought these railcars at significant discounts to replacement cost and yet rented them at market rates. ... All anyone had to do was put the pieces together.”

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cause they haven't been used.” By virtue of this fact, I bought them at dramatically less than their replacement cost. I then looked at the broader rail business and determined how many railcars there were, who had built them, when they had been built and what the general story of the business was. It turned out that in 1979, the US government had changed the tax laws and created a special one-year 100% tax deduction for heavy equipment. Furthermore, in 1979, the United States had built 120,000 boxcars. But between 1979 and 1985, the United States had built a total of only 20 boxcars.

In the meantime, demand for boxcars was as flat as a dead man's EKG. Therefore, nobody wanted to touch the business because there was no growth. During this same period, 65% of the boxcars in the country were scrapped. I reminded myself that everything is about supply and demand. I knew that when the supply and demand curves for boxcars met, I could make a fortune. So I went out and bought all of the used railcars in America. By the time I was done, we owned 92,000 railcars and became the largest lessor of railcars in the United States. We did extraordinarily well because we had bought these railcars at significant discounts to replacement cost and yet rented them at mar-

ket rates. Now, you could tell me I'm a genius but the truth of the matter is that the information I've laid out was available to everybody. All anyone had to do was put the pieces together. For some reason, that's what I do well. I see things differently.

G&D: Could you give us another example where you saw something that was obvious to you but not to others?

SZ: Another division of Itel was in the container leasing business. At the time, the container leasing industry was comprised of the “seven sisters,” which were seven container leasing companies that represented 95% of the world's container leasing business. The one I acquired through Itel was number four. This business had \$100 million of revenue, \$50 million of expenses, and \$50 million of cash flow. Then I looked at the number three business in the industry, which had roughly \$100 million of revenue and \$50 million of cash flow. I considered what would happen if I put these two container leasing businesses together. All of a sudden, I would need only one shipyard in Hong Kong and only one shipyard at the other ports throughout the world, and I would need only one computer system. I don't really believe in synergies, such as cross-selling and all the other elements they teach in business

schools. The only thing that's relevant to me is redundancy. Everything else is if-come-maybe. So, I acquired the number three business in the industry, put the two companies together and the revenue was still \$200 million but the expenses were now \$85 million instead of \$100 million. We picked up a 15% expense difference, which was all profit, and we became the low-cost producer. We then acquired the leasing company that was number seven in market share and became number one in the container leasing industry. By virtue of this, we had the lowest costs in the business and a real competitive advantage.

So that's the way I look at things. It isn't like there are six rules of investing or something like that – certainly there haven't been in my life. One of my criticisms of business schools is that the definition of an MBA graduate is someone who knows how to do the numbers; they just don't know what the numbers mean. This is the product of business schools emphasis on formulas. In other words, business schools teach how the pieces should be put together. But for me, there is no formula. Similarly, I'm pretty agnostic about industries. We've been in the container leasing business, the railcar leasing business, the insurance business, the real estate busi-

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Sam Zell

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ness, the agricultural chemicals business, the oil and gas business, and I could go on and on.

G&D: Are there any industries where you're less comfortable investing? If there are, why is this the case?

SZ: We don't invest in high tech, simply because we don't understand it and because it's valued on if-come-maybe. Maybe I'm a good prognosticator of value but I would tell you that I can do much better prognosticating value on something I understand than on companies that are valued by a third party. That's really key to how I look at things. I've never been willing to depend on a third party to value my investments. I have to value them myself and I have to look at my investments as though I'm going to own them permanently. That's a very different perspective than valuing investments as though I'm going to own them until I determine it's the right time to sell. Generally speaking, we start by focusing on the fact that we're going to own the investment forever. In some cases we have done this.

G&D: Can you provide an example of a company you've owned for a long period of time?

SZ: We own a company called Anixter, which is an-

other interesting story. In November of 1986, a col-

"We don't invest in high tech, simply because we don't understand it and because it's valued on if-come-maybe. ... I can do much better prognosticating value on something I understand than on companies that are valued by a third party. That's really key to how I look at things. I've never been willing to depend on a third party to value my investments. I have to value them myself and I have to look at my investments as though I'm going to own them permanently."

league told me that there was a wire and cable distribution company for sale. The company had done very well and the price was 2x book. Sam Zell buying something at 2x book was extraordinarily difficult for people to conceive. The seller told me I had a week to decide and there was no chance for negotiation. I worried about it for six days. Then, on the seventh day, I realized that there were really two assets for sale – the business and Anixter's ownership interest in a distribution pipeline that determined the fate of other manufacturers. This pipeline was a key determinant of these manufacturers' ability to sell their products. Once I thought about the acquisition as buying a key distribution pipeline, rather than just a distribution business, the values changed dramatically. The company we bought on January 1, 1987 had \$600 million in revenue and \$36 million in operating profit. We still own Anixter today, and it produces \$6 billion in revenue, earns about \$300 million per year and operates all over the world. It's been a phenomenally successful deal really just by taking that pipeline into consideration, and expanding it when appropriate.

When I bought that business, we had operations in the US, Canada and a small operation in England. I was, and am, a great believer in

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Sam Zell

“It’s not my personality to be passive. Where I can control or significantly influence the direction taken by a company, my judgment - at least so far - has proven to be on the better side of good. You don’t necessarily have to have absolute control.”

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globalization. Consequently, I thought it was critical that this company expand worldwide. The problem was that this kind of expansion was extraordinarily expensive. When I bought Anixter, I acquired it in a manner such that it could be a subsidiary of Itel. So on top of Anixter, you now had rail-car and container leasing businesses and a dredging business, each of which were large cash flow and depreciation-generating assets. Over the next three years, I think we spent \$300 million rolling out Anixter worldwide. If I had tried to do that with Anixter as an individual company in a public market, I would’ve gotten slaughtered, but hidden under all of these other businesses as a smaller asset, no one really paid attention. We gradually sold the other businesses of Itel as we grew Anixter to the point where it was a viable independent company.

G&D: Is it fair to say you always see potential investments in the context of control, where you have the ability to effect change?

SZ: It’s not my personality to be passive. Where I can control or significantly influence the direction taken by a company, my judgment - at least so far - has proven to be on the better side of good. You don’t necessarily have to have absolute control. I manage/chair five or six public companies with

less than 20% of the stock ownership. Hopefully, I create and provide the kind of leadership that adds exponential value – enough that people are willing to follow my direction.

G&D: Could you discuss some of the different business cycles you’ve experienced and how you adapted to each new development that followed?

SZ: A lot of things have changed. I went from buying up distressed real estate in the ’70s to building industrial companies in the ’80s. In 1981, Congress changed the law on net operating loss carryforwards. Up until that point, you were allowed to use NOLs forward or backward three years. Then, in 1981, because there were all of these busted REITs with NOLs, they changed the laws to allow companies to use the NOL deduction 15 years forward. As far as I was concerned, they instantly changed the value of every NOL. Yet, when I looked at the stock prices, there was never any value given to these deductions. We bought Great American Management, which was a busted REIT with \$127 million in NOLs. Itel had \$450 million in NOLs. We also bought New Corp, which had \$250 million in NOLs. Then we monetized all these carryforward deductions through the ’80s. So again, we had a comparative advantage because we didn’t

have to pay as much as competitors in taxes and we could acquire and operate businesses with that in mind.

Following the 1990 real estate collapse, there was no source of capital available to real estate – the S&Ls were broke, the banks were broke and the insurance companies had backed away from the asset class. The public markets became the only viable option. Thus, in 1988, I wrote an article entitled “From Cassandra, With Love...” where I laid out what I thought would happen to real estate over the next ten years. This included my expectation of the monetization of real estate and the creation of a modern REIT era. From 1960 to 1990, REITs were a backwater with capital allocated to the entire industry amounting to \$6 billion. Sure enough, 1991 was the beginning of the modern REIT era. I created three of the largest REITs and became a spokesman for the industry, serving as its representative in the interview with Standard and Poor’s when they were deciding whether to include REITs in the S&P 500. In 1999, we then created Equity International because we felt that the monetization of real estate that was occurring in the United States would ultimately occur in the rest of the world.

G&D: How has your

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Sam Zell

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method of investing evolved over the years?

SZ: Well, as an example, in '80 and '81, we no longer liked the real estate business for various reasons. We had been a great beneficiary of inefficient markets. However, the creation of the HPI2 and other technologies changed the playing field. All of a sudden, a broker in New York could send out 27 different packages and elicit bids. Prior to that, there was little or no competition. Secondly, we had always taken advantage of long term fixed rate debt, but in the early '80s, the banks and the insurance companies started shortening terms and putting in kickers. So the world as we perceived it changed. In addition, in roughly 1980, we started to see assets trade for a combination of their economic value and their tax benefits. As far as I was concerned, tax benefits were what you received in exchange for the lack of liquidity in real estate, not an additional value element.

We came to the conclusion that, "If we were really good at the business of real estate, then we were also good businessmen." The very concepts and ideas that influenced the way in which we invested our capital in the real estate industry definitely applied in non-real estate industries. So, in 1980, my partner Bob Lurie and I decided that our firm

would be 50/50 by 1990 – 50% allocated to real estate and 50% allocated to assets in other sectors. We began applying our same principles to non-real estate asset classes. Ideas like consolida-

"I had an inherent skepticism of marketing because I felt that it wasn't measurable. My philosophy was to invest in businesses that served externally created demand – businesses where I didn't have to generate demand. As an example, in the mid-80s, I bought the largest dredging company in the world because I knew that every day the rivers and the harbors are silting, creating demand for the product I produced."

tion, redundancy, and barriers to entry were viewed as critically important.

I had an inherent skepticism of marketing because I felt that it wasn't measurable. My philosophy was to invest in businesses that served externally created demand – businesses where I didn't have to generate demand. As an example, in the mid-80s, I bought the largest dredging company in the world because I knew that every day the rivers and the harbors are silting, creating demand for the product I produced. That's been the way we've always functioned.

We were also very focused on creating verticals that work. In the early 1980s, we bought an agricultural chemicals distribution company. Then we went to a bankruptcy court and bought an ammonia nitrate plant in Iowa. Then we went to Canada and bought a source of potash. We rolled it all up together into one company and found that it was much more efficient than the disparate parts. Eventually, we took that company public.

These are all pretty simple concepts from my perspective but I live by them.

G&D: Do you have another example of a unique investment opportunity that presented itself due to a shift in an economic cycle?

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Sam Zell

“In the early 1990s, when I was again buying up all of the distressed real estate I could in the US, I kept looking over my shoulder asking myself, “Where is everyone else?” It’s not that I like competition, but you do start to wonder why you continue to be the only game in town. ... At some point I stopped to question my thesis, but I went through my whole thought process once again and remained confident that I was right.”

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SZ: As was true for my philosophy of being the first national real estate investor in second-tier cities, I’ve always been willing to shift my ideas and criteria, but I’ve also always believed in what I’m trying to implement. In the early ’70s, buying apartments became too expensive so I started financing builders to build apartments. By 1972, everyone believed the world was going to grow to the sky; there were cranes on every block. But I knew that supply and demand were out of balance, and I stopped backing developers. Then, seemingly overnight, market sentiment shifted, and in 1973, everyone seemed to believe there was no future. Asset prices plummeted, and I realized that this didn’t make sense either. So, I began aggressively acquiring property, financed very cheaply, to take advantage of what I thought was a once-in-a-lifetime distressed opportunity.

Between ’73 and ’77, I acquired \$3 billion worth of real estate. The banks had a problem carrying a large amount of distressed real estate with so many properties in foreclosure. They weren’t looking to make money. They were just trying to mitigate the losses their real estate loan portfolios were expected to generate. In those days, institutions didn’t have to mark-to

-market, so I tried to figure out ways to preserve the principal of the asset for the seller and still make the deal work. It basically amounted to lowering interest rates on the debt to the point where you could almost carry it or you had a defined carry. We realized that if we could accumulate assets - particularly in an inflationary time - with cheap fixed rate debt, it was hard not to make a fortune.

When people looked at our performance during the ’70s, they always asked, “How did you pick all those ripe projects?” But the truth of the matter was that I created \$3 billion worth of 5% fixed rate debt in an inflationary environment of 10, 12 or 13%. In this situation, it was hard for it not to work. And yet, like many others in my career, most people thought I was crazy. I’ve spent my whole life listening to people explain to me that I just don’t understand, but it didn’t change my view. Many times, however, having a totally independent view of conventional wisdom is a very lonely game.

In the early 1990s, when I was again buying up all of the distressed real estate I could in the US, I kept looking over my shoulder asking myself, “Where is everyone else?” It’s not that I like competition, but you do start to wonder why you continue to be the only game in town. And I was --

for roughly three years, from ’88 to ’91. I would buy a building from a bank and they’d ask, “How about three more?” At some point I stopped to question my thesis, but I went through my whole thought process once again and remained confident that I was right.

G&D: We’ve touched on this already but could you talk a bit more about how you value assets?

SZ: It starts with replacement cost. In other words, if we take the example of the Anixter pipeline, there was no physical pipeline, but I could figure out what it would cost to replicate that pipeline. I’ve bought all kinds of real estate at below replacement cost, before considering the value of the land. Ultimately, what does it cost per square foot to build the property and what is your cost basis?

Another question to consider is how difficult a particular business or real estate market is to enter. I spoke a lot about the internet during the ’90s. I thought it was a lot like an interstate highway except that a highway has limited access. The internet had no limitations to access. Therefore, an internet-based business is totally vulnerable. One of my protégés created Groupon and, although he has the first mover advantage, the reality

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Sam Zell

“... it’s all about replacement cost – whether it be ephemeral replacement cost like the Anixter pipeline or brick and mortar replacement cost – and barriers to entry. You have to ask yourself, how difficult is it for somebody to compete with you and what is your comparative advantage.”

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with Groupon is that there’s no barrier to entry for competitors.

I don’t know how to answer the question any more concisely than to say it’s all about replacement cost – whether it be ephemeral replacement cost like the Anixter pipeline or brick and mortar replacement cost – and barriers to entry. You have to ask yourself, how difficult is it for somebody to compete with you and what is your comparative advantage.

G&D: Are there any other key tenets of your investment process?

SZ: I philosophically believe that if you can’t delineate your idea in one or two sentences, it’s not worth doing. I’m the Chairman of everything and the CEO of nothing, which means that the people who work for me come to see me with ideas all day long. My criterion is if they can’t concisely explain their idea, then I throw them out of my office and tell them to come back when they can. Simplicity is critical.

Additionally, one of the greatest risks of any investment is execution risk, and I think it is highly overlooked. I have great respect for execution risk and am always sensitive to people coming up with ideas that don’t have all of the t’s crossed and i’s dotted with respect

to how the plan is actually going to be executed.

G&D: Two critical yet sometimes forgotten characteristics every investor needs is a sense of when to sell and the confidence to follow through. Can you talk about your timely sale of Equity Office Properties in 2007 and how you generally determine when to sell an asset?

SZ: In the case of Equity Office, it was a “Godfather

“... one of the greatest risks of any investment is execution risk, and I think it is highly overlooked. I have great respect for execution risk and am always sensitive to people coming up with ideas that don’t have all of the t’s crossed and i’s dotted with respect to how the plan is actually going to be executed.”

Offer.” I started Equity Office and built it into the largest real estate company in the world. Every quarter, we conducted a detailed valuation of the company, so we felt confident we knew the true value of the business. Then one day, someone made us an offer that was significantly greater than our own internal analysis – an offer we couldn’t refuse. Many people thought at the time that selling Equity Office was a very hard decision for me. But it was a relatively easy decision because the disparity in our valuation versus the bidder’s was so great. Of course, a bidding war began with a second bidder, and the disparity got even greater. So number one, I point to what I would call the “Godfather Factor.”

Number two, some businesses have lifelines and others don’t. I think Anixter continues to grow because it provides a very valuable service. This isn’t always the case. For instance, we started a company called Adams Drugs, which created the over-the-counter drug Mucinex. The entire premise for developing that business was that there were a series of drugs, such as Aspirin, that were grandfathered by the FDA. The second largest drug was the expectorant guaifenesin. The FDA stipulated that if you could take a pre-FDA drug and prove efficacy through clinical tri-

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Sam Zell

“Jack Welch once said, “Either you’re number one, number two or you’re in trouble.” I certainly endorse that sentiment. I am a great believer in competition and I’m particularly interested in competition for you. For me, I’d like a monopoly. If I can’t have a monopoly, I’d like an oligopoly. As an investor, I am constantly focused on competition because I think it is not necessarily always rational.”

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als, then you were granted a monopoly. Somebody came to us with the idea to conduct clinical trials, we funded them and we proved efficacy. As a result, we were given exclusivity for production of the drug and thus the company did extraordinarily well. But I recognized that this was a business that could easily be subject to competition, and that it was a little bar fly in a land of giants. How were we going to compete with Pfizer or any of the big OTC drug companies? We couldn’t. As far as I was concerned, selling Adams two or three years after we had proven the concept and generated revenue made all the sense in the world.

Jack Welch once said, “Either you’re number one, number two or you’re in trouble.” I certainly endorse that sentiment. I am a great believer in competition and I’m particularly interested in competition for you. For me, I’d like a monopoly. If I can’t have a monopoly, I’d like an oligopoly. As an investor, I am constantly focused on competition because I think it is not necessarily always rational. As a matter of fact, often times it is irrational. There’s nothing worse than to be in a competitive situation with an irrational competitor.

G&D: Given your firm’s expertise in distressed investing and the ongoing sov-

ereign debt crisis in Europe, are you interested in investing in Europe?

SZ: We don’t view Europe today as a particularly good investment opportunity. I think there’s just such a high degree of uncertainty combined with a historical approach by European compa-

“We’ve been very involved in emerging markets, particularly Mexico, Brazil and Colombia. These are enormously powerful growth markets. In the case of Brazil, the country is self-sufficient in fuel, water and food, and has a trained executive class, and it growing at something like 4% a year.”

nies to be much less transparent than American companies. It wasn’t too long

ago – maybe 15 or 20 years ago – that European banks had “hidden reserves.”

What in the world were “hidden reserves”? They were money that banks kept for a rainy day, but that wasn’t disclosed to shareholders. You simply couldn’t do that in the United States. In the same manner, I think European accounting is suspect. Finally, I can’t come up with a reason why Europe should grow. And, in the end, as an investor, you have to have growth. Europe is great for castles, cheese, wine, and après-ski though! Likewise, I have no interest in Russia at all. All one has to do is think about Yukos. If Russia can do what they did in the case of Yukos, they can do anything.

G&D: Are there any countries or areas that you find particularly attractive?

SZ: We’ve been very involved in emerging markets, particularly Mexico, Brazil and Colombia. These are enormously powerful growth markets. In the case of Brazil, the country is self-sufficient in fuel, water and food, and has a trained executive class, and is growing at something like 4% a year. I think Brazil is probably the best single major market in the world.

G&D: Can you provide an example of a current investment in Brazil?

SZ: We started BR Malls,

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Sam Zell

“Any time you go into emerging markets, you are trading the rule of law for growth. Anybody who thinks that they could go into a Brazilian court and be treated like a local is very naïve. The same thing is true of Mexico. You have to start with selecting a good partner who can protect you or who is strong enough to give you a real, credible perspective of any situation.”

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which today is the largest shopping center company in the country. Same store sales are 12-14%. Compare that to a top-performing US shopping center company where same store sales are at 1-2%. We also have a homebuilder in Brazil. When you look at the numbers, you discover that Brazil has seven million units of pent-up demand. Just like with dredging, it makes a big difference if you're building into a scenario where pre-existing demand exists versus trying to generate demand.

G&D: Have you found Brazilian and other Latin American governments to be investor friendly or otherwise receptive to outside investors?

SZ: Any time you go into emerging markets, you are trading the rule of law for growth. Anybody who thinks that they could go into a Brazilian court and be treated like a local is very naïve. The same thing is true of Mexico. You have to start with selecting a good partner who can protect you or who is strong enough to give you a real, credible perspective of any situation.

G&D: How do you or your team typically generate investment ideas?

SZ: I have a pretty good address book and a lot of people call me with ideas.

We've done hundreds of transactions and I take great pride in the fact that people are willing to do repeat deals with me. It's very common for us to get phone calls from previous partners who want to introduce us to new opportunities. Then, of course, there are about 30 or 40 managing directors who work in my office, and they in turn have contacts and those connections generate ideas. We're very opportunistic and we're very comfortable looking into new ideas. We have resources in a wide variety of industries so we can learn a lot about a business pretty quickly. We've also been in many industries, so a lot of what we know or have learned in the past is transferrable.

G&D: A lot of readers are also interested in current ideas. Could you talk about any current investments that you like?

SZ: In keeping up with the environment today in the US, we are primarily providing debt to the non-investment grade world -- distressed debt instruments, debtor-in-possession financing and anything else opportunistic. Changes in the last few years have brought about a tremendous bifurcation. If you're an investment grade company, you can get all the capital you want, and at these rates it's practically free. In the past, if a company was sub-investment grade, it was

maybe +200 bps relative to investment grade debt, then for the next level it was another +200 bps and so on as you went up the risk scale.

Today, there are investment grade spreads and then there are 1,400 bps spreads. All of the past incrementalism, at least at the moment, is gone. Therefore, I've never seen a market better for investing capital in high yield debt instruments or high yield debt instruments with kickers. There is a real shortage of cash and appetite for risk in that arena. Note that this is a change from only a few months ago.

In March of '09, you could buy anything at an unbelievably cheap price. By June of '09, everything was trading at a premium, and this continued to be the case until maybe six months ago. Early in 2011, there were a lot of cases where the value we had assessed for a particular investment was X and it was trading at 2X or X plus 20%, particularly in the more liquid debt markets. That phenomenon has certainly changed in the last six months. In May or June of '09, companies were selling junk bonds at 5% or 6% and those same bonds of the same company trade at 12% today.

We did a deal last year where there was a company with \$130 million of debt coming due. The company

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Sam Zell

“I’ve always been a great believer in logic. I have a lot of common sense and I see things differently. Many people see problems, but entrepreneurs see solutions, and that’s really what I do. I recognize differences that other people don’t seem to see.”

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negotiated with the banks until it was a week before the debt’s maturity and the banks rejected the company’s proposals. The company then had a week to decide how they were going to meet that maturity. We provided them with \$130 million in return for an attractive assemblage of opportunities. It wasn’t like our deal was more or less expensive; it was the only deal on the Street.

G&D: What is it about your personality or process that has allowed you to be so successful?

SZ: Number one, I always seemed to have a lot of self-confidence so I didn’t pay attention to conventional wisdom. Number two - you may have heard the quote, “common sense isn’t so common” - I’ve always been a great believer in logic. I have a lot of common sense and I see things differently. Many people see problems, but entrepreneurs see solutions, and that’s really what I do. I recognize differences that other people don’t seem to see.

Third, and most importantly, what I have been able to do is to assess risk and reward accurately throughout my career. The definition of a great investor is someone who starts by understanding the downside. You must make the judgment in advance as to how much downside risk you are

willing to take. I knew that I could always survive the good days, but the critical element is to be able to

“The definition of a great investor is someone who starts by understanding the downside. You must make the judgment in advance as to how much downside risk you are willing to take. I knew that I could always survive the good days, but the critical element is to be able to survive when the market isn’t doing well or the investment isn’t performing. I always focus on how much

exposure I am taking. Investors stumble when they take risk and don’t receive commensurate reward. Investors stumble when they get bull-headed or when they shift to doing something that is outside of their core competencies. My success has been related to being a very good observer, having opinions and being willing to implement them, and understanding and believing in the Bernard Baruch saying “nobody ever went broke taking a profit.”

Lastly, in the simplest philosophical phrase, I’ve always believed in going for greatness. I’m highly motivated and I’ve always been highly motivated, not necessarily because it translates into dollars, but because there’s a great satisfaction in achievement. I think, more than anything else, that is what has always driven me and been a major contributor to my success.

G&D: It was a pleasure speaking with you, Mr. Zell. Thank you.

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William C. Martin

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become interested in investing?

WCM: I started investing when I was 10 years old; my first stock was Hershey Foods. My grandparents invested my college money with Mutual Series, which was run by Michael Price. He was literally one of the first investors I was ever exposed to, via his letters which I read when I was a kid. From there, I attended the University of Virginia. In my sophomore year, I became president of the student investment fund. The capital for the fund was provided by John Griffin of Blue Ridge Capital. Like Price, John Griffin's approach to investing, particularly on the short side, was very influential to me as I was beginning to learn and think about investing.

After my sophomore year I took a bit of a career detour, as the company I had started in my dorm room, online finance site Raging Bull, attracted \$2 million in venture financing from internet incubator CMGI. My partners and I left school and ended up raising another \$20 million in financing less than a year later, ultimately selling the company in early 2000. It's safe to say we gained quite an education in a short period of time, both on the up and the down of the cycle. Like many of the companies I have been involved with, either in terms of starting or funding, Raging Bull

was an intersection of my passion for technology and the markets.

After selling Raging Bull and prior to starting Raging Capital Management in 2006, I started my own independent research company in Princeton, where I wrote an investment newsletter. Of course, I no longer write newsletters but this business ultimately grew to include InsiderScore.com, which is an analytics and research tool that is today used by approximately 250 hedge funds and mutual funds. I am still an owner of InsiderScore.com, but I am no longer involved in the day-to-day operations.

G&D: Your background clearly sounds unique and differentiated.

WCM: Being an entrepreneur has really taught me a lot about the importance of having the proper patience and perspective. Wall Street is so focused on quarter to quarter issues, but businesses do not move as quickly as the whims of investors. It takes time to roll-out a new product, hire a new executive, or turn around a company. I also think the creativity of being an entrepreneur is valuable when you're thinking about investing, particularly in small to mid-cap companies. It helps you to see what's possible and think creatively about a situation. Finally, I have also had some public company board ex-

perience. Most notably, I spent nine years from 2000 to 2009 on the board of Bankrate, during which time the company grew from a roughly \$20 million market cap to a \$570 million sale to private equity. Again, it was nice to have such mentorship at such an early point in my career. In this case, I got to see shareholder friendly corporate governance in action. All of the directors owned a material amount of stock and there was a true, long-term focus towards building value. In contrast, at some of the companies where we have been activists, the board members often own little to none of the company's stock, so there is no urgency or alignment of incentives with stockholders. I think these entrepreneurial and hands-on experiences are a differentiator for me.

G&D: What led to establishing your own investment firm?

WCM: Writing my investment newsletter for a number of years helped me to develop and refine my approach to investing and build a documented track record. I eventually felt it was time to take the next step, which was to manage outside capital. We launched Raging Capital Management in April 2006.

G&D: Can you tell us about your firm and what

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William C. Martin

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has changed since you started it?

WCM: We are based in Princeton, NJ, manage \$275 million, and are entering our seventh year of business.

“We look for companies undergoing management or board changes, companies where there is activism (sometimes our own), or a company with a changing technology or product cycle.”

The team includes two Columbia Business School graduates, Wolf Joffe and Fred Wasch, who is our CFO, as well as Allan Young and Matt Furnas.

On the long side we usually hold 30-35 names. Our top 10 ideas typically represent half of our capital, so we do take larger positions when we believe we have a clear edge and conviction. We focus on two general areas on the long side. The first is emerging growth businesses, where we can hold the companies for a few years and ideally make “multi-bagger” returns. It is a very entrepreneurial approach to public market investing. We try to leverage our network and

creativity in order to connect the dots and find companies that can really show break-out growth. Usually those ideas represent about a third of our capital. We don’t have a set limit on that amount, but usually these ideas are harder to find, and they are typically higher risk so we size them a bit smaller.

Our other area of focus on the long side is finding deep value investments with a catalyst. I’ve always enjoyed hunting for out of favor stocks. Of course, along the way I’ve made my share of mistakes and invested in plenty of value traps. There are certainly a lot of cheap stocks out there, and a lot of them are cheap for a reason. Further, corporate governance is very poor and hard to change at many companies. Over time, I have learned from my mistakes. Today we look for beaten down stocks, but ones that have a clear catalyst. We look for companies undergoing management or board changes, companies where there is activism (sometimes our own), or a company with a changing technology or product cycle. These positions are typically weighted higher because the downside is often protected by the company’s cash buffer or what we think is a high intrinsic value.

The short book is a very important, and probably the most underappreciated part

of what we do. We estimate that we have generated on average more than 1,500 basis points of alpha per year on the short side. For example, in 2011, our strategy was up over 30% net of fees, and we made 69% of our returns on the short side. The short book usually has around 40-50 names in it spread across 50 to 70 points of gross exposure. We don’t believe in using ETFs for shorting, as we view that as lazy. We also don’t use derivatives to create synthetic short exposure. We try to short the largest, most diversified basket of what we believe are crappy, overvalued, fraudulent, fundamentally-challenged businesses, and then try to size them appropriately in our portfolio so that we can sleep well at night and be emotionally neutral. We don’t want to be over-thinking and worrying about one or a few large shorts.

Whereas on the long side we try to connect the dots, read a lot, and talk to many people to source ideas, on the short side we try to be more systematic and methodical in terms of screening names. For example, over the years we’ve built a proprietary key word database for SEC filings which includes approximately 500 keywords of names of insiders, auditors, or terms that raise our level of interest. For example, a term like “preferred ratchet,” which

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“We try to short the largest, most diversified basket of what we believe are crappy, overvalued, fraudulent, fundamentally-challenged businesses, and then try to size them appropriately in our portfolio so that we can sleep well at night and be emotionally neutral.”

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you often see in venture capital, can indicate distress, as the reset provision can be toxic on the wrong balance sheet. One of our senior analysts, Allan Young, has a forensic accounting background, and he will regularly go through the most interesting hits. That's one of the ways we have sourced ideas on the short side.

G&D: How does your team split up industry coverage and the opportunity set?

WCM: We're generalists who seek out value wherever it may lie. In the last year, some of our biggest positions were a copper wiring company, a generic pharmaceutical company, an asset manager, an insurance company, a telecom equipment company, an advanced wound care business and pre-IPO positions in Facebook and LinkedIn. We also helped a company, SMG Indium (Ticker: SMGI), go public that is stockpiling a critical metal called Indium, which is used in LCD, LED and solar technologies. Each member of the team has specific areas of expertise, but they are not limited in what they can work on.

G&D: In your recent quarterly letters you write about successfully shorting a few Chinese companies earlier this year. Can you tell us how you came up with the idea?

WCM: Shorting fraudulent Chinese companies that were listed in the U.S. was one of our biggest winners over the past two years, and accounted for nearly 40% of our short side profits in 2011. We started sourcing some of these ideas one-off in the Spring of 2009 from the SEC filing alerts I talked about earlier, as promoters who had previously been involved with sham Internet companies began to get involved with Chinese reverse mergers and IPOs. By the end of 2009, we had systematically looked at all 600 Chinese companies who had listed in the U.S. We narrowed this list down by focusing on auditing firms, EBITDA margins vs. peers, accounts receivables metrics and a number of other risk flags. In some cases, we hired MBA students in China to help us with deeper field diligence, such as taking pictures of products in stores. We ended up building a diverse basket shorts around this theme.

We began pressing this basket trade after one of our shorts, Rino International, a Nasdaq-listed Chinese company, admitted to fraud in late 2010. Further, in December 2010, the SEC sanctioned a U.S. auditing firm, Moore Stephens, which prompted us to note in our year-end letter that we believed that greater scrutiny over auditors would cause many of these Chinese com-

panies to miss their 2011 10-K filing deadlines. That's exactly what happened as eight shorts in our portfolio had trading halted in Q2 2011 alone due to accounting irregularities and governance issues. Some of these stocks now trade for pennies, if at all.

G&D: This was clearly a very big opportunity that you spotted. Do you try to find themes around which to invest or do you see a lot of one-off opportunities?

WCM: On the long side, it's very company-specific and a matter of connecting the dots. Over time, 70% of our average gains on the long side have been long term capital gains, so out of a portfolio of 30 longs, you don't need all that many new ideas each year. On the short side, we have a lot more names and we turn them over more frequently. The short side often has one or more macro or basket themes as part of it, but that's just a component of a broader book with 40-50 individual shorts. Another example of one of our successful short themes was a basket of some 15 targeted regional banks with specific geographic and construction lending exposure that we shorted in 2006 and 2007. This contributed to a strong year in 2007, when we returned 35% net with half of our gains coming from the short side.

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"Shorting fraudulent Chinese companies that were listed in the U.S. was one of our biggest winners over the past two years, and accounted for nearly 40% of our short side profits in 2011."

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Pictured: Bill Ackman, who sponsors the Pershing Square Capital Challenge at Columbia Business School, in April 2011.

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G&D: What do you think is the next big short opportunity in the market?

WCM: I'm not sure I have that crystal ball. However, today we do have a quarter of our short exposure in commercial REITS. We view much of the group as still facing fundamental headwinds while also being very exposed to any increase in interest rates or spreads. Their stretched valuations and levered-balance sheets leave them with little margin for error. We have also been shorting some of the smaller cap rare earth mining companies. Another area where we have spent a lot of time as of late is on recent IPOs with very frothy valuations. This isn't necessarily companies like LinkedIn and other high profile deals. Rather, there's a whole group of companies below the radar. For example, one of our best shorts last year was Teavana (ticker: TEA). They went public with 160 stores and a \$1 billion market valuation. The company's pitch was: we have high returns on capital and now we're going to deliver exceptional square footage growth, growing to 500 stores over the next few years. In contrast, our view was that this was not a breakout retail concept, a la Lululemon or Chipotle, as evidenced by the unimpressive same store sales growth, declining productivity at new store locations, and the fact that there was a

bit of "financial engineering" that made their same store sales numbers look temporarily good when they went public. We recently covered this short for a nice gain, but it remains on our radar.

G&D: Was your decision to close your short position based on a feeling that there was no longer a big downside or less of a downside at the current \$16-17 price range?

WCM: In short, we are not yet convinced it's the next Rainforest Café, so we're erring on the side of conservatism by booking our gains to date. Remember, if Teavana can maintain current returns on invested capital and scale from 160 to 500 stores this could be a very valuable business. So you have to give some credit to that optionality, even if we don't believe that's likely at the moment.

G&D: Could you give us another example of a company you have shorted?

WCM: A current short is Cornerstone OnDemand (ticker: CSOD), which is a nearly \$1 billion market cap talent management software company. It is on an approximate \$80 million revenue run rate. This is an industry I know very well due to my time spent on the board of Salary.com, which competed with Cornerstone. Cornerstone's industry of talent management is

dramatically more competitive today than it was five years ago. It is no longer the greenfield market opportunity it once was, as a lot of companies have now adopted cloud-based solutions. Further, at their current size, they are a sub-scale competitor competing against the likes of Taleo and SuccessFactors. In our view, Cornerstone is many years away from gaining true operating leverage because any incremental gross dollars are going to have to go back into R&D and sales and marketing just to try to gain scale. They're already in a bit of a catch-22 because growth is starting to decelerate and they're losing money. Management can either show the operating leverage on the bottom line by slowing growth, which is the reason for the big valuation multiple in the first place, or they can erode their bottom line further to reaccelerate growth.

G&D: What kind of importance do you place on meeting with management teams of companies you're either long or short?

WCM: For most of the companies on the long side, we meet with management regularly. Our sweet spot on the long side is \$250 million to \$1.5 billion market caps that are under-covered both by big managers and by Wall Street analysts. For the most part,

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we're important shareholders for these firms so we get pretty good access to management. On the short side, we rarely speak with management. Sometimes we will meet with them to gut check our thesis.

G&D: Could you talk about your efforts where you take on more of an activist shareholder role?

WCM: We view ourselves as active and engaged owners of businesses, and we're often communicating and working with our portfolio companies. For the most part, these are constructive, productive, and low profile conversations. At times though, we do find ourselves in situations where we need to exercise our ownership rights in a more vocal and direct manner.

I think the biggest opportunity with activism is with the value traps. There's no shortage of cheap stocks out there, particularly in our market cap sweet spot. These are companies with material revenues, oftentimes hundreds of millions of dollars of cash on their balance sheet, but they just don't have the necessary scale to drive bottom line returns for shareholders. We're not interested in being a passive investor in this situation. To the extent though that we can utilize activism to serve as our own catalyst and gain at least some control over our destiny, we believe you

take a lot of the "trap" risk out of that value equation.

Credibility and track record are very important for activists so we've been focused, particularly early in our career, on hitting singles and doubles so that we can show that we can add value and do the right things, but also that we are serious and will flex our muscle if necessary. To the extent that you start gaining some success in this area, the next project should become easier, because you can walk in the door with credibility.

One activist project we're involved with today is MRV Communications (ticker: MRVC). While the stock is essentially a net-net, this is also a company that has destroyed a lot of capital over the years. You would not have wanted to be a passive investor in this company. Like other engaged shareholders, we have pushed MRV to return a substantial amount of capital to shareholders, take steps to divest assets, and to restructure the board. We are the largest shareholders in the company and we're pushing to see further progress at the company this year.

Boiling it all down, we believe there's a tremendous amount of option value in having the ability to walk into that value trap situation and be the catalyst. You can take a concentrated position, with fairly well-

defined downside risk, and you can serve as the catalyst to unlock value. We often feel comfortable overweighting these types of positions in our strategy, to a point where we could have 8-12% of our capital in a single name. Thus, if we're successful in catalyzing the situation, we can add a lot of incremental alpha.

G&D: Could you talk a little bit about your due diligence and valuation approaches?

WCM: We like inexpensive assets and options, but we don't have hard and fast valuation rules. Said another way, a stock doesn't need to have a certain PE to fit in our portfolio. For example, a recent investment is a company called Pacific Biosciences (ticker: PACB). They are one of a number of companies that have gone public in the genomic sequencing space. Genomic sequencing is quite interesting but it's an industry that's still in its infant stage. We bought a block of Pacific Biosciences at the end of December in a tax-loss sale at a roughly \$140 million market cap for a company that has spent over 10 years developing its technology with premier Silicon Valley venture backing. It had raised \$400 million as a private company while building its technology and another \$200 million when it went public. So we were buying it for about

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Bill Ackman and David Einhorn at G&D Breakfast in October 2010.

"Boiling it all down, we believe there's a tremendous amount of option value in having the ability to walk into that value trap situation and be the catalyst. You can take a concentrated position, with fairly well-defined downside risk, and you can serve as the catalyst to unlock value."

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70% of its cash on hand and less than 25% of total invested capital for a company with really good management and breakthrough technology in a very competitive and young industry. But, it's also burning a lot of cash and the competitive and adoption risks are significant. In our eyes, though, if we size this position correctly, and at cost this was a less than a 2% portfolio weighting for us, this is an attractive value stock – not to mention a compelling tax loss trade.

We generally have models for important positions, but at the same time we subscribe to Warren Buffett's view that if you can't figure it out on the back of envelope, a big spreadsheet model is not going to give you the right answer either. But, modeling is important when you need to dive into the details on a position and to confirm or deny a hypothesis. For example, we own the TARP Warrants in Hartford Insurance (Ticker: HIG). This is a complicated company, and we have spent a lot of time modeling out their annuity exposure to understand the potential risks and rewards in the position. Additionally, we also spend a lot of time on the phone, aiming to get that nugget of insight that provides clarity for an investment. For example, our analyst Matt Furnas recently called over 100 restaurants to better understand the value proposition and importance of

OpenTable (Ticker: OPEN) to restaurant owners.

G&D: Can we talk about another one of your firm's positions?

WCM: Our current largest position is ATMI Inc. (ticker: ATMI). The company provides specialty gas and materials used to manufacture

“In this business, we really do try to wipe our minds clean of past mistakes. This is not to say that we don't try to learn from our mistakes, but as with golf, you need a clear and confident mind to be successful in an ever-volatile world.”

semiconductors. This is a good annuity-like business, and the boom-bust characteristics as a volume-based supplier are less intense than for the rest of the industry. ATMI has a \$700 million market cap and nearly \$150 million of net cash and investments on the balance sheet. It trades at roughly 5x EV/EBITDA. The company has two interesting growth drivers. First, ATMI has incubated a life sciences business. In the

past one of the big risks for pharmaceutical companies has been that they had to build expensive, FDA-approved manufacturing facilities. The industry is now moving towards outsourced, custom-batch manufacturing, which is similar to the semiconductor foundry model. ATMI has some relevant technologies that they have been able to apply to this nascent market. We estimate that revenues for this business line grew substantially in 2011 to over \$40 million, up from \$10 million in 2010. The investments in this business have depressed profit margins in recent years, and that should begin to reverse as the unit reaches profitability in the near future. We also think there is inefficiency in that the semiconductor analysts who follow the company have not done in-depth work on the life sciences business.

The second growth driver for ATMI is driven by the company's relationship with Intermolecular (ticker: IMI), a company that went public in November. Intermolecular has pioneered a new method of research and development for semiconductor companies. What is underappreciated is that ATMI owns 14% of the company and has a strategic supply relationship with Intermolecular, so as new chips are designed on Intermolecular's platform, we believe ATMI is poised to

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Pictured: Steve Eisman at the Columbia Investment Management Conference in February 2011.

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win a lot of new supply business. We should start to see the benefit of this market share growth as production of 28 and 22 nanometer chips begin to ramp, as we have recently started to see. In fact, what was most intriguing for Wolf as he was researching ATMI was that he found himself piecing together the market share puzzle for some of the industry participants with whom he spoke. Normally

“I believe the regular performance reporting structure has been a positive construct for me. Specifically, as a “long-term” investor, I found I was often willing to look past a company’s bad numbers or ignore my gut. Now, I have no excuse—intellectual honesty has been forced upon me.”

it’s the other way around. That makes us pretty excited about our investment edge.

G&D: Can you talk about some mistakes you’ve made over the years?

WCM: Where do I begin! In this business, we really do try to wipe our minds clean of past mistakes. This is not to say that we don’t try to learn from our mistakes, but as with golf, you need a clear and confident mind to be successful in an ever-volatile world. Our biggest frustration last year was actually in one of our activist positions, Moduslink Global Solutions (ticker: MLNK). We helped to put someone on the board that was very capable and who was working to add value, but in our view, management was more interested in collecting their salaries than unlocking value. Worse, as one of the first activists in, and with the board protected by staggered terms, we underestimated how long it would take to create change. Ultimately, we grew tired of the position and exited it – which is one of the benefits of this business: you are always free to wipe the slate clean of your frustrations and get back to focusing on new ideas.

G&D: Can you talk about an area where you have improved since starting Raging Capital Management?

WCM: I’ve always thought of myself as a long-term focused, value investor, and frankly one of the worries I had when starting my busi-

ness was that I would turn into one of those managers who’s overly focused on short-term performance to the detriment of long-term returns. In fact, the opposite has happened in that I believe the regular performance reporting structure has been a positive construct for me. Specifically, as a “long-term” investor, I found I was often willing to look past a company’s bad numbers or ignore my gut. Now, I have no excuse—intellectual honesty has been forced upon me. My job each day as a portfolio manager is to look for the best places to put my capital to work, and avoid and manage the risk. Our portfolio is still dominated by true long-term or contrarian ideas, but a lot of the intellectual dishonesty has been rooted out.

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

Important Disclosure:
Mr. Martin provides advisory services through his investment advisory firm, Raging Capital Management, LLC and only to qualified investors. This is not an offer of sale of securities or any other products to any person. Investing in products managed by Raging Capital Management, LLC involves significant risk of loss. Past performance is not a guarantee or a reliable indicator of future results. There is no guarantee that the investment strategies discussed will work or are suitable for all investors. Each investor should evaluate his or her ability to invest on a long-term basis, especially during periods of downturn in the market. This article contains the current opinions of Mr. Martin which are subject to change quickly and without notice. This article also reflects Mr. Martin’s verbal and written responses to specific questions asked by the interviewer and should not be considered a complete description of the strategies, methods of analysis and risks associated with Mr. Martin’s investment philosophy or those of Raging Capital Management, LLC. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product.

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BJ's Restaurants, Inc. (BJRI) - Short

Michael Yablon
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(\$ in MM USD except per share data)

Current Capitalization			Multiples			Summary Financials				
Share Price as of 1/27/12	\$48.91		LTM	2011E	2012E		LTM	2011E	2012E	
Basic Shares Outstanding	28	EV/EBIT	40.4x	40.2x	35.0x	Revenue	\$582	\$621	\$704	
Diluted Shares Outstanding	2	EV/(EBITDA-CapEx)	NM	NM	NM	EBIT	\$41	\$41	\$47	
Market Capitalization	1,454	EV/EBITDA	22.5x	20.9x	18.0x	EBITDA	\$73	\$79	\$92	
Cash and Equivalents	40	FCF Yield	NM	NM	NM	EPS	\$1.04	\$1.11	\$1.26	
Capitalized Leases	237	P/E	47.0x	44.0x	38.7x					
Enterprise Value	1,650	P/Book	4.6x	4.6x	4.1x	EBITDA-CapEx	(\$10)	(\$9)	(\$10)	
Trading Statistics		Returns			Free Cash Flow			(\$22)	(\$24)	\$18
52-Week Low-High	\$32.84-\$56.64		LTM	2011E	2012E					
Float %	87%	ROIC	11%	12%	11%	Book Equity	\$319	\$319	\$354	
Short Interest %	16%	ROE	12%	10%	10%	Total Assets	\$467	\$460	\$540	
Borrowing Cost	~50 bps	ROA	8%	7%	7%	Divident Yield	0%	0%	0%	



Michael 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 was an investment banker focused on mergers & acquisitions. Michael holds a BA from Columbia University.

Michael was the winner of the 2012 Moon Lee Prize for his pitch on BJ's Restaurants and was the 2011 winner of the Sonkin Prize for his pitch on Madison Square Garden.

Recommendation:

BJ's Restaurants, Inc. ("BJ's," "BJRI" or "the Company") represents an attractive short investment with near-term catalysts. BJ's operates a chain of casual dining restaurants and trades at a premium valuation. The stock currently trades at 47x LTM earnings but is forecasting just 13% growth. Furthermore, BJ's growth is dependent on a maturing base of restaurants and its ability to secure large restaurant spaces in high traffic areas while improving unit economics and returns on its capital intense business. The Company's execution to date has been strong, creating high expectations and no room for a decline in same store sales or margins. BJ's success has been driven in part by preferential terms received from its largest supplier who is also its largest private shareholder. This supplier only operates in California and Nevada where BJ's is reaching saturation. BJ's margins will decline as it expands away from this supplier out of its highly concentrated base in California. I projected the Company's growth out until 2020 to show the extreme and unrealistic bullishness implied by the stock's current price. I believe the fair market value for BJRI today is \$22/share.

Business Description

BJ's Restaurants, Inc. owns and operates 116 casual dining restaurants in the United States, including 56 in California and 24 in Texas. BJ's offers American-style comfort food in large restaurants that average 8,000 square feet. BJ's competitive positioning is best described as a "premium" casual dining, with a typical restaurant build-out cost per square foot similar to Cheesecake Factory and PF Chang's but with average meal prices in line with Applebees, Chilis and TGI Fridays. The company was founded in 1991 and is based in Huntington Beach, California.

Investment Thesis

Same Store Sales Set to Decline as BJ's Restaurant Base Matures: BJ's states that its restaurants grow fastest from the time they open until year four. As the base of BJ's restaurants matures, fewer locations as a percent of its total restaurant count will be in this honeymoon, high-growth period. This decline will reach its lowest level in Q3 of 2012 when the percent of growth locations will have fallen from 35% to 21%. This natural maturation process has affected peer's same store sales (including Cheesecake and PF Chang's) once they reached 110 units. BJ's has historically outperformed peers on a same store sales basis ("SSS") and this strong performance has driven revenue growth and fueled bullish projections. Any reduction in same store sales will undermine the growth story and reduce BJ's high multiple.

The Jacmar Relationship – BJ's Largest Supplier is also its Largest Private Shareholder:

BJ's margins and returns are artificially high, aided by the fact that BJ's largest supplier is also its largest private shareholder. Jacmar, along with its CEO, owns 11% of the company down from 16% last year and 53% in 2000. Jacmar's CEO, a BJ's board member, was a big seller in 2011, reducing his position by 32%. Jacmar only operates in California and Nevada and this explains BJ's disproportionate concentration in these states versus its peers. The Jacmar relationship has allowed BJ's to bill less in a quarter and make it up later when earnings have improved. As evidence of this in 2008 and 2009, Jacmar's growth in cost of sales moved inversely to the growth of total cost of sales. This relationship led BJ's to disproportionately expand around Jacmar, who only operates in California and Nevada, and is part of the reason BJ's margins outperform peers. BJ's growth in California is nearing saturation and new units in other regions of the US will have a negative impact on margins.

Peers Have Struggled to Grow Past 200 Restaurants, making BJ's Projection of 300+ Locations Unlikely: Large casual dining chains have historically been unable to grow to 300 restaurants, while maintaining margins and returns, and ultimately do not live up to their high multiples.

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BJ's Restaurants (Continued from previous page)

10 years ago, three companies traded above 40x earnings, Cheesecake Factory, PF Chang's and California Pizza Kitchen. However, in 2001 each of these firms had many fewer units and therefore a much bigger runway for growth. Cheesecake Factory had just 41 units, PF Chang's 52 and CPK 71. By the times they reached BJ's current restaurant count, the multiples better reflected their limited growth opportunities, with the average multiple of the three equaling 28x. With 116 units, BJ's multiple is not justified given its current stage of growth. A decade later, which is how long it will take BJ's to reach 300 units, growth has stagnated for these three competitors around 200 units and the stock prices are either flat or way down. Since passing the 110 location threshold, Cheesecake Factory, PF Chang's and California Pizza Kitchen's stocks have returned 2.3%, (7.2%) and 1.1% on an annualized basis, respectively, with CPK's return calculated inclusive of its take-out premium.

The US Real Estate Market and Mall Infrastructure Cannot Support 300+, 8,000 Sq. Ft. Locations:

The Company thinks it can get to 300 units, but the question becomes at what size restaurant. Smaller restaurants have worse economics because less square footage prevents the restaurant from effectively leveraging the fixed cost of the kitchen. The current format requires a large space (>8,000 sf) in a high traffic area. If BJ's is forced to open smaller locations, returns will suffer. Like Cheesecake and PF Chang's, BJ's expansion has centered around large malls due to their traffic density. But there is limited space in Class A Malls and significant competition over a dwindling supply. According to the International Council of Shopping Centers, the national vacancy rate at the top 80 regional malls by size rose to 9.4% in Q3:11, the highest level in 11 years. The ICSC also reported that the total number of shopping centers in the US has not grown in three years. The dearth of quality sites has restricted PF Chang's and Cheesecake Factory's growth. Unit growth at these peers has slowed over the last few years well below BJ's target of 300 restaurants. PF Chang's has added only 4 units since the end of 2009 for a total of 201 and Cheesecake Factory has 154 large-format units. In its Q4:10 earnings call, PF Chang's cited the scarcity of quality locations as limiting the opportunities for expansion.

Mediocre Return on Capital with No Barriers to Entry: Assuming a ten year life for new construction (per the Company's depreciation schedule), the average pretax IRR for a restaurant is 32%, which assumes that no capital improvements are made over the course of ten years. This return is around the 25%-30% range the company touts to the street as its target for new restaurants. However, when G&A is allocated on a per store basis returns drop to 16%, and when taxes are applied the return drops to 12%. BJ's returns are above its cost of capital but nowhere near the 25% it projects to the street. Granted, the company will be able to leverage its G&A expense over a bigger base of restaurants over time, but at square footage growth of 13%, this margin expansion will not have an impact in the near term. In reality, margin compression will likely offset G&A leverage and value creation will be flat to moderate, especially compared to high multiple companies that do not require heavy capital investment to fuel growth.

Valuation

To value the company I projected earnings out to 2020 in three different scenarios. Each DCF scenario assumes a discount rate of 8%, using a mid-year convention, and applies a conservative 17x multiple to 2020 net income. The Street Case illustrates the unrealistic assumptions implied by the current stock price. BJ's must grow to 300 restaurants while increasing gross margins to 22.5% (up from 20.5% currently and well above its peer average of 18.5%) and have SSS of 4% until 2014 and 3% thereafter. In the Bullish Case, which represents a best-case scenario for BJ's, the stock is worth just \$31/share. In the Likely Case, restaurant growth stops at 220 locations, above peers like Cheesecake Factory, PF Chang's and California Pizza Kitchen, while margins decline slightly to 20.0% and SSS grow at 3% until 2015 and 2% thereafter. A short of BJ's is protected by the Company's maxed out unit economics and slow, self-funded growth.

Investment Risks/Considerations

The Multiple Continues to Defy Gravity as the Internally Funded Growth Strategy Takes Time to Unravel: Mitigant - SSS will decline in 2012 and BJ's will have just 13% square footage growth, meaning the multiple is unlikely to expand rapidly and will more likely shrink

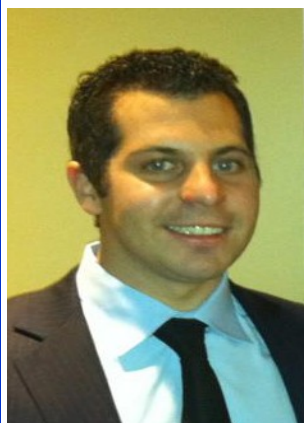
It's Too Soon to Short the Stock - Market Cap is just \$1.5B: Mitigant: Unit productivity is essentially maxed out and it is very unlikely that BJ's will be able to comp +5% over the next two years. If margins or SSS decline, the growth story will be undermined and the stock will fall hard. One doesn't have to wait for the unit growth to slow to see that the stock is overpriced.

	Street Case	Bullish Case	Likely Case
DCF	\$46.00	\$28.00	\$20.00
Normalized EPS ⁽¹⁾	\$3.88	\$2.75	\$1.91
EPS Multiple	13.0x	12.0x	11.0x
Implied Price - EPS Mult.	\$50.44	\$33.00	\$21.01
Implied Price - Avg of DCF & EPS	\$48.00	\$30.50	\$20.50
Current Share Price	\$48.91	\$48.91	\$48.91
Upside/ (Downside)	1.9%	37.6%	58.1%

(1) Average of 2011E-2020E Projected EPS Estimates

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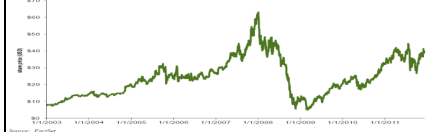
Noah is a second year MBA student. As an MBA he has interned at East Coast Asset Management, Columbia (Vanger) and Halycon Asset Management. Prior to school, he was a long/short investment analyst for Arlon Group. He holds a BS in Finance from the University of Illinois-Champaign/Urbana.

Michael won second-place at the 2012 Moon Lee Competition for his pitch on Chicago Bridge & Iron Company.

Chicago Bridge & Iron Company N.V. (NYSE: CBI)

Noah Snyder, NSnyder12@gsb.columbia.edu

Capital Structure		Guidance, Estimates, and Consensus						Multiples and Share Price					
		Revenues	2009A	2010A	2011E	2012E	2013E	Multiples	2009A	2010A	2011E	2012E	2013E
Price	\$42.00	Guidance			\$4,300-\$4,700	\$5,200-\$5,600		NHS Adj. P/E	17.0x	22.4x	15.9x	11.6x	9.6x
Shares Outstanding	99.8							Consensus P/E	17.0x	22.4x	16.7x	13.9x	12.2x
Market Capitalization	\$4,192.2	NHS	\$4,557	\$3,642	\$4,613	\$6,044	\$7,692	NHS EV/EBITDA	8.0x	9.9x	8.6x	6.7x	5.5x
Cash	\$539.9	Consensus	\$4,557	\$3,642	\$4,548	\$5,572	\$6,473	Consensus EV/EBITDA	8.0x	9.9x	8.8x	7.2x	6.3x
Total Debt	\$80.0												
Net Debt	(\$459.9)	EPS											
Enterprise Value	\$3,732.3	Guidance			\$2.40-\$2.50	\$2.75-\$3.05							
Dividend Yld	0.5%	NHS	\$2.47	\$1.87	\$2.65	\$3.61	\$4.39						
		Consensus	\$2.47	\$1.87	\$2.52	\$3.02	\$3.43						
52 Week High	\$45.12 (1.2%)	EBITDA											
52 Week Low	\$23.88 135.0%	NHS	\$466	\$376	\$435	\$559	\$674						
Volume (3 months) (000's)	1,095	Consensus	\$466	\$376	\$425	\$518	\$596						
Volume (3 months) (000's)	\$45,990												



Company Background: Founded in 1889, Chicago Bridge & Iron N.V. ("CBI" or "the Company") is an integrated engineering, construction ("EPC") and design company with a major portfolio of 2,000 patented energy technologies, delivering comprehensive solutions to customers in the energy resource industry. Essentially, CBI specializes in building football stadium-sized liquefied natural gas (LNG) facilities and cross fertilization and synergies across CBI's business segment is allowing the Company to win a disproportionate amount of new energy projects. During 2010, CBI executed 700 projects in ~70 countries and >80% of its backlog is non-US. Nevertheless, the Company remains a very misunderstood equity story.

CB&I Steel Plate- Legacy CBI (120 years). Global fabrication/construction of storage tanks & steel plate structures. IH '11: 40.4% of revenues, 51.7% of EBIT, 10.2% EBIT Margin.

CB&I Lummus (E&C)- Traditional engineering, construction, and design services for upstream & downstream energy infrastructure facilities. IH '11: 49.3% of revenues, 24.2% of EBIT, 3.9% EBIT Margin.

Lummus Technology- High quality hidden gem. >2,000 proprietary gas processing and refining technology patents. IH '11: 10.2% of revenues, 24.2% of EBIT, 18.9% EBIT Margin.

Target Price and Valuation

CBI is a long with a ~\$60 target price or ~40% upside. Target price is based on two proprietary methods of valuation: 1) Sum-of-parts and 2) Share of global LNG spend.

Sum-of-Parts: CBI has three distinct, yet somewhat overlapping business segments. I modeled out each segment based on its current backlog and I layered in potential new awards based on various end markets. For EBITDA margins I used guidance of Steel Plate 7-10% and E&C 3-6%. I used 2013 as I think this is a mid cycle year and I applied EBITDA multiples of 7-9x 2013 EBITDA based on business quality and barriers to entry for each segment. Steel Plate should trade at 8x EBITDA as it earns ~10% EBITDA margins and it is a low cost producer of steel tanks/storage with fabrication all over the world which would be costly for a new entrant to replicate. CB&I Lummus (E&C) should trade at 7x EBITDA, or in-line with historical engineering multiples as this segment earns mid-single digit EBITDA margins just as its comps do. Finally, Lummus Tech. should trade at 9x EBITDA as it is a higher quality reoccurring licensing

Sum of Parts Valuation			
	2013 EBITDA	Multiple	Segment Value
CB&I Steel Plate	\$311.9	8.0x	\$2,494.9
CB&I Lummus (E&C)	\$213.2	7.0x	\$1,492.6
Lummus Tech.	\$148.4	9.0x	\$1,336.0
Enterprise Value	\$673.5		\$5,323.5
Net Debt			(\$459.9)
Equity Value			\$5,783.4
Target Price			\$57.94

Mid LNG Cycle Valuation						
	Revenues	% of Revenues	EBIT Margin	EBIT	Multiples	Enterprise Value
LNG Potential	\$6,500.0	79.3%	8.0%	\$520.0	8.0x	\$4,160
Other Big Projects	\$500.0	6.1%	4.0%	\$20.0	8.5x	\$170
Book & Burn	\$1,200.0	14.6%	10.0%	\$120.0	9.0x	\$1,080
Total	\$8,200.0	100.0%	8.0%	\$660.0		\$5,410
Net Debt						(\$459.9)
Enterprise Value						\$5,869.9
Diluted Shares						99.8
Target Price						\$58.81

business with >20% EBIT margins.

Share of LNG Spend: Most analysts expect only ~\$200-250bn LNG spend, however my proprietary "project by project" research concludes there is >\$300bn of worldwide LNG projects on the horizon and most of them will be required just to fulfill Far East demand. I conservatively estimate CBI's share of LNG spend will be at 13% vs. a 11.7% share in 2010 even though CBI is winning a disproportionate share of new pre-feasibility and design studies. I use historical average EBIT margins and different EBIT multiples for earnings power based on certainty of revenue realization.

Investment Merits

Backlog Surge Not Priced In & More to Come- YTD 2011 new awards are ~\$7bn compared with \$2.3bn for the corresponding 2010 period. Over the last six months CBI has booked >\$5bn of new awards, yet the stock remains at mid July levels. Subsequent to Q2 '11, CBI has been awarded an LNG construction project in Gorgon, Australia ~\$2.3bn, >\$1bn of tank work in Asia-Pacific and an additional \$500mn of Kernal oil sands work bringing CBI's backlog to ~\$9.3bn. This is nearly an all-time high, but equity traders have not priced in this recent surge. Investors are now paying ~4x backlog EBITDA (using historical ~10% EBITDA margin) and getting all future earnings power for free.

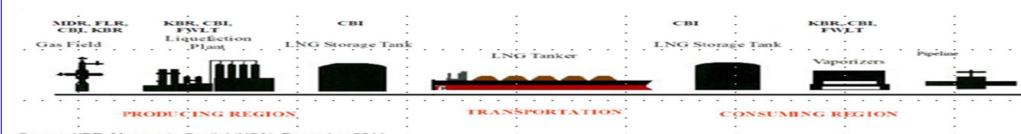
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Chicago Bridge & Iron (continued from previous page)

Entering Golden Age of Gas Use- Oil's share of total energy is now 34% vs. >45% in the 1970s and due to economic, environmental or energy security concerns nat gas will continue to steal share of total energy consumption from coal and oil. In China, which is now the largest energy consumer worldwide its current 5 year plan (2011-2015) calls for nat gas to move from 4% of energy consumption to 9%. To accomplish this China will need to import considerable amounts of LNG as it is impossible to generate sufficient nat gas internally. In addition, with US supply being geographically constrained due to lack of export, CBI Tech. will benefit from the nat gas renaissance in the USA as the cost curve has shifted downward making domestic natural gas ~10x cheaper than crude oil for the foreseeable future. Japan's nuclear meltdown has lead to surging nat gas demand as only 10 of Japan's 44 nuclear generators are operating and Germany has agreed to cancel its nuclear program by 2022 (20% of supply). Globally, leaders are reassessing nuclear plans and shifting consumption towards natural gas. Over the next decade nat gas will continue to take share from coal and nuclear power as it produces ½ the CO₂ and it is cheaper and more abundant than it has been in decades. CBI will be a huge beneficiary of this secular shift in global energy markets.

Barriers to Entry in LNG- As most of the end market demand drivers can not produce nat gas internally the gas will need to be processed, liquefied, and imported through LNG. Driven almost entirely by Asia-Pacific demand for Australia LNG, there will be 13-5 huge LNG projects sanctioned over the coming three years and global LNG spend could



Source: KBR, Macquarie Capital (USA), December 2011

reach >\$50bn by 2013.

CBI is positioned to benefit from this shift with competitive advantages as one of only ~5 companies that can effectively compete for >\$300bn of Australian and global LNG investment that will be required over the next 6 years just to meet nat gas demand. CBI enjoys a ~48% market share in LNG storage units along with ~9% of total LNG liquefaction spend. However, CBI is now winning a disproportionate share of new LNG liquefaction investment. CBI has already completed a ~\$1.5bn fully integrated Peru LNG liquefaction project below budgeted time and cost proving that CBI can execute an entire LNG project and CBI is no longer just a storage tank builder. Additionally, CBI has teamed up with Chiyoda (Japan) and Saipem (Italy) in forming CJV, a JV which is a premier worldwide LNG liquefaction team. Finally, CBI has scale, relationships and know-how, providing CBI w/ insurmountable barriers to entry in competing for \$5bn facilities.

Misunderstood Business Quality- In late 2007, CBI made a game changing deal in acquiring Lummus for \$820mn. Lummus Tech. has patented proprietary technologies for refineries which helps upgrade thicker, lower quality energy resources along with key strengths in ethylene and olefins conversion technology (OCT) in gas processing markets. This diversified CBI's business model allowing CBI to complete an entire LNG project and now 25% of EBIT comes from recurring high (~20%) EBIT margin technology business. By bundling and offering technologies and E&C services, CBI can further differentiate itself from many of its competitors in winning new projects. CBI now boasts a more steady, sustainable cash flow stream with minimal CapEx (\$50mn/yr) leading to a ~20% FCF yield in 2013. However, CBI is yet to re-rate vs. the E&C sector, nor have investors been able to see the "new" CBI fire on all cylinders.

Attractive Valuation- CBI is trading at 12.2x 2013 Consensus P/E and ~9.6x 2013 My EPS, or at the low end of historical trading range of 10x-25x. CBI is cheap as changing energy consumption will be secular and not cyclical or based solely on commodity prices. As CBI's business model is design/engineering heavy, CBI consumes little capital (CapEx = ~1% of sales) and its cost structure is flexible as engineers can easily be hired and fired. Industry standard for construction contracts has also moved to cost plus from fixed price and CBI has executed on this de-risked business model with nearly three years of flawless execution.

Catalyst Rich Story- CBI is currently doing feasibility studies on several >\$1bn LNG projects including Yamal, Arrow, and Browse which the Company will probably win E&C contracts for over the next two years. On top of that CBI is realizing >\$500mn per quarter in "book and burn" nat gas and petrochemical projects in the US due to the US shale gas revolution. CBI has several project in its pipeline which can help investors unlock value.

Potential Value Creation not Baked Into Estimates- Finally, CBI has cash of \$540mn and only \$40mn maturities in 2011 and 2012, respectively. CBI should generate an additional ~\$650mn of FCF over the next five quarters and CBI also has a \$1.1bn untapped revolver which won't expire until July 2014. CBI is well positioned to make another sizeable deal in niches that round out its product offering or the Company can buy back shares with its 10% share buyback in place. As CBI is comfortable at 25% of Debt/EV this means CBI has ~\$1.9bn of capital that it can use for shareholder value creation. By using \$1.5bn to acquire businesses at 20x P/E along with \$400mn for a share buyback (10% outstanding approved) this would allow CBI to add an additional ~\$15 of shareholder value.

Investment Risks: Cost overruns: Industry standard now cost plus vs. fixed price. CBI >50% cost plus contracts vs. 10% in 2005. Short term misses due to delayed investments. Oil prices weaken globally. Competition picking up in less differentiated projects. Overwhelming efficiency gains and/or tighter EPA legislation lead to reduced need for fuel power.

In China, which is now the largest energy consumer worldwide its current 5 year plan (2011-2015) calls for nat gas to move from 4% of energy consumption to 9%.

In 2010, CBI enjoyed a ~48% market share in LNG storage units along with ~9% of total LNG liquefaction spend. CBI is now winning a disproportionate share of new LNG liquefaction investment.

CBI can complete an entire LNG project and now 25% of EBIT comes from recurring high (~20%) EBIT margin technology business.

Sustainable cash flow stream with minimal CapEx (\$50mn/yr) leading to a ~20% FCF yield in 2013.

Currently doing feasibility studies on several >\$1bn LNG projects....which the Company will probably win E&C contracts for over the next 2 years.

CBI will have ~\$1.9bn of capital for shareholder value creation.

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Hewlett Packard (HPQ) - Long

Michael Zapata
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ticker: HPQ mkt cap: \$55.8b price: \$28 intrinsic value: \$51 upside: 83%



Michael is a second year MBA student participating in the Applied Value Investing Program. While at school, he has worked at a value-based hedge fund. Prior to enrolling at Columbia Business School, Michael served nine plus years as a Navy SEAL officer. Michael holds a BS from Texas A&M University.

Michael was selected as a finalist of the 2012 Moon Lee Prize for his pitch on Hewlett Packard.

Stock Information (as of JAN 2012)

Hewlett-Packard is a multinational information technology corporation that provides products, technologies, software, solutions and services to consumers, small- and medium-sized businesses (SMBs) and large enterprises, including customers in the government, health and education sectors.

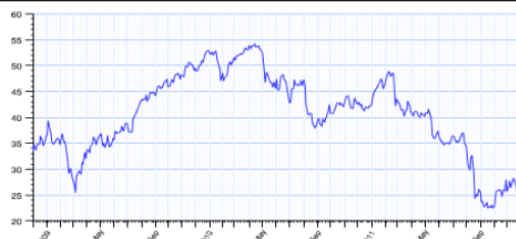
Price	\$ 28.12	Net Debt	22,591
52 Week Low	\$ 21.50	Enterprise Value	78,844
52 Week High	\$ 49.39	% Insider Ownership	0.08%
Shares Out	1,987.0	% Short Interest	0.90%
Market Cap	55,874	% Dividend Yield	1.7%

Key Metrics

	2008	2009	2010	2011
Returns (%)				
Return on Capital	13.0%	12.1%	13.5%	12.7%
Return on Assets	6.7%	6.0%	6.7%	6.7%
Return on Equity	21.5%	19.2%	21.5%	22.8%
Multiples	2008	2009	2010	2011
EV/EBIT	10.74x	9.41x	9.4x	6.4x
P/E	14.3x	13.0x	13.5x	8.6x
P/Book	2.8x	2.4x	2.6x	1.8x

Valuation

Cases (2014)	EBIT	EV/EBIT	EV	EV/Share
Low Case	11,100	6.0x	66,600	\$33
High Case	11,763	10.0x	117,630	\$63
Net Debt				10,000
Base Case	11,507	8.5x	97,810	\$51
Upside				83%



Income Statement

	2008	2009	2010	2011
Revenue	118.4	114.6	126.0	127.2
growth	13.5%	-3.2%	10.0%	1.0%
EBITDA	14.2	15.8	17.7	16.4
margin	12.0%	13.8%	14.1%	12.9%
EBIT	10.8	11.0	12.9	11.4
margin	9.1%	9.6%	10.2%	9.0%
Net Income	8.3	7.7	8.8	7.1
margin	7.0%	6.7%	7.0%	5.6%

Balance Sheet

	2008	2009	2010	2011
Cash and Equivalents	10,153	13,279	10,929	8,043
Total Debt	17,852	15,830	22,207	30,634
Debt/Equity	45.8%	38.8%	54.7%	65.7%
Current Ratio	1.0x	1.2x	1.1x	1.2x
BV per Share	\$ 15.96	\$ 17.13	\$ 18.35	\$ 19.42
Tang BV/Share	\$ (0.56)	\$ 0.34	\$ (2.67)	\$ (8.46)

Recommendation

Hewlett Packard is a buy at \$28 with an intrinsic value of \$51 for 2014, representing an 83% upside. A downside scenario, with flat line EBIT and a low 6x EV/EBIT represents an 18% upside to \$33.

Key Points

Why Undervalued?

- Key management concerns- three CEO change in the past year
- Uncertain long-term plan- PC business spin, caused fear and confusion
- Losing market share- Servers
- Poor acquisitions- \$10 billion Autonomy bid

Strong Industry Leader

- HP is the global leader in PC, Printers, Servers
- #2 market leader in Networking and Management products
- #3 market leader in Operating System and Storage
- Tremendous brand recognition and economies of scale

Strong Financial Position

- Strong Cash Flow Generator- \$13 billion in 2011, 14% FCF yield
- Ability to pay down debt
- Steady share repurchases and stable dividends
- Stated the current focus on paying down debt and increasing sales force and R&D in 2012

Potential Catalyst Primers

- New CEO, \$1 salary, performance based bonus, will provide clarity and focus
- Strategic roadmap pending announcement in 2012
- Activist investor recently appointed to BOD

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Hewlett Packard—Long (Continued from previous page)

Executive Summary

Thesis

Hewlett Packard is a strong cash flow generating, market-leading company that is being punished by the market for recent company announcements and multiple CEO changes. The sell off has been overdone, with HP stock moving from the year high of \$50 to the recent low at \$22 in September. The current price of \$28 represents an opportunity to buy HP with a 45% margin of safety to its intrinsic value. Overall, the underlying business has not changed, the company has recently appointed a focused, goal oriented CEO, has appointed a seat on their board to a prominent activist investor, and is primed to communicate a long-term strategy that will provide a well-defined road ahead for investors to regain confidence in the company.

Summary

The current state of the IT industry is stable and across each of HP's segments, the company is repositioning its foothold to propel the company forward through its focus on short and long-term strategic implementations. HP is a world leading company with brand, economies of scale, and customer captivity represented through its market leading positions in PC, printers, and server divisions.

From a management standpoint, the incoming CEO, Meg Whitman, will allow the company to be focused by providing the structure needed through the pending release of its strategic vision. Additionally, while only on a performance based salary for the first year, the CEO will look to fewer headlines, which will benefit HP as this will be a positive sign that the company is moving forward and management is not hindering growth.

Organically, the refocus of HP on its hardware division, while working to increase its software sales across its business segments, will provide a clear picture to both its customers and the market. The commitment to its PC segment will allow the company to move forward to provide a comprehensive ecosystem for its customer base. Additionally, the increase in the critical operating expenses of research and development and sales staff will provide short and long-tails to supporting HP's focus and dominance in the IT industry.

Growth wise, although overpriced, the recent Autonomy acquisition provides the company a springboard to the higher margin software sales. Autonomy will increase HP software sales by 33%, which will affect the bottom line. The company will also allow HP the opportunity to cross sell the unstructured search software into its hardware and server divisions. This is a great starting point for long-term HP opportunities.

Financially, HP generates strong cash flows and is dedicated to the return of a strong balance sheet, which translates to a commitment to pay down its debt. Ms Whitman has stated that the company will not make any major acquisitions in 2012. With a 14% FCF yield, HP is well positioned. Additionally, with the appointment of activist Ralph Whitworth to the board, HP working to provide confidence to investors, as the company will likely pursue additional options to return capital to shareholders.

HP is the world leader in PC, printer, and server sales, and the number-two leader in server and networking sales. The company is primed to grow software sales, which will expand margins and increase the potential for higher multiples. At the current EV/EBIT of 6.7x (and P/E of 6.2x, record lows of past 20 years), resulting in a \$28 stock price, HP represents a compelling buying opportunity with a 45% MOS and 83% upside.

Potential Catalyst

HP's recent appointment of Meg Whitman represents the beginning of an HP turnaround. However, due to potential Euro and macro headwinds, the decision to increase operating expenses to expand the sales force and research and development, and the current higher debt, the potential catalysts will be slow burning until Ms Whitman communicates HP's long-term vision in 2012. This pending catalyst, couple with aligned and diligent actions across HP, will convey a roadmap and clear vision to investors, who will be able to invest with confidence in Hewlett Packard.

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Young Ju is a first year MBA student. Prior to school, she was an investment analyst at Blue Pool Capital and Citadel Investment Group in Hong Kong. She holds a BBA from Seoul Natl. University.



Jane is a first year MBA student. Prior to school, she was an equity research analyst with CLSA in Hong Kong. She holds a BCom degree from Tsinghua University and a master of finance degree from University of Melbourne. She is a CFA charter holder.



Sachee is a first year MBA student. Prior to school, she was a consultant at KPMG in London. She holds a masters degree in electrical engineering from Univ. of Maryland and a bachelor's degree in electrical engineering from Indian Institute of Technology.



Jing is a first year MBA student. Prior to school, she was an associate in Investment Banking at Royal Bank of Scotland in Hong Kong. She holds a Bachelor of Economics & Finance from University of Hong Kong.

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Hankook Tire (000240 KS) - CBS Finalists at WIN Conference

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Investment summary

Year to 31 Dec	2009	2010	2011F	2012F	2013F
Revenue (KRW b)	5,145	5,813	6,647	7,354	8,324
Growth (%)	15%	13%	14%	11%	13%
Diluted EPS (KRW)	2,356	3,017	3,111	4,186	5,468
Growth (%)	n.m.	28%	3%	35%	31%
P/E (x)	18.1	14.2	13.7	10.2	7.8
EV/EBITDA (x)	7.4	7.2	7.2	5.5	4.5
P/B (x)	3.1	2.6	2.2	1.9	1.6
ROE (%)	18.6%	20.0%	17.5%	20.0%	21.7%
ROIC (%)	16.3%	18.8%	17.0%	19.9%	23.1%
Div yield (%)	0.8%	0.8%	0.9%	1.2%	1.6%
Net gearing (%)	56.9%	46.0%	47.0%	27.1%	18.7%

Key stats

Close Price	KRW	42,750
Pricing as of		Nov 8 2011
Total market Cap	KRW bn	6,207
Total market Cap	USD mn	5,589
Enterprise value	KRW bn	7,088
Avg daily turnover (3M)	USD mn	40
12M Range (KRW)		27,200-50,000
Total shares Out. (mn shares)		145
Free float (%)		52%
Net debt (FY11, KRW bn)		881
Net debt / equity FY11		47%
KRW/USD exchange rate		1,111

Recommendation:

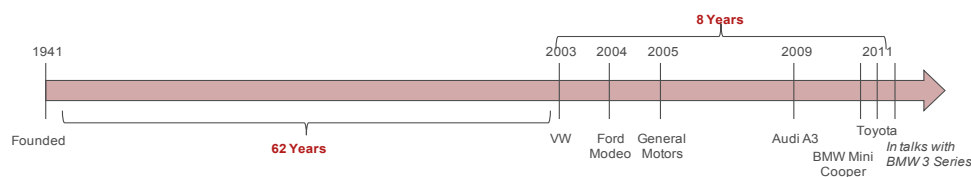
We recommend buying the Hankook Tire share (Hankook or "the Company") because we believe market is underestimating the product price growth potential of Hankook led by improvement in brand value. Our target price is ₩71,000 (13x 2013E PE) implying 66% upside.

Company Description:

Hankook manufactures radial tires for passenger cars, truck and buses. In 2010, Hankook's global production capacity was 80mn units with the largest production facility located in Korea (45mn) followed by China (30mn) and Hungary (5mn). Replacement tires (RE tire) account for 65% of revenue and original equipment tires (OE tire) account for 35%. Hankook makes 80% of revenue from overseas market. Hankook is No.1 player both in Korea and China with 52% and 19% market share, respectively. Hankook's global market share is 3.1% (7th ranked). Hankook's customers are Hyundai, Volkswagen, Ford, BMW, Toyota and Audi.

Investment Thesis:

Product price growth potential on the back of improving brand: In the past, Hankook has not been a price setter for the tire industry but has followed the industry leaders' (such as Michelin, Bridgestone) pricing policy. However, the trend is likely to change because Hankook enters a virtuous cycle on the back of strong growth from emerging markets and improved brand image. The expansion of customer base to the leading auto makers such as BMW and Toyota in 2011 sets a favorable pricing environment for Hankook. We expect Hankook will be able to achieve 9% ASP growth during next 3-5 years vs consensus estimates of 2-3%. In 2010, Hankook's implied ASP (total revenue / total capacity) was still 50% lower than the top tier tire companies indicating there is an ample room for Hankook to raise product price.



Why 9% growth? Hankook today is the Bridgestone in Japan in 1980s: We believe Hankook today is comparable to Bridgestone in 1988 based on the size of business. From 1988 to 1998, Bridgestone was able to grow its revenue at 13% CAGR. Considering a stable volume growth (4%) during that period, it implies Bridgestone was also able to raise ASP (either through a voluntary price hike or through product mix improvement) at c9%. This supports our price argument of 8-10% for Hankook for next five years. Furthermore, Hankook has a stronger volume growth outlook than Bridgestone because of much larger emerging market exposure (37% vs Bridgestone's 19%). The stronger demand in emerging markets can lead to a more favorable pricing environment.

US\$ Mn	Bridgestone (1988)	Hankook (2010)	Bridgestone (2010)	Bridgestone CAGR from 88-98
Revenue	5,276	5,813	32,617	13%
Operating Profit	567	536	1,897	13%
Net Profit	190	147	1,127	16%
Total asset	5,285	4,979	30,850	12%

Hankook Tire (continued from previous page)

Product price growth will lead to margin expansion: We forecast 9% increase in ASP across all regions will lead to 2ppt gross profit margin expansions in 2012-2013 because of lower rise in unit cost-growth(5%). This will lead to 32% and 29% bottom-line growth in 2012 and 2013, respectively. We are not taking any bet on the foreign exchange rates. However, highly likelihood of Rmb appreciation could

	2011F	2012F	2013F		2011F	2012F	2013F
ASP increase in local currency	9%	9%	9%	Volume (k unit)	85,200	87,180	92,100
ASP per tire (USD)	61.8	67.0	72.3	% change	6%	2%	6%
Cost per tire (USD)	50.5	53.1	55.6	Gross profit (KRW bn)	1,036	1,265	1,502
% change	9%	5%	5%	Gross margin	28.0%	30.0%	31.7%
Gross profit per tire (USD)	11.3	13.9	16.7	Net profit	441	584	752
% change	4%	23%	20%	% change	1%	32%	29%

surprise on the upside.

Valuation:

Our 2-year price target for Hankook is W71,000 per share, representing 66% upside from the current price of W42,750. We have applied current FY2011 PE multiples (13x) to FY2013E earnings to arrive at the intrinsic valuation of Hankook in 2 years. The base case assumes an annual ASP growth of 9% from 2011-2015, the bear case assumes 3% and the bull case assumes 12%. Based on these cases, we believe Hankook is worth between W29,000~W99,000 (risk reward -32% ~ +123% off of the current price of

	Bear			Base			Bull		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
EBITDA	1,049	1,035	978	1,049	1,295	1,552	1,049	1,460	1,932
EBITDA growth	2.9%	-1.3%	-5.5%	2.9%	23.4%	19.9%	2.9%	39.1%	32.4%
EPS	3,111	2,741	2,238	3,111	4,186	5,468	3,111	5,105	7,610
EPS growth	3.1%	-11.9%	-18.4%	3.1%	34.6%	30.6%	3.1%	64.1%	49.1%
Intrinsic value per share based on EV/EBITDA									
6.0x	34,385	35,729	32,017	34,385	47,336	58,972	34,385	54,722	76,821
7.0x	41,612	42,859	38,753	41,612	56,252	69,660	41,612	64,775	90,130
8.0x	48,839	49,989	45,490	48,839	65,169	80,348	48,839	74,829	103,439
Intrinsic value per share based on PE									
12.0x	37,328	32,897	26,853	37,328	50,229	65,616	37,328	61,259	91,322
13.0x	40,439	35,638	29,090	40,439	54,415	71,084	40,439	66,364	98,932
14.0x	43,549	38,379	31,328	43,549	58,601	76,552	43,549	71,469	106,542

W42,750) with upside/downside ratio at 4x.

Risks:

Sharp rise in rubber price: Rubber costs (both natural and synthetic) accounts for 50% of raw material cost and 20% of revenue. If rubber price goes up too quickly, Hankook may not fully realize benefit from price increase.

Currency risk Hankook is short position of US dollars (raw material cost is mostly denominated in USD) and long position of Euro and other foreign currency. If KRW depreciates 10% against USD, impact on EPS is -24% assuming KRW stays flat against other currency. Against Euro, if KRW depreciates 10%, impact on EPS is +4%.



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Graham & Doddsville 2012 / 2013 Editors



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