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Issue XIX

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Guy Spier — Build Your Life in a Way That Suits You



Guy Spier

Guy Spier is the founder and managing partner of Aquamarine Capital, an investment partnership styled after the original 1950's Buffett partnerships. In 2008 Mr. Spier, along with Mohnish Pabrai, had lunch with Warren Buffett after submitting the winning bid for Buffett's annual Glide charity auction. Mr. Spier completed his undergraduate studies at Oxford and earned an M.B.A. from Harvard Business School.

Graham and Doddsville (G&D): How did you first become interested in investing? What drew you in and what keeps you going?

Guy Spier (GS): I guess there are some natural proclivities that I have. One is that I don't like managing people and I'm really bad at executing on stuff. Getting Mr. Guy Spier to have the ambition of building Starbucks like Howard Schultz did would never happen. Guy would still be running some crummy coffee shop because I'm just not very good at execution. I know that I'm an extrovert, I enjoy meeting people but on

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Koch Industries — Creating Value in Society



Dave Robertson



Steve Feilmeier

Koch Industries is an industrial conglomerate headquartered in Wichita, Kansas. It is the second largest private company in the U.S. with \$115 billion in sales. Its businesses range from petroleum refineries and fertilizers to chemicals and fibers, as well as Georgia-Pacific, which Koch acquired in 2005 for \$21 billion.

Koch's recent investments include a \$1.5 billion minority stake in Guardian Industries, an architectural glass manufacturer; an investment in Colfax Corporation, a diversified manufacturing and engineering company; and a \$240 million preferred stock investment in American Greetings Corp.

Richard Hunt, *Graham and Doddsville's* former AVP and a summer business

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Welcome to Graham & Doddsville



Pictured: Heilbrunn Center Director Louisa Serene Schneider. 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 are among the most heavily demanded and highly rated classes at Columbia Business School.



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

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It is our pleasure to bring you the 19th edition of *Graham & Doddsville*. This student-led investment publication of Columbia Business School is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA).

As students return to campus here at Columbia Business School, we are reminded and implore our readers to continue the search for what Charlie Munger has called "worldly wisdom." By dedicating our lives to continuous learning, we become not just better investors, but better thinkers and contributors to the world in which we live.

Our first interview is with **Guy Spier**, the founder and portfolio manager of Aquamarine Capital. In a candid discussion with *Graham & Doddsville*, Mr. Spier discusses everything from his use of checklists to several of his recent investments. Insightfully, he points out that it does little good to aspire to be a different investor, but instead suggests to focus on creating an investment philosophy and portfolio that is consistent with who you are.

We also sat down with Koch Industries Executive Vice President and Chief Financial Officer, **Steve Feilmeier**, as well as President and Chief Operating Officer, **Dave Robertson**. They discuss their approach to finding investments that are not only great standalone businesses, but also ones that can be integrated into their existing operations.

We continue to bring you pitches from current students at Columbia Business School. CSIMA's Investment Ideas Club meets regularly throughout the year, including during the summer, and provides CBS students the opportunity to practice crafting and delivering investment pitches. Three of the best ideas from this summer are contained for your perusal—long the 9.75% senior guaranteed 2020 USD notes of Homex (EJ0116982), long Wabash National shares (WNC), and long Active Network shares (ACTV).

Looking forward to the coming academic year, we are working to bring you even more fascinating interviews; we plan to expand our gaze to international investors as well

as to some of the newer and less-familiar faces in the investment community. We also have a few other ideas in store, so stay tuned for our upcoming editions.

As always, we thank our interviewees for contributing their time and insights not only to us but to the investment community as a whole, and we thank you for reading.

- *G&Dsville* Editors



Bill Ackman and David Winters at the Omaha Dinner in May



Students waiting to hear the final presentations at the 2013 Pershing Square Challenge



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Guy Spier



Guy Spier

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some level I lose patience with humanity as well. Being in a situation where I don't have to deal with too many people if I don't want to, and I don't have to manage them is a big plus. So I think there are very specific ways in which it was natural for me to go into investing. I think it's something that is suitable for me, but at the same time the world of investing is broad so you still want to find a niche or a place in it that suits your own particularities.

Five years ago I asked Warren, 'Berkshire Hathaway is structured a bit like the starfish versus the spider?' The idea is that a starfish, if you cut off a leg, it regenerates. A starfish is a decentralized organism and a spider is not – you pick off a leg and it doesn't grow back a new leg. Decentralized organisms are more resilient to having their legs cut off and Berkshire Hathaway is the same way. It's very resilient as opposed to a command and control organization. I asked Warren, 'That's really smart. Did you figure that out twenty years ago?' And he said, 'No. I absolutely had not figured any of that out. Berkshire Hathaway is the way it is because it suits me. It suits my particular personality.' I don't know if he actually said it, but he clearly implied that if he had Jack Welch's personality and abilities and internal wiring, Berkshire Hathaway would have looked very, very different. So why investing? I

think that at the end of the day, it suited my internal wiring. I think I'm aware of some of that wiring but I'm not aware of all of it.

"I sometimes ask myself, 'If you had the choice between either Oxford/HBS and the education that you get around Warren Buffett, Charlie Munger, Ben Graham, etc.' I think hands down Charlie Munger, Ben Graham and all of that is much better."

G&D: Can you talk about your background at Oxford where you studied philosophy, policy and economics? Did that affect your investment methodology or philosophy?

GS: I was lucky enough to attend both Oxford University and Harvard Business School. But I sometimes ask myself which I would have chosen if I could only do one. Two very different educations.

People who go to Oxford are great thinkers, they just can't get anything done. That's a broad generalization. Oxford brought out my proclivity for discussing, writing essays, all of those things. Harvard Business School on the other hand, is much more practical. It would have been very hard to choose between those two.

Then I sometimes ask myself, 'If you had the choice between either Oxford/HBS and the education that you get around Warren Buffett, Charlie Munger, Ben Graham, etc.' I think hands down Charlie Munger, Ben Graham and all of that is much better, for me at least.

At Oxford, for example, I studied the Rudi Dornbusch exchange rate overshooting model. It's a beautiful thing and it might describe some measure of reality. But it's a very powerful idea that grabbed hold of the whole of academic economics, this idea that you could solve equations representing the economy through time by assuming rational expectations, which is now an important part and parcel of the neoclassical model of economics. Now you've got a way of moving things to equilibrium through time even if people don't know what the outcome is because somehow all the actors in aggregate are moving the market price to their rational expectation of

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Guy Spier

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what it should be.

I think that it handicapped me in a profound way. Because there I was at Harvard Business School and Warren Buffett shows up and I have no interest in him. I also have no interest in the financial markets because in my rational expectations view, there are no dollar bills on the ground; they would have been picked up by this spectacularly efficient market. Now I'm sure I learned plenty at Oxford and at HBS, but I don't think they helped me much professionally. I'm sure I'm a better human being but they did not help me with investing. I don't think. And I don't know one person I studied with who even understands what I do or understands the basic philosophies of value investing. They just think, 'Whatever. He's just a finance guy.'

G&D: Not even David Cameron gets it?

GS: David Cameron is a very, very, very smart guy and he understands British politics and understands what can and cannot be done with Britain in a way that I could be living in Britain 100 years and not understand. But we underestimate how many people have any clue about the way we feel, which is, 'Oh my God. This is so exciting. There are market inefficiencies that I can exploit. If I just get a few

things aligned right I could make billions and live this incredible life.' And many people who do value investing end up living these incredible lives. And we live long lives is what we've figured out. We know from Warren Buffett that it's not

"It took me a long time to figure out that my job is not to be Warren Buffett or to be Bill Ackman. My job is to be Guy Spier."

got to do with intelligence - he says some people get it, some people don't.

I got it, but my God, have I strayed from the path in so many different ways. I had such a narrow understanding of the wisdom that Warren Buffett had to impart. If my investment career is the only thing we're talking about, I definitely lost at least five years, perhaps more, getting started on it because my head was filled with all these ideas of efficient markets. But I've lost more time by not fully learning the lessons that are available there for all to see.

The basic tenets of *The*

Intelligent Investor - Mr. Market, things having intrinsic value, stocks representing part interest in businesses - are fantastic. But I was in a position ten years ago not to charge a management fee the way Warren Buffett did, but I was charging a management fee. Why on earth was I doing that? I don't know how many years ago I met Mohnish [Pabrai]. He was not charging a management fee. I was an example of the guy sitting on the other side of the road at the gas station. You know the Tom Peters story? Mohnish talks about cloning and seeing whether people are willing to clone or not. I'm sitting there, laughing at all those idiots who don't clone. At some point I realized, 'Wait. I'm the guy on the other side of the road who is not cloning what is obviously working.' There are so many things that I lost time with and didn't learn because I had too narrow an understanding of the wisdom that was to be imparted.

G&D: You went straight from being in investment banking to managing money raised from friends and family. What caused you to do that?

GS: A few things. It took me a long time to figure out that my job is not to be Warren Buffett or to be Bill Ackman. My job is to be Guy Spier. I'm not going to do a very good job of being

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Guy Spier

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Bill Ackman or being Warren Buffett but I'm going to do a damned good job of being Guy Spier, better than anybody on the planet.

Everybody's path is unique and I think it's really, really important that we find our own path. If I look back at the path that I took, there are many mistakes that I made. Many things I would have done differently. But that's yet another thing we have to learn, to own our path with its mistakes and to be accepting that every single person has massive mistakes in their path, and that's part of life.

Leaving business school, I had this pristine resume. I'd worked for a consulting firm, had a great undergraduate degree, Harvard Business School and I wanted to throw up all over anything that had to do with the establishment. I just had no interest. I did not pursue interviews with Goldman Sachs and all of those people. Which I think was a mistake. I was feeling rebellious and had to break out of these straight and narrow tracks. However, I think that there's so much to be said for being on the corporate bandwagon for a while and not getting off it right away.

I started working for a guy who was also a graduate of Harvard Business School who had his own banking/investment firm, he was very solidly in the third tier.

If the first tier is Morgan Stanley, Goldman Sachs, Credit Suisse, globally recognized brand names and then you have a second tier of Robert Baird and Associates and regional investment banks. Then you have this third tier doing things like taking penny stocks public or venture investment banking where you would take a company that didn't have any earnings and take it public. After I joined, I discovered that there were people engaging in practices which were on the borderline of legal. In fact, five years after I left, the SEC shut down half of the firm. I knew that to go and join Goldman Sachs I would have been a glorified photocopier or something like that. I didn't care what brand name I had, I wasn't doing that. I was doing something real. That said I should have left that place three months into it because it was a snake pit.

What happened to me, and again I'm just describing my path, was I was reading all sorts of books. I pick up *The Intelligent Investor* and a light goes on in my head. An aha! moment happens and now I'm applying for jobs as an analyst doing what you guys do, except that I'd gone to work for DH Blair. I was interviewing with a number of places but I wasn't having an easy time of it and these question marks arose. I made a very, very, very bad judgment call in terms of my own personal reputation. I had associated myself with a

guy that I should not have associated myself with, and in finance especially, your associations count. People don't have the time, the energy or the interest to really dig deep to find out if this is a good guy or not. You don't have to get yourself burned. If you see there's smoke you don't have to put your hand in the fire. The good news is that when you make mistakes you want to make them early. You want to make those mistakes when you're 25 and not when you're 40 or 50 or 60.

In my case, I was very interested in this investing stuff. I started putting together mock portfolios. I met some great people on the way, Carley Cunniff was very generous. That's when I started going to the Berkshire meetings. I didn't know anybody, but just started showing up. Then in my case what happened is that my father notices this. There's a family business in London trading agricultural chemicals. He had made some money and he started investing that with me. From my father's perspective he wanted me involved, whether consciously or subconsciously, he realized that by getting me to invest the family wealth he was getting me back involved. I didn't realize but at that point, on some level, I had re-joined the family business.

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Guy Spier

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G&D: How did you feel comfortable starting out on your own and managing close relations' money?

GS: My father is the kind of person who doesn't do things half measure. He doesn't say, 'Here's 10% of my wealth and if you do well with it I'll give you another 10%.' He dumps all his liquid wealth on me, which was pretty much everything, which instantly made me unbelievably risk averse because I knew exactly what I was dealing with. Then again, I've gone back and said to myself, 'If he would have dribbled it out to me, I think I would have been much more willing to take big gutsy bets.' In that period I had really great investments. One was Duff & Phelps which is one of the credit rating agencies. It's now part of Fimalac and that was a 7X over three or four years, just a wonderful, amazing situation, but I didn't invest very much. I was scared stiff. One thing that I'm adamant about is I'll leave with one track record and all of those things go into the track record.

Something I believe quite strongly is that if you want to understand who an investor is, you need to understand both their relationship to money in general, their relationship to the money that they specifically manage, and what the money means to them. Money means very different things to very

different people.

I don't understand some peoples' approach to money. I don't understand why they love it so much. Now contrast that with somebody that we all know pretty well—Mohnish. Mohnish is on record as saying that his dad went bankrupt a number of times so he's very familiar with having money and not having money. And he's very familiar with seeing how his parents were unchanged through that. His core family circumstances actually didn't change that much. He has a much lower fear of loss of money I think because of that. The other thing is when he started Pabrai Funds it wasn't Guy's dad saying, 'Here's some money that I've made. Invest it.' It was Mohnish having sold his business and taking a portion of that and investing it. That again is a very, very different psychological relationship to money and I think that drives a huge amount of investment behavior.

I would love to do the analysis on Bill Ackman on that front. I don't have enough information, but Bill I think, like me, came from an environment where there was established wealth. For Bill, money, it seems to me, is the opportunity to play out stuff that on some psychological level he cares about. Misgovernance in the companies that he follows gets under his skin. Some

people just go, 'You know... Warren owned Coca Cola during the period when Doug Ivester was messing up completely but it didn't get under Warren's skin.' People had to practically read the Riot Act to him before he acted to remove Doug Ivester. You have one extreme there and then you have Bill. I think understanding those personality traits and realizing they are unbelievably idiosyncratic in each one of us is really important to do.

G&D: Clearly you're heavily influenced by Benjamin Graham and Warren Buffett, value investing legends. But what do you think sets you apart from those guys that gives you an edge in investing?

GS: I'm dumber. The Aquamarine Fund is open but I'm not really trying to raise money and it's a wonderful release because I don't care about distinguishing myself and differentiating myself and all of those things. Warren Buffett has a 180 IQ, maybe higher. Mohnish has a way higher IQ than I do; it's 160 or more. If you ask me, I think Mohnish's IQ is not as high as Warren's but I tell you they're both streets ahead of me. Warren runs around saying that you don't need a high IQ, he's just being nice. Having a high IQ really helps. He says it's better to be sensible than to be super smart – he's

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"The investors that we appreciate and do well somehow have found a way to reflect their inner life in a very fundamental way in their investing moves."

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Guy Spier



Pictured: Bill Ackman and Louisa Serene Schneider at the Omaha Dinner in May 2013.

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absolutely right. But if you can be sensible *and* super smart that is definitely better.

The investors that we appreciate and do well somehow have found a way to reflect their inner life in a very fundamental way in their investing moves. At the end of the day, every successful investor ends up differentiating themselves on the unique aspects of their personality and who they are. I'm not trying to be the best investor. I'm just trying to be Guy Spier. If you give me a path in life that involves higher returns to my limited partners and/or high returns to me, but it makes me less Guy Spier, I wouldn't take it. So in a certain way I guess I disagree with the premise of the question, which is I'm different to all those investors because I'm Guy Spier and I'm not Ben Graham and I'm not Warren Buffett. I shouldn't try to out-Warren Warren.

To compare myself to any of those other people is a very dangerous thing to do and probably not helpful actually. But they are all smarter than me and they're all better investors and that's okay. I'm comfortable with that. It's about being the best version of yourself. That may be investing in low cost index funds because that's where you're at in terms of your ability to analyze and your relationship to money, and that's perfectly fine. Warren

Buffett has deep respect for John Bogel. In many ways John Bogel is not an investor; he's just a guy who runs a machine.

G&D: How do your personality and your life experiences manifest themselves in your investing decisions? What do you look for?

GS: I don't like situations where there's a lot of public controversy. I get particularly scared when I see very smart people on both sides of the equation. I know that I'm much more comfortable in a place where people just aren't paying attention. That feels much, much better to me. I figured out I know absolutely nothing about retail, that retail is just a dumb place for me. I've realized that it would not be smart for me to invest in the healthcare sector, but I think I can get through life without investing in the healthcare sector.

G&D: Which industries attract you more?

GS: The core home base for me is branded consumer goods. It's really hard to find something that's super attractively cheap but I just know that I'm on safe territory there. I actually now feel I'm in a lot safer territory in terms of natural resources. They have to be the lowest cost producer, for example, and we have to understand the supply and demand dynamics of a

particular commodity. I never thought that I would understand banks and I know that I nailed banks two years ago but it was really specific—large American money center banks were unbelievably underpriced and a really safe place to put lots of money.

People jeeringly said to me, 'You don't understand Bank of America's balance sheet.' I'd come right back and say, 'Neither does Brian Moynihan but it doesn't matter.' I think that what's interesting is I have a much better sense of when something is in my circle of competence and I'm much more willing to define stuff outside of my circle of competence.

In reverse engineering the Berkshire Hathaway 13-F filing, one of the positions they have is a company called VeriSign. VeriSign is a beautiful, beautiful business. It's probably not cheap but I never thought that a company that is in the tech space would be within my circle of competence. I gave up doing the work because it's too expensive and because allocating one's time to the stuff that's cheap rather than spending all this time studying great businesses is smarter. But I think I would have been ready to define VeriSign as being within my circle of competence.

G&D: Would you by any chance be willing to discuss

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any current ideas you have?

GS: I will tell you that, where I am right now, I have not found something that I want to put in the portfolio for quite a long time. There's been quite a dry spell; it's not like we're not looking. I'm happy with my portfolio the way it is so I haven't done a lot recently. I'll tell you one that I rejected, but I think it is an interesting business and is such a puzzle.

The one that came up was Reciprocal Patent Exchange (RPX). So I was introduced to the whole world of intellectual property. First of all, IP is a big deal. What I learned is that 200,000 or 300,000 patents get granted every year and nobody completely knows what the patent covers or doesn't cover. But in the US and Western countries, the policy is, we grant people patents. A patent lasts 25 years. What does that patent give you the right to do? It gives you the right to pull somebody to court and say, 'You're violating my patent.' It's an interesting right and it becomes a lot more interesting or uncertain when you realize the scope. At the end of the day a judge has to decide was the patent being violated or not? What happened with Apple versus Samsung is extremely unusual because what happens is like nuclear warfare between two countries, when you have two big corporations with a

lot to lose you can counter-sue each other and you can say, 'If you're going to get me on violating this set of patents I'm going to get you on others so why don't we just call it a day? You get on with your business and we'll get on with ours.' This is what usually happens.

Then there are these things called patent trolls. They just sue people for violations of patents and collect some kind of reward. If I'm a patent troll, I will acquire a pool of patents from somebody and haul Apple into court and I say, 'You're violating this set of patents.' I didn't invent it, and I don't have a business off it, but I own the IP. The law is if you own the IP, you're the inventor. The problem that Apple has is Apple has to go and defend that. Now if I was some other operating business Apple would say, 'Let's sit down and talk. Let's see what you've got. Let's get some arbitration, we don't really want to go to court. We can see you're a small business, you're trying to grow this division. Why don't we buy a whole bunch of stuff from you? Why don't we license you?' There's some kind of business arrangement that settles it out. Not with the patent trolls. The patent trolls say, 'We don't have a business. We are secure. You can't sue us for anything but we can sue you for that.' So at the end of the day Apple settles.

This is a huge cost to American industry. On the one side they're hated by people like Apple and the other large companies and on the other side they're the champions of inventors who often feel they've been screwed over by big industry. What Reciprocal Patent Exchange does is they go to all these companies that are basically settling at the court's door or they're paying these companies to go away and they say, 'Why don't we pool our resources?' To cut a long story short, it's fractional ownership of patents. Like fractional jet ownership, fractional patent ownership. You pay a subscription to us, we'll acquire all this IP and you'll never get sued on account of this IP. It doesn't take away the legal risk entirely, but it massively reduces the legal risk and they now have much more buying power because it's on behalf of all of their clients and they have something like 200 clients. It is a really interesting business and it's cheap and they generate massive amounts of cash. Really, really interesting, but at the end of the day I put it in the 'too hard' pile.

G&D: What about Fiat, would you be comfortable discussing that investment?

GS: What I'd say about Fiat, I don't want to talk too much about it because of commitment, consistency and all of those things but it

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"The idea that we're managing some finely tuned machine is just not the case. I'm just trying to get it right 55% of the time or get it slightly better 55% of the time."

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Guy Spier



Pictured: Rahul Raymoulik, Richard Hunt, and Stephen Lieu at the 2013 Pershing Square Challenge.

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really is an interesting situation. What I think is interesting about Fiat is that what the Italians and the Europeans see is some also-ran European automobile manufacturer. They see a company that is a much smaller automobile manufacturer with sales skewed to Southern Europe, which has been much worse hit than Northern Europe. They don't have a clue what Chrysler is but people here in the United States understand that Chrysler is a substantial business, they have some blockbuster brands, and it has a real franchise value. But they can't invest in Chrysler because it's all owned by the VEBA, this voluntary employee benefits association, and Fiat. I think that is one of those unusual situations.

The whole way in which Fiat acquired Chrysler is very interesting. Sergio Marchionne, the CEO of Fiat, comes to the negotiating table. They're close to doing a deal for an undisclosed sum of money, but the day before Barack Obama says, 'we're going to save Chrysler as well.' So Sergio says to the people negotiating on behalf of the government, 'Do you really want to go back to your president and say that actually there is no deal and what the president said to the American public isn't true? It's that or you're giving it to us for free.' The US government didn't care

about the money being made or lost. They cared about saving jobs.

I think there is space on the planet for one Italian brand. We have four or five German brands, global German brands. The only company that has a chance of being a global automobile brand from Italy and not just in the high end like Ferrari is Fiat. Chrysler does an amazing thing for Fiat. Fiat's business has already improved dramatically because they now have the ability to allocate costs and production around the planet.

Fiat used to be very heavily under the thumb of the Italian government and Italian unions. Now Fiat can say, 'Yeah, we're headquartered in Turin but we don't have to manufacture cars in Turin. We'll produce them in Brazil and we'll import them to you...' Chrysler has given them a global base from which to really allocate production across different factories. I think that takes three or four years to play out.

I got the permission from the people I did the work with on Chrysler to talk to *Forbes* about it but I think that for me, investment theses are fragile. I don't want to say what I just said too many times; the more times I say it the more difficult it becomes should I want to change my mind. Keynes said, 'When the

facts change I change my mind. What do you do?' You want to be in a position to do that. The more people who know what your opinion is on Fiat, the less easy it is to change your mind. Dangerous stuff.

G&D: How do you make your sell decisions?

GS: Very badly. The idea that we're managing some finely tuned machine is just not the case. I'm just trying to get it right 55% of the time or get it slightly better 55% of the time. What has worked for me is first of all, do not touch the portfolio unless you have a clear reason for action. One of the things that I do is I don't want to look at the portfolio too often. I know I will perform better if I can do this.

A lot of the time what happens to me is I'm cleaning positions out for something else. I look at the investment more as a source of performance or as a source of cash. When I have a great new idea I'm saying, 'Where am I going to raise money for it?' and I will sell the thing that I believe is the least undervalued or the least likely to contribute to performance going forward. But I've been surprised a number of times by things that I've had in the portfolio that have gone up anyway. I will tell you, an experiment that is really worth running is to pick portfolios by darts

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or by any other system and then you just leave those portfolios alone, and it's often only one or two companies that provide most of the performance. I think that meddling just ends up reducing returns so I really try to leave it alone until there's a compelling reason for action.

I'd like to be optimal, I just don't know how to be optimal. I have two barriers, or two difficulties, in doing that. One is I don't actually know if the conclusions that I'm drawing are accurate conclusions. I don't know if the information that I have is the right or the full and complete information or whether I have enough information. I don't know if I'm analyzing it correctly. Then there's overcoming my bias towards inaction and overcoming all the personal psychological biases about endowment effects and all of those things - fricking nightmares.

G&D: I think there's an investor presentation I looked at that had a litany of biases that humans have in decision making. So what do you do specifically to make sure you don't fall prey to those biases?

GS: Suffer.

G&D: And use a checklist?

GS: That's a great one. A checklist is a very personal thing for me. It's what mistakes have I made, what mistakes have people close

to me made that I understand, and am I repeating these mistakes? It's a bit like the common law. You're not trying to talk in generalities. You're saying, 'I remember when I invested in EBC oil and someone in management was going through a divorce and it really messed up the investment. Is anybody here going through a divorce I need to know about?' I remember when I invested in Lab Corp of America it was over-leveraged. We didn't realize it was over-leveraged. It was a great business but the investment went down by 80%. Is that the case here? That's definitely one thing.

I will tell you that other things I've picked up from Mohnish that are just smart moves. Don't buy when the market's open. Don't trade when the market's open. I don't like to talk to the traders. I just want to send them an e-mail. I don't want any feedback from the market or any of those things.

Sequencing the information that I get is another way. A sales person will get in touch and say, 'Hey, I want to call you up and talk about something.' The standard response is, 'Please put it in writing.' Make people submit stuff to you in writing first because we know that we're less biased when we get the information in writing.

Our information diet goes

from the sugar and sweets to the meat and potatoes. Sugar and sweets is most of the stuff that comes up in a Google search. It's designed to get that instant response. Meat and potatoes is down in the 10-K. Reading the 10-K or reading something that, because of the process through which it went through - e.g. in the case of the 10-K, legal checking by lawyers - to make sure the claims being made are correct. That's where we really want to start. Then once we've got the solid diet, the meat and potatoes, we can move on to the sugar and sweets. But if we allow the sugar and sweets in first, there's no space for the meat and potatoes and we know that what comes into our brains first affects us massively. If I favor the meat and potatoes sources of information before other sources of information, over a lifetime of decision-making, my decision-making will be a little bit better and that little bit better is what I need.

Another simple thing is how one communicates with management, which is part of this information diet idea. Company visits are a very dangerous thing. I haven't done a company visit in quite a while, but my goal is not to make a buy or sell decision within three days of visiting a company because there are all sorts of influences.

For instance, a company

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“What has worked for me is first of all do not touch the portfolio unless you have a clear reason for action.”

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Guy Spier

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called Quicksilver Resources. I've no idea how and why it came onto my screen. Another reject. Very good reputation, family controlled, natural gas, making a lot of money on their hedges. I e-mailed the investor relations guy and he said, 'I'm happy to get on the phone and talk to you about the company.' I said, 'That will be great. But before we do that, I just have two questions. Maybe you have an e-mail answer for me which would be quicker.' Again, wanting to have the written communication before the verbal communication because I know this guy can sell the pants off me. 'I'm having trouble understanding how you have been so successful at hedging over so many years.' The price at which they're selling the natural gas is at \$2.60 or \$2.70 but it's coming in with the hedges at \$5. But if you're doing that year after year after year these hedges must cost a lot of money and I just couldn't figure out where the cash was coming from. And I said, 'Could you tell me what your all-in cost of production is?' No response. That shouldn't take more than a paragraph to answer. My conclusion was that their cost of production was way higher than they'd like it to be. If you're doing anything, if you're half doing stuff right, you know that number and you're trying to allocate resources based on it because some wells are high

cost of production and some wells are lower cost and obviously you decide where to go based on those costs. I knew I didn't have to go any further.

The other thing that I would say is unbelievably critical is to have relationships with the right people. How does one practically do that? I think that this really works; if somebody I know is not a healthy influence on me for decision-making, I'll respond to their e-mail three or four days later. Maybe I'll leave it in my inbox for a month. So they'll get a response, but I'm simply prioritizing and being mindful and conscious about how and why I'm prioritizing.

In fact, take the people with whom one can have healthy conversations and write them a thank you note every now and then or send them something or find a reason to deepen that relationship, even if it's just a little bit. Over a short period of time there's no obvious change but over a long period of time that can make a massive, massive difference.

G&D: What other ways besides through your network do you find the right contacts?

GS: Something I've tried without much success, but is really interesting, is LinkedIn. So pull up the company, see who's connected to it, e-mail 20 people. But don't just say,

'I'm trying to find out about Quicksilver,' or 'I'm trying to find out about RPX.' Instead say, 'I've been doing some work on RPX. Looks like an interesting business. Here are three articles that I think are the best articles I've found. Here are some links. Here are some of the things that I've learned but I would love to see if you might be willing to contribute to my knowledge or point me in the right direction.' It's giving value in the e-mail at the same time as asking for something. If anything, you develop your network.

G&D: Honestly, as a student you get an almost 100% response rate.

GS: I would still develop the habit of adding value to them and not just saying 'I'll be really grateful to you and happy to do something for you in the future.' What you're doing is building up your analyst franchise. In five years' time you want to be in a place where there are so many people who just love you because every time you have had a conversation about some company you have found a way to add value back in their lives. Your information flow will be that much better than other people who weren't doing that. You don't have much of a way to distinguish yourself now from many other people but over five years that makes a big difference. How did I learn this?

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Guy Spier

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G&D: Mohnish Pabrai and the practice of cloning?

GS: What's so beautiful about cloning is that it's not mutually exclusive. The more you do it, it's helpful for the whole community and enough of humanity will never do it. I'm at the Berkshire meeting with Mohnish and all of these people are coming up to him. He has spent the last twenty years making people feel glad that Mohnish Pabrai's on the planet. In small ways and in big ways, just doing it as a habit. So if you've been handling people right for 20 years, you become a very real asset to whatever business you're a part of because you're just going to get lucky more often. I've experienced that over the last five years. I've gotten luckier with people more and more often and it's just a lovely thing. I had to realize I was not put on earth to help Guy Spier. I was put on earth to help humanity.

I'll give you an example. Bill Ackman got into doing this a year or two before me. I knew him; he was a year above me in business school. They had offices in 245 Park Avenue and he just said, 'Come here, use Bloomberg, spend as much time as you like. Really happy to have you here.' I remember that and I would leap at the opportunity to help him out in some way if he asked me to.

G&D: Mohnish got that

idea from Robert Cialdini, right?

GS: There's a huge amount of wisdom there. I told somebody 10 years ago, 'I'm writing 20 thank you notes a week.' And they say, 'How ridiculous. Who are you writing thank you notes to?' I say, 'The doorman, anybody I can put my hands on really, the person who served me at the shop. You name it, left, right and center.' They're like, 'How's that working for you? Have you seen any changes?' Not really. They say, 'What a dumb idea.' I say, 'Well, the doorman was really nice to me this morning.'

So say I'm writing thank you notes like that and I attend the Pabrai Fund Annual Meeting and I write him a thank you note, one of twenty I wrote that week, but that may have been the only thank you note Mohnish received from the meeting he held in Chicago. And when he was in New York for some reason he had the idea to call or to e-mail me and to say, 'Would you like to get dinner?' These simple changes in behavior make such a massive difference because at the time my derisive friend is asking me how my relationship with the doorman is going, the thank you note to Mohnish Pabrai hadn't been written.

I'll tell you something else. It's made me more successful than the average member of Joe Q. Public

and the average person in my set of friends is incapable of giving it the attribution it deserves. They'll say, 'You're lucky. You're smart. You're in the right place at the right time.' And I'm like, 'No, no, no. It's because I was doing Cialdini for the last five years. You can do it too.' You know, in some way that is even more surprising to me than value investing because value investing is a very narrow thing. All we're talking about now is a strategy for anyone to improve their lives. Finally, after ten years of being married and five years of doing this, my wife gets it.

As you can see, in a certain way I'm more enthusiastic about this than value investing. Having read Ben Graham would not have helped me if I was a poor boy in Bangladesh, but this Cialdini reciprocity stuff is much more basic and would have helped anyone. Warren has this famous saying about how he was very lucky as to where he was born. If he was born in Bangladesh those good business practices wouldn't have made a big difference.

It's like Wal-Mart. Sam Walton figured something out with Wal-Mart: stack it high, sell it cheap, keep delivering massive value to the consumer, always give them better value than they can find elsewhere, work really hard to negotiate with your suppliers to give

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Pictured: Mario Gabelli '67 speaking at the 2013 Omaha Dinner.

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Guy Spier

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[customers] great stuff at low cost. Who would have thought that piling it high and selling it cheap would have developed into the amazing business franchise that Wal-Mart is now. Where I started off on this little reverie is that we can do the same things. I can't be Wal-Mart and I can't be Sam Walton but my God, I have the tools to develop a similar unique Guy Spier franchise just by getting mind space and getting people to feel a certain way about me. It's just caring about them, caring about the outcomes in their lives, and figuring out a way to help them. That's the ideal, actually helping them, but the second best is to let them know you would have wanted to help them. That's effectively what a card does. I have a rule—every single person who sends me a job application gets an e-mail back. It's particularly important for people who apply as analysts because they're likely to go on and do great things so I want them to like me. I want to help them.

G&D: Could we talk about the lunch you had with Buffett? Can you give us some questions that you asked him and were you surprised by any of the answers to his questions?

GS: One of the things that Mohnish did is he set the tone of the lunch in the right direction. We were there to say thank you. What can you guys give the

people that you want to get close to? The first natural response is, 'Nothing.' But we can. First of all, thanking people. Every human being wants to feel thanked. We were there to say thank you and we were there to appreciate him, not just some idiot on the street, but as people who had studied him really closely.

I sent my most recent annual letter to Debbie Bosanek. Here's what I said to Debbie. I said, 'Debbie, there's no wisdom in here Warren's going to glean, nothing about the world that he doesn't already know, but I think he might enjoy seeing what a powerful impact he has had on me. This thing has got 'See what Warren Buffett inspired me to do' written all over it and he might enjoy it on that level'.

I think the mentors that you and I want, we can't necessarily spend every day with because they don't have time and you may not know them and they may not even be alive. So studying them really closely to get a good sense of the answers they would give to the questions we have is totally the right track and a very, very smart thing to do, especially with people who are not alive. What would Shackleton say? What would Ben Graham say? What would Franklin say? You can go to Seneca. You can go to Marcus Aurelius. They're all available the minute you drop the idea that they have

to be in the room with you to mentor to you.

Before our meeting with Buffett, we sent our bios over. I sent this bio, 'I grew up in South Africa and Israel, lived in London, and moved to the United States.' My wife Lory, the only thing her bio says pretty much is 'born in Salisbury, North Carolina.' Warren had no interest in the fact that I'd lived in Iran, Israel, whatever, but he liked the fact that Lory grew up some place. That's his mind-set. He's not just an American guy; he's a guy from the American mid-west and he knows what he likes and he likes what he likes and he's not interested in experimenting very much with other stuff.

The starfish and the spider that I talked about was really an awakener for me. It was not just what he said, but the way he said it because he knew exactly where I was coming from. In a certain way he was teaching me a really important lesson. 'Don't try to build the best business you can build. Build the business that suits you the best. Build your life in a way that suits you.'

Realize you only have one life to live on the planet. 'Yeah, Berkshire Hathaway is this wonderful big company, but it suits me.' That's the most important thing about Berkshire to Warren. So in a certain way

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“My goal is not to make a buy or sell decision within three days of visiting a company because there are all sorts of influences.”

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I came away with a renewed appreciation of how unusual Warren is. Given the choice between building a bigger Berkshire and building a Berkshire more suited to him, or building a Berkshire with higher returns, he takes the Berkshire more suited to him. He said, 'We're not going to make any decision that would get us more money if it means we lose one night of sleep.' That's effectively saying, 'I want this to suit me. I don't want to be the best, biggest, fastest.'

That's just a profound insight and I can tell you it's scary for me to stand up in front of my investors and say, 'I'm not trying to have the highest possible returns. I'm trying to run this in a way that fundamentally really suits who I am.' Half your investors leave the room.

I'll just give you one final thing. We talked about the limits to the size of Berkshire. For some reason we haven't had a company that's broken through a trillion dollars in market cap and somehow that seems to be the limit to size. The fierce pride with which Warren asserted that Berkshire wasn't subject to that was fascinating.

G&D: What did you learn from Debbie?

GS: Let me tell you how special a person Debbie is. She's somebody who's so self-confident about who

she is that she doesn't mind being perceived as Warren Buffett's assistant. She's so

"In five years' time you want to be in a place where there are so many people who just love you because every time you have had a conversation about some company you have found a way to add value back in their lives."

much more than that. She knows everything that's going on. It's impossible for Warren to function if she doesn't. She's a repository of a huge amount of knowledge at Berkshire Hathaway. She's a repository of many things that managers at Berkshire

don't know. I don't think Warren could be who he is if Debbie wasn't who she is.

Something I've learned is that to say I have a relationship with Warren is to say he knows who I am. But if I want a good relationship with people like Warren, the key is to have a good relationship with their assistant. And it's not trying to manipulate them into doing right for you. It's really genuinely caring about who they are, caring about what their job is, and trying to help them to do a good job for the guy that they're working for. When you get them as allies it's a huge amount of fun and joy. I don't even address anything to Warren anymore. I address it to Debbie. I say, 'Dear Debbie dot dot dot.' Or I might say, 'Warren might want to see this, but only if you're printing it out for him and giving it to him at the right time when he's not busy, when he's ready for a bit of a laugh.'

G&D: Guy, thank you for your time.

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Peter is a second year MBA student participating in the Value Investing Program. During the summer, he worked at Perry Capital researching high yield and distressed debt opportunities. Prior to Columbia Business School, he worked at a farmland investment fund based in Argentina. Peter holds a BS from Boston College.

Peter was part of the 1st place team in Columbia's 2012 Restructuring Case Competition. He was a semi-finalist in Origami Capital's 2013 Global Investment Idea Competition for his research on water rights. Peter is co-President of the student-run Commodity Club.

The student pitches featured in this issue are a selection from Columbia Business School's Investment Ideas Club ("IIC"). If you are interested in hearing more pitches by serving as an IIC judge, please contact Ben Isaac (bisaac14@gsb.columbia.edu) or Charles Buaron (cbuaron14@gsb.columbia.edu).

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Homex (9.75% Sr. Guaranteed 2020 US\$ Notes) - Long @ 36.94 (5/28/13)

Peter Bowley
PBowley14@gsb.columbia.edu

Capital Structure (MXN\$ MM)	Financial Highlights (MXN\$ MM)	Annual				Quarter	Consensus	
		FY09A	FY10A	FY11A	FY12A	1Q13A	FY13E	FY14E
Stock Price (28-May-13)	\$7.99						NA	NA
Shares (MM)	334.9						NA	NA
Market Cap (US\$ MM)	\$2,676						-	-
(+) Secured Bank Debt (ex-Inbursa)	\$8,924						-	-
(+) 2015/2019/2020 Notes	\$11,691						\$18,824	\$21,608
(-) Cash (Net of Prison Sale/Derivatives)	\$1,417						-24%	15%
Enterprise Value	\$21,874							
P/E (NTM)	3.8x						\$3,442	\$4,959
EV / EBITDA (NTM)	6.4x						18.3%	22.9%
Total Debt / LTM Adj. EBITDA	4.5x							
Net Debt / LTM Adj. EBITDA	4.2x							
Debt / Equity	141.3%						NA	NA
Adj. EBITDA / Int. Exp.	1.9x						NA	NA

	Scenarios			Up/Down		
	Performing	Restructuring	Liquidation	Total	Prob. Weighted	Absolute
Probability	30.0%	60.0%	10.0%	100.0%		
IRR	37.0%	13.8%	-21.6%			
Prob. Weighted Return	11.1%	8.3%	-2.2%	17.2%	9.0x	1.7x

Recommendation:

BUY Homex ("HMX") 9.75% Senior 2020 Notes. Even assuming aggressive down-side scenarios (30% of face tender offer/restructuring or liquidation), making money (on prob.

weighted avg. return basis) requires only a 5% probability the notes remain performing. I estimate this probability as at least

30% due to HMX's market leadership, relationships with government/domestic and international banks/suppliers, non-core assets available for sale, Mexico's significant remaining housing supply deficit, continued government subsidy support to subsidize housing demand and Mexico's favorable macroeconomic outlook. Restructuring is a much more likely outcome than liquidation, due to family-controlled nature of the company, as well as the significantly larger value of land bank as an on-going concern versus liquidation value.

Background

HMX is a vertically integrated homebuilder focused on affordable entry-level and middle-income housing in Mexico, as well as a small operation in Brazil. Its tourism development division targets high-income foreigners, and its infrastructure division constructs/operates public-private partnership projects like prisons. In 2012, HMX operated in 35 cities/22 states, building 46,357 homes (#3 player with 2.0% market share), 91% in the affordable entry level segment. In 1Q13, HMX had a land reserve of 76.7 MM m² in Mexico, 2.3 MM m² in Brazil, as well as 0.3 MM m² tourism-related land bank and a hotel. Customer price/sale risk has historically been reduced through federally-subsidized mortgages (INFONAVIT/FOVISSSTE) for low-income earners (financed via obligatory payroll taxes), to reduce Mexico's 4.3 MM housing unit deficit (+2.5 MM fed/state/muni. formal-sector employees alone).

During 2011-12, leading Mexican homebuilders expanded land banks into 2nd/3rd tier regions. Simultaneously, their horizontal row-house building model generally failed as suburban locations lacked transportation infrastructure for residents to reach workplaces. Many homeowners "mailed back keys" (100% LTV purchases from government-subsidized mortgages), turning some developments into abandoned ghettos. Government payments of receivables to homebuilders slowed significantly in 4Q12-1Q13 as ministries transitioned for newly elected President Peña Nieto. To address the failed suburban row-house building model, the government announced homebuilders will be required to build urban vertical developments (more costly; less land available). These factors created a liquidity crunch for Mexican homebuilders, including HMX, which burned (MXN\$6.1 BN) and (MXN\$3.2 BN) in operating cash flow in 2012 and 1Q13. HMX has MXN\$20.6 BN in debt (incl. 1Q13 Inbursa bank debt), of which 56% is Senior Unsecured notes. In April 2013, HMX breached a covenant on US\$70 MM of swaps with Credit Suisse and Barclays (who are taking HMX to court for payment remedies), as well as on a loan from a Brazilian bank for HMX's Brazil operations. Both events could qualify as an event of default for HMX's Senior Unsecured Notes, including the 2020 Notes. Further contributing to the homebuilder liquidity crunch, in late-May 2013, INFONAVIT (the Mexican government mortgage credit agency; issues 2/3 of housing sales by HMX) was ordered by courts to suspend payments to homebuilders due to legal actions of foreign/local creditors to the homebuilders.

Prob. Weighted Avg. Return

Prob. Remain Performing	Prob. Weighted Avg. Return	Up / Down	
		Prob. Weighted	Absolute
5%	11.4%	6.3x	1.7x
10%	12.6%	6.8x	1.7x
20%	14.9%	7.9x	1.7x
30%	17.2%	9.0x	1.7x
40%	19.6%	10.0x	1.7x
50%	21.9%	11.1x	1.7x
60%	24.2%	12.2x	1.7x
70%	26.5%	13.3x	1.7x

Make money with only
+5% probability notes
remains performing

Desarrolladora Homex (Continued from previous page)

Investment Thesis:

A. HMX selling non-core assets and focus on cash flow generation: MXN\$4 BN sale of prison assets; MXN\$2 BN for debt repayment, MXN\$2 BN for working capital; actively marketing tourism land bank (MXN\$750 MM market value); owns 2.3 MM m² Brazil land bank, a 150 room hotel and 2 airplanes

B. HMX has sufficient liquidity through 2013E, even in a downside scenario: +MXN\$2 BN in new working capital to unlock value from current construction in progress; low capex needs (<MXN\$100 MM); 13E debt amort + interest of MXN\$3.0 BN; (MXN\$1.4 BN) financing gap can be met by non-core asset sales (high demand for tourism assets as constitutional ban to be removed for foreigners to own beach front land; large real estate fund believed Brazil land bank could be developed for industrial use).

C. Federal government and domestic banks need top homebuilders to survive: still +2.5 MM home unit deficit for salaried police/army employees alone; Top 4 homebuilders build +150k new units/year (20% of affordable homes in 2012); President announced +MXN\$7 TN in public infrastructure spending; HMX CEO has strong relationship with new president and helped get elected, should benefit from new, high-ROIC infrastructure deals; domestic banks are large creditors to homebuilding sector with symbiotic relationship (uninterested in foreclosing on land bank/work-in-progress construction creating price collapse; also repackage mortgages into CMBS).

D. Vertical Building Model: Gradual and Subsidized Transition: government mandate for vertical homebuilding won't take effect until 2014-2015; new government subsidy program to guarantee first 30% loss on new loans for vertical construction (HMX already received US\$12 MM bridge loan from ABC Capital/Cemex); HMX increased to 55% vertical construction in 2012 (from 5% in 2010).

E. Mexico Macroeconomic Tailwinds: balanced budget since 2006; 27% debt/GDP; increased tax collection and energy/PEMEX reform to drive 13E/14E GDP growth of 3-4% p.a.; May 2013 Fitch upgraded Mexico to BBB+ (if fiscal/energy reforms passed could go to A-level).

Valuation/Recovery Analysis:

- My liquidation valuation: (i) 70% discount to homebuilding land banks, (ii) 30% discount to tourism land bank, (iii) 40% discount to other assets, (iv) no value assigned to infrastructure division other than the prison service operation.

Liquidation Value (3/31/13)

(MXN MM), USD:MXN: 12.99	MM m2	MXN\$/ m2	MXN\$ MM	% Discount	MXN\$ MM
Land Bank					
Mexico: Homebuilding Land Bank ⁽¹⁾	76.67	\$531	\$40,741	70.0%	\$12,222
Mexico: Tourism Land (Cabo/Cancun/Loreto) ⁽²⁾	0.33	\$2,391	\$779	30.0%	\$546
Brazil: Homebuilding Land Bank ⁽³⁾	2.30	\$531	\$1,222	70.0%	\$367
A. Total Land Bank Value	79.30				\$13,134
Prison Services					
Prison Services Annual Oper. Income ⁽⁴⁾					\$29
% Stake in Services Opco by Homex after Sale to Inbursa ⁽⁵⁾					20.0%
Discount Rate					14.0%
B. Prison Equity Value					\$41
Other Assets					
A/R, Net of Prison A/R ⁽⁶⁾	-	-	\$8,581	40.0%	\$5,148
Infrastructure Division	-	-	NA	-	NA
Mexico: Loreto Baja Golf Resort/Spa ⁽⁷⁾	-	-	\$453	40.0%	\$272
Airplanes ⁽⁸⁾	-	-	\$133	40.0%	\$80
NOLs	-	-	\$1.55	100.0%	\$0
Corporate Real Estate (Land + Building) ⁽⁹⁾	-	-	\$560	40.0%	\$336
C. Other Assets					\$5,836
D. Total Liquidation Value (A+B+C)					\$19,012
(-) Pro-forma Sr. Secured Debt ⁽¹⁰⁾					\$8,924
(-) Pension Liabilities					\$6
(-) Def. Tax Liabilities					\$6,316
(-) Est. Liquidation Prof./Advisor Fees ⁽¹¹⁾					\$760
E. Leftover Value for Unsecured					\$3,005
Unsecured Notes (2015, 2020, 2022)					\$11,691
A/P					\$4,724
Other Liabilities					\$3,961
F. Total Unsecured					\$20,376
% Unsecured Debt Recovery (F / E)					14.7%

9.75% 2020 Notes Return Assumptions

Face Value (MXN\$ MM)	\$5,196
Interest Rate	9.75%
Interest Payments	Semi-Annual
Maturity Date	03/25/20
Acquisition Price	36.9%
Acquisition Price	\$1,919
Liquidation Recovery	14.7%
Restructuring	
Target Debt / EBITDA Ratio	2.5x
2014E EBITDA	\$4,959
Target Total Debt	\$12,397
Total Debt (Face Value)	\$20,615
Implied Haircut (% of Face)	60.1%
Voluntary Tender Haircut (% of Face)	30.0%

Investment Risks/Considerations:

- Distressed sale of competitor's land bank/home inventory: could cause land bank and housing prices to drop
- Extended suspension of payments from INFONAVIT: past 3-4Q13 could impair HMX liquidity (post non-core asset sales)
- Collateral value expropriation in a liquidation: CEO/family is controlling shareholder
- Weak bankruptcy laws/institutions: judgments in pesos; subsidiary guarantees/fraudulent conveyance; intercompany debt (Vitro case)

(1) Assumes 115% of avg. BV of land / m², then discounted for liquidation sale.

1Q13 earnings call: management stated land is significantly more valuable than book value.

(2) Currently being marketed for US\$60 MM, as per 1Q13 earnings call.

(3) SJ dos Campos, Marilia and Campo Grande. Assumes 115% of avg. BV of land / m², then discounted for liquidation sale.

1Q13 earnings call: management stated land is significantly more valuable than book value.

(4) 2011 20F (p. 180).

(5) 20% stake retained in prison services vehicle, as per 1Q13 earnings call.

(6) 70% from federal government (INFONAVIT/FOV/ISSSTE), 30% from state government/commercial banks.

Excludes LT receivables from prison construction that were sold in 2Q13.

(7) 155 rooms. Assumes US\$225,000/room.

(8) Book value, then discounted for liquidation sale, 2011 20F (p. 137).

(9) Book value, then discounted for liquidation sale, 2011 20F (p. 137).

(10) 1Q13 Senior Secured debt (MXN\$10.7 BN), net of MXN\$1.8 BN debt repaid to Inbursa with proceeds of prisons sale.

(11) 4.5% of Total Liquidation Value.



Adam is a second year MBA student focused on investment management. Prior to enrolling at Columbia Business School, he was an investment analyst at Mont Pelerin Capital. Adam holds a BS in Finance from California State University.

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Wabash National Corp. (WNC) - Long

Adam Trivison
ATrivison14@gsb.columbia.edu

Ticker: WNC (NYSE)
Current Price: \$10.47 (7/19/13)
Shares Outstanding: 68.5mm
Price Target: \$14.50
Target Time Horizon: One year
Target Return: 40%

Market Cap: \$717mm
Enterprise Value: \$1,088mm
ROE: 51% (FY2012)
ROIC: 12% (FY2012)
EV/EBITDA: 6.8x (Consensus NTM)
NTM P/E: 11.9x (Consensus NTM)

Business Description

Wabash National Corporation is a leading manufacturer of truck trailers in the US. Headquartered in Lafayette, Indiana, the company has leading positions in the Dry Van and platform trailer markets, and also has top 3 positions in the market for Refrigerated and Dump trailers. The company's customer base is primarily comprised of large trucking fleets (e.g. UPS, Werner Enterprises and Knight Transportation) and large corporations that own trucking fleets (Dillard's and Safeway). WNC also provides parts and support for its products through a dealership network. With the acquisition of Walker Group (specifically its liquid storage business), WNC gained exposure to the chemical, energy, aviation, and food industries.

Investment Thesis

North American trailer cycle is still in early innings with strong secular and structural supports: Significant underinvestment by trucking fleets during the 2008-2010 time period has led to an elevation of the average truck trailer age to record levels. Currently, the system wide trailer age stands at near 8 years old, versus an average long-haul life of 10 years. As trailers age, maintenance costs increase and the economics of a new trailer purchases improve. Moreover, the US trailer population is 10% lower than pre-2008 levels despite the fact that aggregate truck tonnage has recovered to (and exceeded) pre-2008 levels. Purchases thus far in the cycle have only served to replace old trailers, thus trailer purchase volumes will need to outpace current levels (and expectations) to grow the trailer population as tonnage continues to increase. Industry organizations currently expect volumes to remain flat at just under the 250k level; the two most recent cycles have had multiple years above the 250k level. Regulatory pressures, specifically Hours of Service rule changes and CSA 2010, are forcing truckers to increase trailer purchases. The compliance date for the Federal Motor Carrier Safety Administration's final regulations governing Hours of Service for commercial drivers was July 1, 2013. The rule changes reduce a driver's maximum work week by 12 hours to 70 hours from 84. WNC management has stated that customers have indicated that they will increase the use of drop-and-hook activity (i.e. when a driver simply "drops" his trailer at a customer location and "hooks" to another trailer), which will increase trailer demand. Also, the Compliance, Safety, Accountability (CSA) program, instituted in 2010, has created incentives for equipment replacement through a scoring system that is partially based on the fleet condition. The environment for truckers is fairly positive as tonnage has grown consistently since its 2009 trough and diesel fuel prices have stabilized near \$4.00. Increased home building activity has added another vector to the growth of tonnage, particularly in the flatbed segment of the market, in which WNC has a leadership position through its acquisition of Transcraft and Benson in 2007 and 2008, respectively. NTM consensus revenue growth expectations for public trucking companies sit in the mid-single-digit range and NTM EBITDA growth expectations in the mid-teens.

Efforts to diversify the business have transformed the firm, creating a more stable cash flow stream: Historically, WNC's business has been almost entirely reliant on dry van trailer sales. Dry van cycles are extremely volatile and, in the past, the Company regularly incurred large losses during cycle troughs. In 2007, WNC's management instituted their Next Steps initiative, a plan focused on diversifying the business and improving operations. Since then, the Company has expanded outside of their traditional dry van trailer business through organic initiatives and the acquisition of four businesses. These new businesses create value through synergies that can be broken down into several buckets, including supply chain optimization, commercialization and distribution of new and existing products, back office and administrative consolidation. Moreover, these acquisitions and initiatives represent significant growth opportunities as they are levered to secular growth drivers (i.e. fuel efficiency, US energy production). Most notably, the acquisition of Walker Group in May 2012, gave the Company a leadership position in liquid transportation systems and relationships with a Blue-chip customer base. Moreover, Walker's +25% gross margins helped to raise company-wide gross margins. The acquisition should create more than \$10mm of annual synergies over the next year.

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Wabash National Corporation (Continued from previous page)

Profitability will continue to improve as multiple factors drive margin expansion: The Company has also been more selective in terms of the orders they are taking on, raising prices at a mid-single-digit rate. Volumes initially decreased with the price taking, but management has stated that they are beginning to see those customers who initially walked away from the higher prices come back. The price taking has helped to expand their Commercial Truck segment's margins from the low single-digits in late 2011 to the high-single-digits in the most recent quarter. Ultimately, Commercial truck margins should reach the low-teens later in the cycle as volumes and prices continue to increase. Moreover, aluminum (one of WNC's primary raw materials) prices have fallen from \$0.95 per pound in January to \$0.80 in July. The benefit of the decreased cost should be evident in 3Q12 results. The Company has mitigated its exposure to wood and rubber prices through escalators in customer contracts.

Competitive Dynamics:

The truck trailer market is an oligopoly (four-firm concentration ~65%). Players in the industry offer marginally differentiated products, thus only two criteria matter: Price and Relationships. Scale is important as it drives down cost and allows for profit at market prices, thus all small players focus on a market niches. The largest players include Wabash Nation Corporation (20% of industry market share), Great Dane (20% of industry market share), Utility (15% of industry market share), Hyundai Translead (10% of industry market share), and Stoughton (5% of industry market share). Wabash dominates in the dry van, flatbed, and liquid tank categories, while Utility leads in the refrigerated segment.

Industry Outlook:

Despite popular belief, the amount of tonnage transported by trucks is growing and rail transport is not a threat to trucking volumes. If anything, intermodal transport will cannibalize rail volumes over the next 10 years. According to the American Trucking Association, Truckload volumes will grow 3.2% through 2018 and 1.1% annually between 2019 and 2024. Less-than-truckload volume should grow 3.5% annually through 2018 and by 2.4% until 2024. In general, US Trailer fleets are in decent financial shape in terms of leverage and business outlook.

Valuation:

WNC offers a compelling risk/reward payoff at current levels as the market currently underestimates future trailer order volumes and thus WNC's future revenues and profit. WNC can earn an EPS of \$2.50 in 2017 based on mid-single digit revenue growth, gross margin expansion in the commercial trailer segment to prior cycle levels of 11%, and lower interest expense as the Company pays down debt and buys back shares with free cash flow. My price target for the stock is \$14.50 based on an 8.0x P/E multiple on 2017 earnings, discounted to the present at a discount rate of 10.8%. The 8.0x multiple sits relative to historical peak earnings multiples of 6.0x; the higher multiple reflects the high quality of WNC's business relative to prior periods. The peak earnings valuation is confirmed by free cash flow valuations as they produce price targets that bracket the peak earnings price target.

FCF Valuation							
In \$mm	Actual	Company Projections					Terminal
FCF Calculation:	2012	2013	2014	2015	2016	2017	2018
EBITDA	118.4	168.8	205.6	241.5	271.3	295.2	295.2
EBIT	87.7	129.5	167.6	204.6	235.5	260.3	-
NOPAT	54.8	84.2	108.9	133.0	153.1	169.2	169.2
NWI	116.8	130.9	142.7	151.6	154.7	159.4	-
Change in NWI	-	14.2	11.7	9.0	3.1	4.6	-
NFA	132.2	128.9	122.2	115.3	108.2	100.8	-
Change in NFA	-	(3.3)	(6.7)	(6.9)	(7.2)	(7.4)	-
Deferred Taxes	64.2	64.2	64.2	64.2	64.2	64.2	-
Change in Deferred Taxes	-	0.0	0.0	0.0	0.0	0.0	-
FCF	-	73.3	103.8	130.9	157.2	171.9	171.9
FCF Yield	-	10.2%	14.4%	18.1%	21.8%	23.8%	23.8%
Discounted FCF	-	64.5	84.7	96.4	104.5	103.2	-
Tax Rate	37.5%	35.0%	35.0%	35.0%	35.0%	35.0%	-

WACC	10.8%	Competitive Markets		EBITDA Exit Multiple	
PV of yr. 1-10	\$453.2	NOPAT for 2017	169.2	EBITDA Multiple	5.0x
Peak P/E Multiple		TV at 2017	1,573.5	TV at 2017	1,476.0
2017 Earnings	\$2.55	TV PV	944.3	TV PV	885.8
Peak P/E Multiple	8.0x	Firm Value	1,397.5	Firm Value	1,339.0
2016 Equity Price Target	\$20.40	Equity Value	987.5	Equity Value	929.0
Current Equity Value PS	\$14.56	Equity Value Per Share	\$14.74	Equity Value Per Share	\$13.87

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Wes is a second year MBA student focused on investment management. Prior to enrolling at Columbia Business School, he worked in public accounting, beginning at BDO Seidman in assurance. He went on to found his firm (now Aull & Cooper, CPAs PLLC).

He graduated *magna cum laude* from the University of Kentucky with a BS Mathematical Economics. He also earned his Master's of Public Accounting at the University of Texas—Austin.

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Active Network, Inc. (ACTV) - Long on 7/21/13

Wes Aull, CPA
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Recommendation:

Active Network, Inc. (ACTV) has significant upside potential with catalysts in the coming year to realize EBITDA expansion and improved performance. The main catalysts are reduced R&D spend, due to end of a new cloud-based platform implementation, along with improved management after the founders' overdue departure. Increased EBITDA and improved management should further catalyze multiple expansion to valuation more in-line with peers. The downside to Active Network's current base revenue is small due to its leading market position and competitive advantages (e.g. sticky customer groups).

Business Description

Leading provider of SaaS, cloud-based event/organization management in four activity segments: sports, communities, outdoors, and business. Its solutions help over 55K organizations process ~90M transactions for 200K+ activities. ACTV's platform provides operations management, analytics, marketing, registration, and payment tools.

Investment Thesis

Strong Base of Revenue With Leading Market Share in Its Activity Segments, Solidified by Competitive Advantages.

ACTV has established customers with multi-year contracts in each of its segments: Sports—Ironman, Little League Baseball, USA Triathlon; Communities—60 of top 100 North American park dept.'s; Outdoors—National Park Service, California State Parks; Business—CISCO Live!, Oracle OpenWorld, Macworld. 25% of revenue derived from corporate conference platforms, seeking best in brand. 25% of revenue derived from state and federal government agencies with sticky contracts.

Customer captivity created because of ease in using existing marketing/operational functionality for event organizers and their end users year-on-year. Database and tool conversion creates painful switching costs.

ACTV has a leading market share amongst a fragmented industry. Because of ACTV's research and development spend (~20% of sales) with its superior market share, the company has a R&D lead over most competitors. ACTV's R&D spend is nearly 2x of Constant Contact, a significant competitor.

Bar Lowered for ACTV Over FY '12 and 1st Half FY '13: Expectations That Can Be Beat Based on Founding Mgmt.'s Departing Performance

From mid-2012 to mid-2013, ACTV disappointed investors and anchored low expectations because of:

- ♦ Progressively lowered guidance on sales growth from 20-30% to 10-20% YOY.
- ♦ Longer-than expected spend and implement. of new cloud-based ActiveWorks platform, resulting in significantly higher R&D spend over past 2-3 yrs.
- ♦ ACTV founders (chairman and CEO) both resigned in May '13 after leading the organization for over 12 years. The stock price has seen a 60% drop during their tenure after ACTV's IPO in 2011.
- ♦ Poor performance in outdoor (due to cold spring) and one-time marketing svc.'s in Q1 '13 were outside of normalized earnings.

Active Network, Inc.

ACTV: NYSE

Current Price:	8.98
52-Wk High:	14.75
52-Wk Low:	3.83
Mkt Cap:	551M
Insider %:	4.18

Proj. 2013 EBITDA (\$M):	48.78
Proj. 2014 EBITDA (\$M):	68.92

1-yr Price Target:	15.89
2-yr Price Target:	22.45

Active Network, Inc. (Continued from previous page)

ACTV substantially undervalued against its peers despite its higher quality earnings.

While ACTV has a lower gross margin versus its peers, its EBITDA margin of 7% (vs peer avg. of 2.9%) stands notably higher despite ACTV's greater R&D spend. Because of ACTV's scale and lean SGA, it is able to operate with a much lower sales & marketing (as % of sales) versus its peers.

In spite of the higher EBITDA margin, the market gives ACTV's earnings a lower valuation (EV/EBITDA—9.2 versus 20.3 peer avg.; EV/Sales—1.0 versus 2.3 peer avg.). While sales growth has slowed, it does not justify the dramatic valuation difference.

EBITDA expansion and improved management to catalyze stock appreciation.

- ♦ R&D expense will be significantly reduced following implementation of cloud-based Active-Works (end of 2013). **Reversion of R&D as % of sales to forecasted 16-17% in '14 results in a 23-33% increase EBITDA.**
- ♦ New management will improve Active Network, Inc. where prior 'founding' leadership was limited or lacked vision/execution. **Ripe for a turnaround?** Founding chairman and CEO both unexpectedly resigned together, signaling a potential board move after disappointing results in prior years. After their resignation, the stock price did not retreat but celebrated management's departure.

B2B Cloud/SaaS Comparables		Percentage of Sales Metrics				
	Research	Deprec.	Sales &		Gen. &	FY 2012
Name	Develop.	& Amort.	Marketing	CAPEX	Admin.	Sales
ACTIVE NETWORK INC/THE	19.4	14.6	23.0	9.7	16	419
Average of Micro/Small-Cap Comp.'s	13.8	7.5	38.5	8.0	17.6	168
CONSTANT CONTACT INC	15.4	7.5	41.4	8.7	12.3	252
VOCUS INC	7.8	9.3	57.3	3.0	23.8	171
CALLIDUS SOFTWARE INC	17.5	9.0	34.2	13.6	21.0	95
LIVEPERSON INC	19.1	5.0	31.5	7.1	20.1	157
RESPONSYS INC	9.3	6.7	28.0	7.5	10.9	163

B2B Cloud/SaaS Comparables		Operating Metrics							
Name	Gross Margin	Gross Margin		Operating Margin		EBITDA Margin		Free Cash Flow	
		3Yr Avg.	Margin	3Yr Avg.	Margin	3Yr Avg.	Margin	Margin	Total Employees
ACTIVE NETWORK INC/THE	54.2	55.4	(9.5)	(7.2)	7.0	6.9	9.6	3,036.0	137,975
Average of Micro/Small-Cap Comp.'s	65.8	64.7	(5.0)	(0.7)	2.9	6.1	3.6	932.4	180,906
CONSTANT CONTACT INC	70.83	70.99	1.65	2.58	8.07	9.61	6	1,162	217,000
VOCUS INC	80.24	80.55	-12.82	-6.73	-0.88	-0.62	10.68	1,273	134,174
CALLIDUS SOFTWARE INC	46.98	42.72	-25.72	-20.37	-12.6	-12.14	-7.26	613	154,897
LIVEPERSON INC	77.4	75.16	6.57	11.46	8.29	17.24	2.8	748	210,440
RESPONSYS INC	53.69	54.09	5.51	9.57	11.57	16.24	5.88	866	188,018

B2B Cloud/SaaS Comparables		Valuation Metrics			
Name	Market Cap (\$M)	EV/EBITDA		EV/Sales	
		(2012)	(2013E)	(2012)	(2013E)
ACTIVE NETWORK INC/THE	551	9.2	6.7	1.0	0.9
Average of Micro/Small-Cap Comp.'s	451	20.3	14.7	2.3	2.0
CONSTANT CONTACT INC	537	9.5	8.2	1.5	1.4
VOCUS INC	232	16.9	10.6	1.4	1.3
CALLIDUS SOFTWARE INC	255	26.7	20.4	2.8	2.4
LIVEPERSON INC	551	22.8	16.0	2.6	2.2
RESPONSYS INC	682	25.4	18.5	3.0	2.6

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Koch Industries



Dave Robertson

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development intern at Koch Industries, sat down with Steve Feilmeier and Dave Robertson at Koch's headquarters. Steve Feilmeier is Koch's executive vice president and chief financial officer and has been with the company since 1997. Steve earned his bachelor's and master's degrees in accounting from Wichita State University. Dave is president and chief operating officer of Koch and started his career with the company in 1984. Dave earned his bachelor's degree in business administration and marketing from Emporia State University.

Graham and Doddsville (G&D): Koch Industries has one of the best long-term compounding records, with mid-teens compound annual growth for over 50 years. Why do you think Koch has been so successful over the years?

Dave Robertson (DR): Our management philosophy, Market-Based Management®, is what allows us to achieve those types of returns over time. When we acquire a new company, Market-Based Management® unleashes the knowledge and ideas that people in that firm have to innovate and to make their product or process better.

Our incentive system is very

key to unleashing those pent-up ideas and innovations. The system allows all of our employees to share in a portion of the value that they are creating. It doesn't matter what your role is—if you can find ways to help us better serve our customers so that we profit more, we want you to share in some of that profit. You are rewarded like an entrepreneur is rewarded. If you're successful at that, you'll do better and if you fail, then you won't do as well.

Steve Feilmeier (SF): It's also the incentive to speak up when you think somebody else's idea has some limitations—what we call our challenge process. Not only do we incentivize people to speak up, but we also expect the recipient of that information not to be defensive so he or she is open to incorporating different viewpoints. We'd much rather limit the mistake rather than invest in it—then you've really got a mess on your hands.

Having an open and honest culture where we trust each other is key. A lot of companies think they do a good job at incentivizing people, then they get in here and say, "Wow, it's night and day."

G&D: A recent article in the Wall Street Journal talked about how Koch Industries wants to be considered alongside Berkshire Hathaway as a

buyer who can do big deals quickly. What sets you apart from not only Berkshire Hathaway, but also other financial or strategic buyers when it comes to investing in businesses?

SF: It's our ability to tailor our investment to the very specific needs of our counterparty to solve the problem they're trying to solve. A typical hedge fund or private equity fund is limited in the types of things they can do, types of securities they can invest in, or the duration of the investment because they are beholden to their own investors who may prescribe certain mandates or rules.

We try to listen and will adapt to meet our counterparty's needs. The key is to make sure we're being compensated for the risk that we're taking.

G&D: Koch is in a unique position to allocate capital given its diverse set of businesses and significant capital to invest in new opportunities. Can you explain Koch's overall capital allocation philosophy?

SF: First, you have to be in the right businesses where you have the capability to create real value. Then, don't try to optimize and trade in and out of them like a private equity firm has to do.

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Koch Industries

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As Charles [Koch] likes to say, it's hard enough to find good businesses. Why would you want to sell one once you already own it? That is a very important key to how you compound—get good businesses, and then invest in them for the long run.

Another critical dimension is to stay very rigorous in your discipline. All too often, you'll hear public companies acquiring businesses for "strategic reasons." For us, if we're not earning an appropriate rate of return, it's never strategic. Strategic should mean that you're creating real value in society. If you're not earning an appropriate return on your investment, by definition, you're not creating value.

So we stick to our disciplines and make sure that the returns on risks are appropriate each and every time. Then we look at things not through a filter of "who's going to get how much capital this year." We'll fund any and all projects in each of the businesses we have that meet these criteria.

DR: A lot of firms have a budget mentality where they say "we'll give this business this much capital," and we're not doing that. We have shareholders who historically have reinvested 90% of the earnings back in the company. So we're looking at any and all opportunities and then

trying to pick the ones that provide the best return on the risk that we're taking.

It's a little bit of first-come, first-served in that when we see good opportunities that present an attractive return on the risk, then we go after them.

"As Charles [Koch] likes to say, it's hard enough to find good businesses. Why would you want to sell one once you already own it? That is a very important key to how you compound: get good businesses, and then invest in them for the long run."

SF: We've never been in a situation where our internal funding hasn't generated enough capital where we've been constrained. So we're not constrained by the fact that we're private. We're

typically constrained by whether or not the markets are offering an appropriate return or whether or not we've got the capabilities to manage the investment. When we have more ideas or good opportunities than capital, we could always use debt capital but this is rare. Our goal is to finance everything with equity.

DR: Our transaction excellence capability is the discipline that Steve's talking about. We can evaluate each of these opportunities, whether it's a project to add on to an existing facility, an acquisition, or an equity investment. We're putting each of those through the same rigor and analysis to determine the expected risk-adjusted return.

G&D: You have said in the past that Koch is not bounded by any industry—instead, it's bounded by its capabilities. Could you describe Koch's capabilities? And given how fast the world changes, how do you think about developing new capabilities?

SF: Most of our businesses have more in common than might meet the eye. We take some form of commodity and we'll process it through a very, very large plant that requires sophisticated technology and analysis to ensure that we have a competitive advantage and a capability to go to market in scale. Then we'll optimize

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Steve Feilmeier

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Pictured: Leon Cooperman '67 speaking at the 2013 Omaha Dinner.

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around that processing or manufacturing process because there is raw material risk, commodity risk, and counterparty risk.

We also have the capability to be very efficient and effective from a cost perspective and the capability to constantly innovate because the technology changes in these big plants. We must be adaptable to ensure that we don't fall from the first quartile to the second, third, or fourth quartile in cost advantage.

Our other core capabilities besides innovation and operations excellence are Market-Based Management®; trading; transaction excellence; and public sector, which encompasses legal, communication, community relations, and government relations.

So, whether it's crude oil going into refined products, natural gas going into fertilizer, naphtha going into chemicals, trees going into pulp, metals going into our manufacturing businesses—each of these businesses fit the capabilities described above.

Certain businesses simply do not benefit from these capabilities. We're not a big, multi-unit retailer. The capabilities of the largest retailers are being very, very sophisticated at information technology management and logistics. They make their

money by being excellent at getting product to the store and having the right inventory at the right place at the right time. And they have the scale to do so at low cost, too.

“A great business is one where you have a significant competitive advantage with offshoots that allow that business to grow. That advantage could come from a raw material advantage, technology advantage, or a number of other sources.”

We don't have that capability. So there are certain things that we couldn't envision—that doesn't mean that we wouldn't build the capability. We would consider building capabilities whenever it's evident that society is not effectively allocating capital to an industry. That

requires looking forward and trying to understand the trends that might really matter, for example, energy and agriculture products should continue to be in high demand. The world is going to need more of the products from these industries in the future.

G&D: How would you define a great business? What are some examples of great businesses that you admire?

DR: A great business is one where you have a significant competitive advantage with offshoots that allow that business to grow. That advantage could come from a raw material advantage, technology advantage, or a number of other sources.

Take our Pine Bend, MN refinery. It's a great business. We buy advantaged feedstocks, convert those into very high-value end products, and sell them in one of the best marketplaces in the country. That has propelled us into other businesses, like our petroleum coke business in Koch Minerals.

SF: When we say “competitive advantage,” that does not mean an advantage over our customer where we can profit at their expense. It means that we have created something that creates a great advantage over the way things used to be done or over the way our

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Koch Industries

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competition does it today. As a consequence of that, we're using fewer resources to produce goods or services that somebody will value. And that's good for society. Everybody wins. Our customers win because they'll participate in that value creation.

We stress this idea to all of our employees that we're not seeking the type of advantage where you win and someone loses. Not every business thinks of it this way. We think of this as subsidization or cronyism which distorts markets and is not good for society.

DR: It's a great point because win/lose is not sustainable over time. You can't do what Koch has done over 50 years by us winning and our customers losing. Competitive advantage assumes that we can provide goods and services to our customers and be their best alternative. The spread in that equation is profit, and we believe profit really is the measure of how much value we are adding in society.

The only reason a business exists is to make people's lives better. We use resources more efficiently to produce goods and services that people want to buy. If we do that effectively, then we are creating value in society. It's an important backdrop to this discussion.

G&D: Dave, you've said

that Koch often has more than 100 companies on its investment watch list. How does Koch go about generating these investment ideas?

DR: We have business development (BD) personnel in all of our different businesses. So for example, Georgia-Pacific has

“We must be able to do something with a business that the incumbent owners cannot, or else we're not creating any value—they're a better owner than we are otherwise. It doesn't make sense for us to own anything unless we add value to it.”

a BD Team and Flint Hills has a BD team. Within Steve's group at a corporate level, we also have a business development team. Those teams' daily activity is

to find actionable opportunities that would fit our capabilities. We have well over 100 business development personnel across all the companies.

SF: We must be able to do something with a business that the incumbent owners cannot, or else we're not creating any value—they're a better owner than we are otherwise. It doesn't make sense for us to own anything unless we add value to it.

I'll give you two examples out of our fertilizer business. Agrotain, which produces a specialty molecule that, when combined with straight-run commodity fertilizer, makes a much better product for the farmer. With Agrotain applied, the amount of fertilizer that actually reaches the plant goes way up, and that creates value for everybody. J&H Bunn in the UK is good at fertilizer distribution, blending, and warehousing and dealing directly with the customer.

Koch Fertilizer's core competency before acquiring these two businesses was having a global breadth and depth of manufacturing commodity fertilizers, and then getting them to market through our terminal system and marketing capability. The Agrotain and Bunn business lacked the capability that we have to reach global markets.

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These businesses came together synergistically where we could take Agrotain, use J&H Bunn's knowledge of blending, storing, distribution, and customer service, and do that globally.

That's what we brought to both of these businesses and why transactions made sense for all three businesses.

DR: We can't just dream up or manufacture these opportunities amongst business development people. They have to have contacts and relationships in the industry to have the opportunities shown to us. So it requires a lot of different interactions to be able to size up, screen, and think about where the opportunities might be.

G&D: How do you judge whether or not the culture of a potential acquisition will be a good fit for Koch? How do you prevent mistakes?

DR: It's very difficult to do, and it depends on the type of deal. If it's a public company deal, you get very little due diligence. You're not going to get a full picture of the culture, other than the feel you get from the handful of leaders that you meet.

If you're doing an asset-based deal or carve-out, you may get a lot more time to work with the counterparty to find out what their culture is like. But it is very

easy to make a mistake. We know that our culture is unique—we talk about that a lot. So we're not going to find someone whose culture fits exactly.

We try to make sure that their culture isn't so antithetical to ours that we wouldn't be able to, over time, meld it or blend it into our culture. But it's something that we haven't really been great at. We're trying to get better by spending more time and energy assessing it and understanding how different they are, what those differences are, and what we need to do to bring them into our culture.

SF: Culture is many different things. For us, it starts with our ten principles. They are each important because they work together, but there is one in particular that I pay attention to when we're looking at another company, and that is humility.

Being open to challenge is really important. The way people treat each other is also really important. I was with a company yesterday where the CEO knew every single person's name that he passed by. It tells you a lot!

Understanding culture before we acquire a business could be the most important thing we do. And it's been the one of the hardest to do. You have to talk to the employees, customers, and suppliers.

You learn a lot about how the company treats them.

DR: If we thought a company's culture was one that lacked integrity and compliance, we'd back away. We wouldn't do the deal; it's not worth it. And that has happened more than once.

G&D: Given that gasoline consumption in the U.S. is in structural decline from increases in fuel efficiency and the shift toward hybrid and electric vehicles, is the refinery business still a good business?

DR: Yes, depending on the asset. We look at these businesses on a supply stack from who we think is most competitive to who we think is least competitive. As volume shrinks in a market, you move closer to the more competitive players to be able to meet the demand in the marketplace. As long as you're far left in the supply stack, then it can be a very attractive business. If you're far right—if you're a high-cost producer—and the market is shrinking, then it's a bad place to be because you're going to be less profitable, or unprofitable.

We feel good about our position in the refining business, but for those with marginal assets, it's probably not a good place to be.

SF: Having the correct vision for the business is

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key. For example, Flint Hills used to view themselves as strictly a crude-oil-based refined products business. Now they view themselves as a transportation fuels business. These visions are very different.

When you make that shift in how you think about the world, suddenly you will look at ethanol, biodiesel, and hybrid vehicles differently. It's changed the way we invest in those assets. Time will tell how good the vision is, but we'll adapt it again as we need to.

G&D: How do you think about investing in areas boosted by big government subsidies such as ethanol, especially given Charles Koch's free-market views?

DR: We're not in favor of any subsidies or mandates where the government picks winners and losers. We're opposed to all of that, even if it's detrimental to us. The ethanol industry is not subsidized anymore today, but it is mandated. It's great that the subsidy went away, and we'd like to see the mandate go away and let ethanol compete on its own merits.

If you look at the energy content in ethanol, it's not as good as gasoline or diesel fuel. But ethanol is a very cost-effective way to get octane. To meet the miles per gallon requirements, engine manufacturers are making smaller engines with higher compression. Those

engines need higher octane.

A blend of gasoline with ethanol to increase the octane level makes sense to feed those engines. So ethanol has a place in the transportation fuel industry

today, even without subsidies or mandates.

SF: Here are some numbers to put with that. You can buy 87, 89, or 91 octane gasoline. That is regular unleaded, mid-grade, or premium. One way to achieve 89 or 91 is by blending a higher-octane component with regular gasoline.

Ethanol has a high octane value of about 99 or 100. When you blend it with carbon-based motor gasoline it has the equivalent of 120 octane value because of the chemistry. So as the engine manufacturers increase their compression ratios to get higher fuel efficiency, we're going to need more octane in the future.

People often look at us and say, "You guys are hypocrites because you're investing in an industry that has a subsidy or a mandate." That's not why we're invested. We're invested because it will be an important fuel of the future. The industry survives just fine without subsidies or mandates and we advocate for such policies.

G&D: Given your diverse set of businesses, it seems like you'd have a lot of insights into the current state of the U.S. economy and where it's headed. Are there any unique or interesting data points you look at to get a read on the

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"We don't spend a lot of energy trying to predict the future. That goes back to getting into businesses where you have competitive advantages, where you can build out a platform, and where you have optionality in what you do. Then you can adjust as things change in the economy. We're much more effective at doing that than spending time trying to predict the future."

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health of the economy or to help you make investment decisions? For example, Warren Buffett often mentions railcar loadings as a good indicator of the health and direction of the economy.

SF: We look at our business over the next 20 years. We do not worry too much about short-term data points that might help explain our quarterly earnings. We worry about the long run and I will give you two examples.

First, many policies coming out of Washington are going to distort the economy in a big way. For example, the very artificially low interest rates that are being pushed on us by the government and the Federal Reserve are causing artificially higher asset values.

It's interesting to me that they're doing it as a response to a problem that they created in the first place with the exact same low interest rate policy that was there throughout the beginning of this decade. We now know that much of the investment following these low rates was unproductive and unprofitable. The Fed is making the same mistake over again.

We are very wary of assets with sky-high valuations. We are not tempted to invest in them because it's going to end badly. Second, from a policy

perspective, the EPA is promulgating policies through regulation that they can't get done through legislation, in my opinion. It makes it very difficult to meet the immediate demands of consumers when this happens. So, we look at the implications of those policies. Do we want to be an industry like that? If we can't get a permit to evolve our assets in a productive manner, it's a hard industry to be involved with.

"We take some form of commodity and we'll process it through a very, very large plant that requires sophisticated technology and analysis to ensure that we have a competitive advantage."

Those are the macroeconomic things we look at. Short-term

measures like rail loadings might help us manage working capital levels or something of that sort, but long term fundamentals are what matter most.

DR: Many companies embark on those things to try to predict the future, but we think the future is unknown and unknowable. So we don't spend a lot of energy trying to predict the future.

That goes back to getting into businesses where you have competitive advantages, where you can build out a platform, and where you have optionality in what you do. Then you can adjust as things change in the economy. We're much more effective at doing that than spending time trying to predict the future.

G&D: Going back to your comment on the Fed. Steve, how do you see the unprecedented Fed intervention ending, and what do you do as CFO of Koch Industries to prepare Koch for that eventuality?

SF: There are lots of ways to manage risk. One way to manage risk is simply not to take the risk. Here's an example. If you invest in an asset, you need to look at what the source of return is from that asset. If you're investing in a 10-year treasury, your source of return is almost 100% attributable to the duration

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of that security and very little attributable to credit risk. If you believe there's much more downside than upside because of all the manipulation, don't try to time it—just don't do it because you can't time it.

We would rather invest where the source of the return comes from the capability or the innovation of a project or business. If that means taking on more illiquidity or duration risk, those risks are much more palatable in this environment than taking on interest rate risk. That's how we look at it. That's how we're trying to do it anyway (laughs).

What we're doing with the American Greetings investment ties into this idea. Although it is an interest-rate-sensitive security, the valuation of the investment will not move around very much because the primary source of return comes from the capability of the equity investors that we're supporting and the capabilities within their industry.

G&D: What is the thesis behind the American Greetings investment?

SF: Even though the industry demand trends are flat, they still create tremendous value for their customers. They have very strong relationships with their retail partners and long-term contracts with

them. It is the most profitable single item that a grocery store sells on a per-square-foot-of-retail-space-required basis.

That's why the greeting card section still has massive amounts of square foot allocated to it, and it is prominently featured so you're likely to walk by it before you leave the grocery store.

A reporter commented to me on the day the deal was announced, "I still don't get it. The internet is taking over this whole space." And I said, "Not really, I don't think you're right. The facts don't bear that out. Let me ask you a question. Are you married?" And the reporter said, "Yeah, but what does that have to do with this interview?" I said, "Everything. Try sending your wife a text on her next birthday. Tell me how that works out for you!" And he said, "I kind of get it now!" (laughs)

When we see the value that's being created for their customers and the capability of the company to continue to create value through innovation, we're very comfortable supporting that investment and earning a return that's not 100% tied to the discount rate, but more tied to the capabilities that they have.

G&D: Can you share some of the biggest investing mistakes Koch has made and what you've learned

from them?

SF: Well, this is going to use the rest of the time! (Laughs.)

I think our single biggest mistake was the polyester business that we acquired from Hoechst, a German company. We probably got back about 80% or 90% of the capital we put in the business. That's definitely a mistake when you don't get your capital back. In this case, we did not understand how significantly the Chinese economy had invested in polyester.

"The number one thing that appeals to the companies we talk to is our focus on the next twenty years, not on the next ninety days."

When the treaties between the United States and the other WTO countries were put in place, a lot of polyester started coming over to the United States. We had no idea how sophisticated these Chinese producers were and how much volume would actually land on our shores. It displaced a lot of capacity that existed here that we

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Pictured: Professor Tano Santos at the 2013 Omaha Dinner.

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had just purchased. We also didn't understand that the rate of learning within the industry had substantially accelerated. For example, a plant that once cost \$500 million to build fell to \$250 million within three years.

A couple key lessons came out of that acquisition: one was that we must have global knowledge systems, not just regional knowledge systems, and have a much greater awareness of how globally fungible our products are. Second, we must talk to customers, suppliers, and vendors before we do an acquisition so we can be attuned to the speed of the technological change within the industry.

DR: Another thing we've learned the hard way is how much debt we are willing to put on a deal. Too much leverage not only stresses a deal, but the associated debt covenants also limit your ability to invest for the long term. During downturns, you start to bump up against those covenants, and then you become very restricted in making good long-term decisions.

So you start making short-term decisions just to make it through the next quarter to meet those debt covenant metrics. We've learned that it's just inconsistent with our long-term philosophy, so we're going to be relatively conservative in how much debt we're willing to put on

a deal. We don't want to be handcuffed in our ability to invest and do the right things for the long-term benefit of the business.

G&D: Corporate profits in the United States as a percentage of GDP are currently around 11%, which is at all-time high and well above the average over the last 20 years of about 7%. Do you guys expect a reversion to the mean, and how do you think about investing in an environment when asset values probably reflect these record-high profits?

SF: In this part of the business cycle, labor normally starts getting a bigger piece of the overall GDP via expansion of employment and wage rates.

There are a couple things happening that are different than in previous cycles, which have caused profits to be higher. First, U.S. companies aren't just competing with U.S. companies anymore; they're competing with global companies. Even though U.S. workers are much more productive, there is still a cap on our ability to pay more to stay competitive globally and to expand employment.

A second reason is the uncertainty caused by public policy coming out of Washington. If you don't know what the Affordable Care Act is going to do to your healthcare costs, for

example, then it's hard to make the investments in new capacity that would get supply and demand back in balance. This puts upward pressure on prices in a supply constrained industry.

So ironically, the very policies that the federal government is promoting are causing the opposite of their intended effect on employment and wages. And, when supply and demand stay imbalanced, you're going to have higher profits by definition.

So that's why we're where we are as a country and corporate America. Will that change? Well, we hope so. We want less non-value-added bureaucratic regulation. We want the ability to take care of our customers.

This doesn't mean that all regulations are bad. But when you layer on regulation after regulation after regulation, it becomes extremely counterproductive. We have a lot of that right now.

Higher profits will reverse over time as new economies emerge and compete. Exchange rates will also eventually adjust and our prosperity will be challenged without change.

DR: Uncertainty is one of the biggest factors as to why you see these profit levels. For example, if you want to get a permit to build a

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greenfield facility or to expand capacity, you may be in the permitting process for five, six, or seven years.

To start committing capital to something which may not start for seven or eight years from now is a very, very high-risk bet because you don't know what the environment's going to be. You don't know what the supply and demand balance is going to be. You don't even know whether the product is going to be needed that far in the future.

So that dampens additional investment, which keeps capacity low and margins high. If only the U.S. does that, then all the manufacturing and production will eventually go to other countries that are more advantaged, and we'll be an importer.

SF: Look what happened to Wal-Mart just recently in Washington, D.C. where the city council tried to impose upon them a \$12 minimum wage. So what happened? When that kind of regulation came in, Wal-Mart said, "We're not building."

Is that good for the consumers? The rest of the retailers have less competition, and prices will be higher. So profits are higher and labor is constrained. Those kinds of regulations are causing these high profits.

DR: It hurts the poor. The consumers are the ones who suffer the most because the goods they need just for necessities are more expensive.

SF: Any form of a price control causes this imbalance. In Venezuela, the former Chavez administration stipulated that, "The price of milk cannot exceed X." Guess what happens? There's no incentive for people to create milk. And there's no milk. It leads to scarcity. When you have scarcity, you have very high profits for the people that are left in the business, and that's happening on a much larger, more discrete scale here.

G&D: Is there anything else you'd like to add about Koch Industries' strategy in acquiring businesses?

SF: The number one thing that appeals to the companies we talk to is our focus on the next twenty years, not on the next ninety days. That unleashes companies to make different decisions that they don't get to make when they're a public company under the scrutiny of an investor base that's trading, not investing, in their shares.

We're talking to a company right now that is in the trough. Their industry is being significantly constrained because there was overbuilding and demand is weak. As a result of this temporary condition,

this company is being forced to let go very highly skilled, great-culture-fit engineers within their company—people that in the long run would create much more value staying employed with the company than not. Yet they're letting them go because their investors are putting so much pressure on the management team that they have to reduce their costs to meet short term objectives.

So they're making poor decisions for the long run. Look at how disruptive that is. It's disruptive to the company because it is getting rid of capability that it needs. It's disruptive to the family of that employee that is being let go. We don't need to think that way here. We look at an investment in that kind of an employee as an investment in the long run. Let's find something that he or she can be working on until the market comes back. That is the number one thing that I talk to people about, and it's pretty compelling to them.

G&D: Dave and Steve, thank you for your time.

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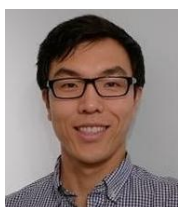
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