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“Parsimony is Extremely Profitable” — Mason Hawkins

Mason Hawkins founded Southeastern Asset Management in 1975, and today the firm manages over \$30 billion in value investments. The firm built on its tremendous track record in 2009, with its Longleaf Partners Fund posting its best absolute annual return of nearly 54%.

G&D: Could you tell us a little bit about how you developed an interest in investing?

MH: When I was in high school, my dad gave me the first edition of the Intelligent Investor and the second edi-

tion of Security Analysis. Like most teenagers, investing was not my primary focus, but I did read the Intelligent Investor and much of Ben Graham's three main tenets resonated with me. After high school, I was lucky enough to have Security Analysis as the core textbook in an undergraduate course, in an MBA program later, as well as in the three CFA courses. I'm grateful that the proper foundation was established in my early years. The most significant catalyst for me occurred in the bear market of 1970. During my senior year at University of Florida, I went through the entire S&P stock



Mason Hawkins, Portfolio Manager - Southeastern Asset Management

guide and recorded companies selling below net-net, identified those selling below their net-cash and

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“The Belt & Suspenders Guys” — Tweedy, Browne

Tweedy Browne has a legendary reputation in value investing, uncovering undervalued securities since 1920. The firm provided brokerage services to Ben Graham, Walter Schloss, and Warren Buffett before transitioning to a direct investment management role in the late 1960's. On February 8th, we interviewed the four managing partners of the firm, Thomas Shrager, Bob Wyckoff, William Browne, and John Spears.

G&D: Let's start with some background for each of you, how you came to Tweedy, and how you got interested in value investing.

Thomas Shrager: I went to Columbia undergrad at the school of International Affairs. I worked myself through college – I went to school full-time and worked full-time. After Columbia, I joined Arthur B. Little, where I did valuation for about two years. Subsequent to that, I started working at Bear Stearns where I got the bug in in-

vestment banking. I joined in 1987 on Black Monday – my first day! I received encouraging remarks like the world is coming to an end. What I learned as an associate at Bear Stearns was how investment bankers value companies. I think that experience was helpful for me getting a position at Tweedy, because after three years there, I realized I didn't want to be a banker. I wrote a letter to Will – a cold letter; he invited me over and I was offered a job.

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Welcome to *Graham & Doddsville*

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

This issue features an interview with Mason Hawkins, founder and portfolio manager at Southeastern Asset Management. Mr. Hawkins shares the investment philosophy, valuation discipline, and independent perspec-

tive that he has developed for over 35 years at Southeastern, giving a unique insight into the value foundation of the firm's success.

The issue also features a rare interview with all four of the Managing Partners at Tweedy, Browne Company: William Browne, Bob Wyckoff, Thomas Shrager, and John Spears. The partners discuss the evolution of Tweedy's investment process from its Graham & Dodd roots to a more holistic business assessment.

We also aim to offer spe-

cific investment ideas that are relevant today. The current issue includes two student investment ideas, including G&D's first distressed debt investment recommendation. Rich Tosi presents his thesis for Nextar Broadcasting bonds and Matt Cohen recommends the purchase of SOHU.com common stock.

Please feel free to contact us if you have comments or ideas about the newsletter as we continue to refine this publication for future editions. Enjoy!

2009 Omaha Trek—Wisdom from the Oracle



Columbia's Omaha group with Mr. Buffett.

"Feel free to ask anything you like, except what we're buying or selling," was the only ground rule Warren Buffett offered before opening the floor to questions from more than 125 business students gathered on

the top floor of Kiewit Plaza in Omaha on October 9, 2009. Everyone was eager to ask questions of the world's most successful investor after a remarkable period for the capital markets.

The day started off with a tour of Berkshire Hathaway's Nebraska Furniture Mart – the largest furniture store in the United States. After the tour, Mr. Buffett invited all of the students back to his office for two hours of questions and answers to be followed by lunch at one of his favorite local restaurants, Piccolo Pete's.

The Economy

With the recent market turmoil still on most people's minds, it was not surprising that one of the first questioners asked Mr. Buffett whether the recession had impacted the way in

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Mason Hawkins

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bought a few, literally buying dollars for fifty cents. That experience hooked me for my career. There were no computer screens at that point.

G&D: That sounds similar to what John Templeton talked about doing in some emerging markets. Were there any other influences on your investing style, in addition to Ben Graham?

MH: Chronologically, my Dad, Ben Graham, John Templeton, Warren Buffett and my partner, Staley Cates shaped my investment thinking.

G&D: When Buffett moved back to Omaha he said that escaping the hectic New York atmosphere allowed him to think more clearly. Do you think that has been a factor at Southeastern in Memphis?

MH: Yes. We depend almost exclusively on our appraisals and our assessment of our management partners and their companies' competitive positions. We clearly remind our associates that you're right because of your facts and reasoning, not because someone agrees or disagrees with you. And you do eliminate a lot of interference by being in Memphis as opposed to Manhattan.

G&D: That's a very independent approach, sticking to your facts and reasoning

and not being swayed by outside factors. One thing that sways a lot of managers is a desire to minimize career risk by hugging a benchmark. Your firm takes a completely different view on that. Could you talk about the benchmark you use and your attempts to track that benchmark?

"We clearly remind our associates that you're right because of your facts and reasoning, not because someone agrees or disagrees with you."

MH: We try to hug good investments not benchmarks. We've established inflation plus 10% as our absolute investment goal and that's been the case for our history. There's not a lot of solace in being down 20% when the market is down 30%. Investing should lend itself to risk avoidance.

G&D: A lot of people talk about value investing, but what does value investing mean to you and how does that differentiate your firm?

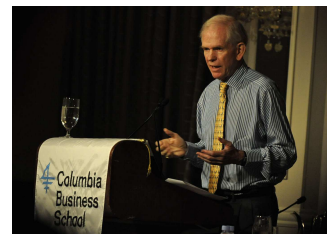
MH: Graham provided the definition in the Intelligent Investor. An investment is one that promises safety of principal and an adequate return. By deduction, those that don't are speculators. We believe that buying securities at large discounts to conservative appraisals provides the best route to above average compounding. We're focused on nailing down our evaluations so we can use them to make significant long-term investment commitments when sellers are under duress or traders are consumed with ephemeral short-term issues.

G&D: Where do you look to find these ideas?

MH: Value Line, new low lists around the globe, industry rags, computer screens, investee managements and boards, competitors of our investees, respected investors, US and international "best company" wish lists, and 35 years of appraisals help produce our investment ideas.

G&D: Obviously management is very important to you. How do you approach evaluating a management team?

MH: We strive to know as



Jeremy Grantham delivering the keynote address at the 2009 Graham & Dodd Breakfast.

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much as we can about our prospective CEO-partners. We want to understand their business acumen and their personal histories. As others have said, we believe it's impossible to do a good deal with a bad person.

We endeavor to read everything that's available on management, but meeting them in person is critical. It's always important to hear their challenges and how they're addressing them. Business is tough, and the more realistic the manager is the more likely he'll be successful. We talk to their competitors, ex-employees, board members we've known, and community associates – to name a few of our checks.

G&D: When you're setting an appraisal for a business, what process do you follow?

MH: We spend a lot of time on free cash flow generation after required capex and working capital charges and then assess the value of that free cash generation. If the company is not reasonably predictable and competitively entrenched, we are very careful about using DCFs. We also look at the net asset or liquidation values.

We then compare DCF and net asset values to our comparable sales database. We've recorded most M&A, take-private, or liquidation transactions. We compare

those comparable sale yardsticks against our assessment of the net-asset or free-cash values and we use the lower of the two. It's important to make sure that when you record a transaction, you note the interest rate environment under which it occurred. If you recorded a transaction in

that don't produce any earnings. Burlington Northern in the early 1980's became very cheap in relation to its land, oil, natural gas, gold, timber, and pipeline assets when the company operated at a loss.

G&D: What do you think about Buffett's decision on BNI?

MH: I think Mr. Buffett's a very, very able investor, if not the most talented long-term investor, and I think he values highly BNI's competitive position. I believe they have over 95% of the rail traffic in Montana, for example. Burlington Northern is a call on much higher energy prices. It is understandable. It has significant operating leverage coming out of our economic funk. It will deliver significantly better-than-treasury returns in my opinion, but we believe it was a fully-priced acquisition.

G&D: It seems that your funds are more concentrated than the average mutual fund. How do you think about concentration on an individual name and sector basis?

MH: Mathematically, you can diversify about 80% of your individual company risk with a dozen names in different industries. You can eliminate some 90% with 18 to 20 companies. Beyond that, there's very little di-

“We’ve made a lot of money in net-asset investing. There are companies that have significant asset values that don’t produce any earnings.”

1982 when the long treasury was 15%, you're going to see a much lower set of metrics than if the comp occurred in 2007 when the long treasury was under 4%.

We've made a lot of money in net-asset investing. There are companies that have significant asset values

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versification benefit. Ideally, you want to have your money in your most attractive quantitative and qualitative qualifiers to give you the best opportunity for returns. It's been our long-standing belief that it does not make sense to own your 30th best qualifier when you can concentrate in your top 15. You reduce your return potential as you add names. It's mindless to do so after you've achieved adequate diversification.

G&D: What is the dynamic on your team when evaluating new positions?

MH: There are 9 and a half of us - I'm a half. Each analyst is opportunistically searching for a terrific investment. When somebody finds an idea, they write it up. They assess business, people, and price and then everybody gets a copy of the report which attempts to lay out the relevant facts and the investment case. Seniority plays no role. We are all very mindful that the investment succeeds or fails based on the facts. Usually, if an important question can't be addressed adequately, the idea fails. Furthermore, we assign a devil's advocate to each investment idea.

G&D: What is a normal gestation period on a new idea?

MH: It can be 5 minutes, or it can be 5 months. If

we're buying a company that's selling below the cash on its balance sheet, it can be done quickly. If we're buying a normal operating business that has competitive challenges, you want to be able to assess it conservatively and explore all the potential threats. Usually, our best ideas are vetted quickly.

"You reduce your return potential as you add names. It's mindless to do so after you've achieved adequate diversification."

G&D: Not only are your funds more concentrated, they also have a much lower turnover rate. How often do you add a new idea to the portfolio?

MH: We've averaged less than 20% turnover over the

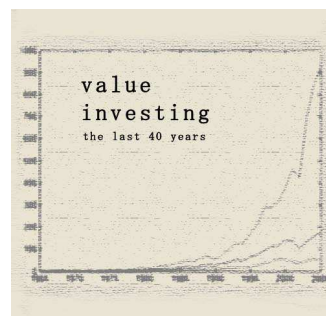
long run, which means our average holding period is over 5 years. We sell businesses when they approach intrinsic value and there's no longer a margin of safety. We also might sell a company if we can improve our position by 100%.

John Templeton called it the 100% rule. He wanted a 100% improvement in his position to make a change. If a stock was at 80% of appraisal, he wanted to buy one that was about 40% of value to make the switch. That's because taxable investors have to pay taxes, and you have to be right on the appraisal of the company you're selling and the company you're buying. Also, in Templeton's day, there were substantial transaction commission costs, and even today there are still material market impact costs from buying and selling.

Another cause for change in our portfolio is deterioration in the competitive position of the company, which will usually occur quite slowly. We've had some that have been challenged more quickly than you might expect. Another reason for turnover is that management might turn out to be less than trustworthy or capable and changing them out would be too difficult or expensive.

G&D: As you're discussing appraisals and margin of safety, you've mentioned

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Columbia Business School is a leading resource for investment management professionals and the only Ivy League business school in New York City. The School, where value investing originated, is consistently ranked among the top programs for finance in the world.

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Mason Hawkins



Jean-Marie Eveillard and Tom Russo at the 2009 Graham & Dodd Breakfast.

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investing in net-nets. Do you find margin of safety in the quality of the business or just a cheap price?

MH: Valuable growth is the great eraser if you misprice your purchase. Buying good businesses is critical to profitable long-term equity investing. There are three components of an equity investment's return. One is the discount to intrinsic value. The second is the growth in intrinsic value. And the third is the rapidity at which the gap between price and value closes.

Mathematically, we know that if you buy a business at half of value, and value accretes at 12% per annum, and the price reflects intrinsic value in the 5th year, you get 29% per annum compounding. And you sleep very well at night knowing that the value is greater than the price. Clearly, Ben Graham wrote a lot about the margin of safety and protecting your principal, but there was less emphasis on the benefits to returns from buying good businesses at cheap prices.

If you bought this example at fair value and it stays at fair value, you just get the value accretion, 12%. However, if you bought it at half of intrinsic value, you pick up another 17 points per year of compounding. So, parsimony is extremely profitable. The less elaborated aspect of value investing is the huge plus you get

from stealing a good company.

G&D: What areas of the market do you think are particularly interesting?

MH: If we had to cite one, it would be US natural gas.

“Valuable growth is the great eraser if you misprice your purchase. Buying good businesses is critical to profitable long-term equity investing.”

Natural gas is currently cheaper than other hydrocarbons, oil and coal. It is by far the cleanest. It is politically secure. Risk adjusted, it is most attractive. Lastly, using more of it benefits security, our balance of trade and therefore the US dollar. We believe companies that have growing reserves and production of natural gas in this country should fare very well.

Chesapeake Energy and Pioneer Natural Resources are our two major commitments.

G&D: The market's opinion on the natural gas situation in the US has changed significantly with shale deposits and increasing reserves. You used to hear about natural gas dependent industries being at a permanent competitive disadvantage in the U.S., and now there is a lot of talk about oversupply and lower prices moving forward. Are you concerned about this increase?

MH: We believe demand will rise to that supply, as you substitute natural gas for oil and coal and as the industrial use of natural gas recovers. Furthermore, we believe natural gas directly, or indirectly via hybrid and electric power trains, will be used in transportation, both in autos and in trucking.

G&D: Does your investment thesis anticipate any government spurred action or is independent of a public policy response?

MH: Our appraisals do not build in any government mandates, but we believe they're probable.

G&D: Another sector that is garnering a lot of discussion is health care, which I notice has a zero percent weighting in the partner's fund. Is that related to uncertainty regarding how

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things will shake out or simply better opportunities elsewhere?

MH: I was an ethical drug analyst in my first job, and we have partners here that have explored all aspects of the health delivery systems. We have exposure through Phillips' medical equipment business, which is its most valuable division. The reason health care is not a large weighting is because we haven't found compelling values. Drug companies have depleting revenue sources that you have to replenish and there are price pressures from the purchasers of those products, be they individuals or third parties. We'd like to participate in the wonderful demographic healthcare demand profile of this country and that of the world, but we haven't found a company that qualifies business, people, and price.

G&D: Another area is international opportunities. Obviously, you have a lot of international exposure. Do you think about international investing any differently than domestic investing? Do you have a greater deal of optimism for emerging market investments?

MH: Much of the world outside the United States will grow more quickly, and as real incomes rise, you'll get pretty rapid demand growth in emerging markets. However, investment challenges are numerous. High security prices is the

paramount one. Proper corporate governance and stewardship are others. If there's not corporate democracy, and there's not a focus on shareholder interests, it's probably not going to make it into our portfolios. Some countries, though, protect shareholder

racy and accountability. Nationalization risk is not one we'll knowingly take. Said another way, if you wouldn't feel comfortable leaving your money in a bank in a country, you certainly wouldn't want to own the equity of a business in that country.

G&D: So does that put more of a focus on developed markets as opposed to emerging, more volatile markets?

MH: It does. There's another challenge if the currency is an issue. Many years ago, we found a terrific Coca-Cola bottler in Brazil, but the currency was going to cost us 20+% a year, and that prevented us from making the investment.

G&D: You mentioned that labor issues could be a factor on an investment. You've been an investor in the auto industry in the past — what are your thoughts on the sector now?

MH: We are not interested in labor-intensive, capital-intensive, low-return businesses. Our foray into GM was predicated on a sum of the parts appraisal, where there was significant value at the time in their investments in DTV, GMAC and some of the separable assets that they had. It was not based on the automobile industry's economics.

G&D: In that case, you transitioned into converti-

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“We assume an owner-operator mentality as you know. If you work for Southeastern, you have to do all of your equity investing via the Longleaf Partners Funds.”

ers better than the US. For example, in South Africa when we owned DeBeers, we were able to block a sub-optimal takeover bid with a 20% vote and demand appraisal rights which got us intrinsic value. Thus, we spend time looking at governance rules. We want to be treated fairly, and we believe in corporate democ-

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bles. How do you think about investments in other areas of the capital structure?

MH: Yes, we bought convertible senior debt, but the rules for the debt-holder changed in that particular incident. The rule of law was threatened. Indentures and contracts were jeopardized.

G&D: In some ways the auto industry is representative of the broader U.S. manufacturing industry. Do you think the U.S. can be competitive in those industries longer-term?

MH: There are major headwinds, but it is company specific and hard to generalize. But if a business is highly capital and labor intensive, they'll have trouble.

G&D: You've had a long career in investment management and seen the industry change over your career. What's your outlook on the industry going forward? Do you have any thoughts on how the industry should be changing?

MH: We've never thought of our business as an industry. We think more about our existence as investors. We believe that if we deliver good returns with low risk for our partners, then the rest takes care of itself. We assume an owner-operator mentality as you

know.

If you work for Southeastern, you have to do all of your equity investing via the Longleaf Partners Funds. I believe that benefits us in two ways. It removes conflicts of interest, and it focuses everyone's attention on the companies in the portfolio. When you see

"If people are very fearful, you normally can buy in great quantity. And if people are very greedy, you normally can sell in great quantity."

your boss in the mirror in the morning, you can assess your career risk solely on your investment results and not on politics or relative returns. Our owner-operator culture helps us focus on the investments and doing the right thing for our partners.

Another thing that advantages the Longleaf Partners Funds is our long-term time horizon. It's very difficult to find a long-term investor today, and we believe that's beneficial to us. The average holding period on the New York Stock Exchange has dropped to 6-months from 5 years, 30 years ago. So, there's a lot of "moving about" in the industry and that average NYSE holding period dropping is an indication of just how short-term everybody has become in their thinking.

More participants are traders, believing that investing for long-term returns is not a worthwhile pursuit. We know it is. Growth in corporate intrinsic value is often obfuscated by stock price movement, which does not appropriately track the accretion in business value. That's good for all of us who are appraisers of businesses, because it means you get more mispricing and better opportunity to get a franchise at a cheap price.

G&D: You're also willing to close the funds when they get too big. Has size been a major detractor as the firm's gotten bigger?

MH: We had our best absolute and relative year in 2009 when our AUM was significant. We've closed our funds when the opportunity set was small and we believed that the investment

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prospects were not attractive. We don't need to hold excessive amounts of cash and people don't need to pay us to buy treasury bills. So if our cash is building rapidly and our prospect of finding good investments is diminished, then we close the funds and wait patiently.

Secondly, the question should be how big is the qualifying investment universe vis-a-vis the pool of capital. In a vacuum, the larger the pool of capital, the more difficult it is to manage. But, an intelligent investor knows there is great liquidity at each end of the psychological barbell. If people are very fearful, you normally can buy in great quantity.

And if people are very greedy, you normally can sell in great quantity. It's in between the two extremes that liquidity is a challenge. I might add that in the fourth quarter of 2008 to the first quarter of 2009, we probably could have put 10x the amount of assets that we had to work effectively. In today's environment, it's a challenge getting smaller sums invested appropriately.

G&D: That's interesting, because in some ways you seem very optimistic, with your portfolio price to value below your long-term average.

MH: If you read our annual report, you'll see that our

average price to values have been around 68% over our funds' histories and currently they are still meaningfully below that average, and we've delivered good returns from the average. So if the individual companies

"You want to pursue it for the intellectual challenge, for the reward of being correct about your investment decisions, and for the opportunity to help others. Those would be the three primary reasons...to pursue a career in investing."

are selling at prices of 62-63% of conservative appraisals, they're still attractively offered. If you had landed on this planet today and you were reviewing our long-term price to value relationships, you would say that they're adequately dis-

counted. Only if you compare them to the extreme discounts that stocks got to in the fourth quarter of 2008 and the first quarter of 2009 would they seem less compelling.

G&D: One final question, what advice do you have for business school students interested in a career in investing?

MH: You want to pursue it for the intellectual challenge, for the reward of being correct about your investment decisions, and for the opportunity to help others. Those would be the three primary reasons I would counsel you to pursue a career in investing. If you start out just doing it because you want to make a lot of money, I doubt that you'll be as successful.

G&D: Not many managers talk about investing in terms of helping others, but that's an interesting perspective to have.

MH: Most of our partners at Southeastern come in daily for altruistic reasons, not only to help retirees and college students, but to produce the free cash flow coupon at Southeastern that can be reinvested to help those who are less fortunate.

G&D: That's a great note to end on. Thank you Mr. Hawkins.



Professor Bruce Greenwald at the 2009 G&D Breakfast

Bruce C. N. Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Described by the New York Times as "a guru to Wall Street's gurus," Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.

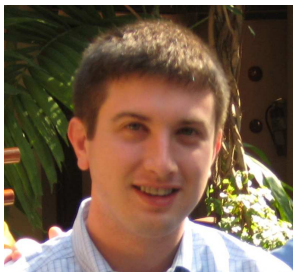
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Nexstar Broadcasting, Inc. — Buy 12% Senior Sub PIK Notes

Rich Tosi
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February 2010



Nexstar Broadcasting, Inc.
(NXST) 12% PIK Notes
Price: \$63.00
(Feb. 17, 2010 - Pricing
according to Barclays)

Rich is currently a member of the Applied Value Investing program at Columbia Business School. Over the summer, Rich was an analyst at the event-driven credit fund Schultze Asset Management in New York. At Schultze, he was a generalist covering a variety of bankrupt and distressed companies. Prior to Columbia, he spent two years at an equity long/short fund analyzing special situations and three years at a law firm. Rich holds a BA from Columbia University.

Company Overview:

Nexstar Broadcasting, Inc. ("Nexstar", "NXST" or "the Company") owns and operates 34 local broadcast television stations. The Company operates, programs or provides other services to an additional 29 stations, mainly those of Mission Broadcasting, Inc. ("Mission"). The 63 stations are in 34 markets, 22 of which are Nexstar duopolies, and have a reach of 13mm households (11.5% of the US). NBC, CBS, ABC, and Fox affiliated stations represented approximately 33.0%, 28.1%, 14.7% and 23.7% of revenue respectively in 2008. In 75% of Nexstar's markets they have a #1 or 2 revenue market share.

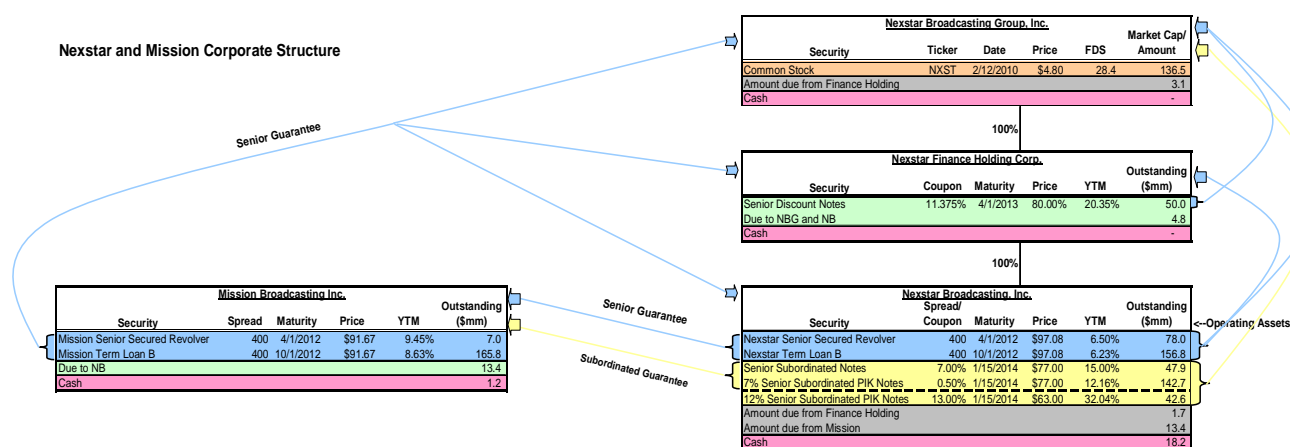
Recommendation:

I recommend buying the Nexstar 12% Senior Subordinated PIK Notes ("12% PIKs") at 63. They are trading 18 points cheap of the 7% Senior Subordinated Notes ("7% Cash-pays") and 14 points cheap of the 7% Senior Subordinated PIK Notes ("7% PIKs") even though they all are pari passu in the Nexstar capital structure. The reason for the disparity seems to be the fact that the 12% PIKs are not guaranteed by Mission even though the 7% PIKs and 7% Cash-pays are. This guarantee is on a subordinated basis to the Mission guarantee of the Nexstar Credit Facility. However, this sub guarantee is worthless. Using an average of the last two years' EBITDA, Mission is trading at 10.3x through its \$172.9mm of bank debt leaving no recovery for the 7% PIKs and 7% Cash-pays. The YTW is 32% for the 12% PIKs versus 12.2% for the 7% PIKs and 13.4% for the 7% Cash-pays. If the 12% PIKs were trading at par, they would have a YTW of 14.8% which is still 140 bps wide of the 7% Cash-pays. This disparity more than compensates for the lack of the guarantee, which really only has option value.

To make a bet solely on the value of this guarantee, one could buy the 12% PIKs and short out the 7% PIKs, which do not pay a cash coupon until July 15, 2011 (they pay PIK interest at 0.5% through Jan. 15, 2011). One could also buy the 12% PIKs and short the 11.375% Senior Discount Notes ("HoldCo Notes"). These HoldCo Notes are structurally subordinated to the 12% PIKs yet they are trading at 85 and a YTW of 17.9%. Since the 12% PIKs are the most expensive piece of debt in the capital structure (accruing at 13% currently which steps up eventually to 15% after Jan. 15, 2012), I believe NXST will try to repurchase them before any other note especially now that the 12% PIKs went cash-pay on Jan. 15, 2010. With NXST's recently amended leverage ratios that increase to 10.25x total leverage and 7.5x senior leverage for the June 2010 quarter, there is also very little chance of default.

Investment Overview/Catalysts:

Nexstar operates in many markets as a duopoly. With these arrangements, NXST is able to spread the high fixed operating, programming and selling costs over a large revenue base. Margins in



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duopoly markets are about 800 bps higher than in other markets. NXST is also such a good operator that there are many owners that contract with NXST for a fee or revenue split for their services. Mission Broadcasting is one such company and consolidated for accounting purposes despite 0% ownership.

Television advertising is expected to grow anywhere from 5-10% in 2010 depending on who is making the forecast. This will be led by political advertising which is expected to be up 31.3% from 2008. One of the main drivers of this increase and may be the impact from the *Citizens United* Supreme Court decision. NXST is currently conservatively forecasting that political revenue will be about the same as it was in 2008 (\$33mm). However, with the current acrimonious political atmosphere and expected Democratic vulnerabilities in typical states, I expect this target to be easily exceeded. There will

Nexstar Broadcasting, Inc. (Continued from previous page)

be 13 gubernatorial races, 15 Senate races and 58 congressional races in markets NXST serves which is the most the Company has ever had. Also helping in 2010 is the Olympics and NBC changing their late night line-up.

A significant catalyst going forward is revenue from retransmission agreements with cable, telco and satellite pay television to broadcast NXST's local stations. Retrans revenue is expected to exceed \$32mm in 2009 and YTD has been up 45% over YTD 2008. This is almost all incremental revenue which flows through at a near 100% cash margin. Since NXST has lead the charge on negotiating

Nexstar Broadcasting Group Inc.

Today 2/21/2010 Updated 2/23/2010 Balance sheet date 9/30/2009

Capital structure overview

		LIBOR Floor		1.000%		Face Value		Create Through		LIBOR margin	Fixed Coupon	Current Rate	Interest	Current Yield	YTW
Summary capitalization	Committed	Maturity	Drawn	Market Price	Market Value	x LTM EBITDA	x 2010E EBITDA	x LTM EBITDA	x 2010E EBITDA						
Nexstar Senior Secured Revolver	82.5	4/1/2012	78.0	97.08%	75.7	Net	Net	Net	Net	400		5.00%	3.9	5.2%	6.50%
Nexstar Term Loan B		10/1/2012	156.8	97.08%	152.2					400		5.00%	7.8	5.2%	6.23%
Total Nexstar secured debt			234.8		227.9	3.4x	2.7x	3.3x	2.7x						
						3.1x	2.5x	3.0x	2.4x						
Mission Senior Secured Revolver	15.0	4/1/2012	7.0	91.67%	6.4					400		5.00%	0.4	5.5%	9.45%
Mission Term Loan B		10/1/2012	165.8	91.67%	152.0					400		5.00%	8.3	5.5%	8.63%
Total secured/guaranteed debt			407.6		386.3	5.9x	4.7x	5.7x	4.6x						
						5.6x	4.5x	5.4x	4.3x						
Total senior debt			407.6		386.3	5.9x	4.7x	5.9x	4.7x						
						5.6x	4.5x	5.6x	4.5x						
7% Senior Subordinated Notes		1/15/2014	47.9	81.00%	38.8						7.00%	7.00%	3.4	8.6%	13.41%
7% Senior Subordinated PIK Notes		1/15/2014	142.7	77.00%	109.9						0.50%	0.50%	0.7	0.6%	12.16%
12% Senior Subordinated PIK Notes		1/15/2014	42.6	63.00%	26.9						13.00%	13.00%	5.5	20.6%	32.04%
Total OpCo debt			640.8		561.8	9.3x	7.5x	8.4x	6.8x						
						9.0x	7.2x	8.2x	6.6x						
11.375% Senior Discount Notes		4/1/2013	50.0	85.00%	42.5						11.38%	11.38%	5.7	13.4%	17.85%
Total debt			690.8		604.3	10.0x	8.0x	9.9x	7.9x				35.7		
						9.7x	7.8x	9.6x	7.7x						
Equity value	Shares O/S	Price													
Cash	28.4	\$4.80	136.5		136.5										
			(19.3)		(19.3)										
Total capitalization			807.9		721.5	11.7x	9.4x	10.4x	8.4x						
													0.7	Less PIK interest	
													35.0	Cash interest	

large compensation agreements, the Company is now in its second round of contracts with pay-TV operators which gives them significantly more leverage. There is a large amount of upside in retrans and other companies are helping to move the ball down the court like Chase Carey of Fox who was demanding \$5 per sub. Also now that Comcast owns NBC, they have expressed their support for retransmission contracts.

Television is not going away as US households set a new record recently for watching 8 hours 21 minutes of television per day on average. Television is better targeted and cheaper than advertising in the local paper at ~\$20 per cpm versus \$30-35 per cpm for a newspaper. Local television affiliates' websites are turning into the place where people now get their local news, video and sports highlights, displacing the local paper. Nexstar has been out in front of this trend with well-developed affiliate websites. Revenue from electronic sources grew 100% in 2008 and is expected to be over 5% of revenue in 2010.

The industry has just come out of a significant capital spending cycle because of the digital television conversion. Now Nexstar can greatly cut back on CapEx. The Company estimates that spending should come in below \$15mm next year, down nearly 50%. Coupled with all the cuts the company has made to the operating cost structure, Nexstar should generate a substantial amount of free cash flow next year. A free option on the upside comes in the form of white space on the spectrum that they still own that the company could monetize.

Valuation

There are only two analysts that provide estimates for NXST which is another reason that there may be severe mispricing here. Their estimates seem to be very low considering what the company is saying about growth compared to 2008 and 2009 and cost cutting measures undertaken in 2009. I am forecasting revenue of \$313mm and EBITDA of \$107mm in 2010 versus analysts that are at \$274mm in revenue and \$86mm in EBITDA. With \$107mm in EBITDA, you can create the company at the Senior Sub level for 5.0x on a net basis assuming all the Senior Sub Notes trade in line with the 12% PIK Notes at 63. On a LTM basis, you can buy in at the 12% PIK Notes' level for 7.8x. But to smooth out the even and odd years it is probably best to take an average for the last 24 months, in which case you can create the company at 6.4x. LIN TV has Senior Sub Notes at 7.7x EBITDA yielding 8.8% and Allbritton has Senior Subs at 7.3x yielding 8.3% so the NXST 12% PIKs are cheap compared to comps and well-covered in a potential bankruptcy.

Summary financial information	LTM					Analysts	
	2005	2006	2007	2008	9/30/2009	2009E	2010E
Revenue	228.9	265.2	266.8	284.9	258.3	247.6	273.7
Growth		15.8%	0.6%	6.8%		-13.1%	10.5%
Gross profit	161.3	193.7	192.7	206.6	181.4		
Margin	70.4%	73.0%	72.2%	72.5%	70.2%		
EBIT	19.9	46.5	38.6	46.6	17.6	14.2	36.0
Margin	8.7%	17.5%	14.5%	16.4%	6.8%	5.7%	13.2%
EBITDA	63.1	88.5	85.1	96.2	69.1	64.2	86.0
Margin	27.6%	33.4%	31.9%	33.8%	26.7%	25.9%	31.4%
Leverage	8.3x	5.7x	6.3x	6.2x	6.5x	8.2x	6.1x
Leverage Covenant	8.5x	7.0x	7.0x	6.5x	6.8x	8.8x	7.8x
Senior Leverage	6.5x	4.6x	4.8x	4.2x	5.3x	6.3x	4.7x
Senior Leverage Covenant		5.0x	4.6x	4.8x	5.5x	7.0x	5.5x
Cash Interest expense	44.9	38.2	40.6	39.0	31.8	34.0	35.0
Interest Coverage	1.4x	2.3x	2.1x	2.5x	2.2x	1.9x	2.5x
Interest Coverage Covenant		1.5x	1.5x	1.8x	1.6x	1.8x	2.0x
Capital expenditures	14.0	24.4	18.5	30.8	27.0	20.0	15.0
Maintenance capital expenditures	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Cash taxes	(0.1)	0.0	0.1	0.2	1.0	1.0	1.0
Free Cash Flow	0.4	30.1	18.5	29.8	2.7	14.2	35.0
Mission EBITDA	10.8	19.5	17.7	20.1	16.8		
Leverage Through Mission Bank Debt	21.8x	12.1x	13.2x	11.7x	14.0x		

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Sohu.com, Inc. (SOHU)
Price: \$48.48
(Feb. 23, 2010)

Matt is a second year MBA student and a participant in Columbia's Applied Value Investing Program. Over the summer he worked at Permian Investment Partners and the investment office of NY-Presbyterian Hospital. Prior to school, Matt spent one year in investment banking with J.P. Morgan and three years in private wealth management with Goldman Sachs.

Matt holds a BA from Colgate University.

Sohu.com, Inc. (LONG)

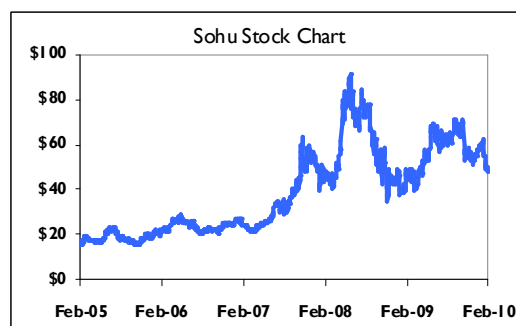
Matthew Cohen
macohen10@gsb.columbia.edu

February 2010

Summary Statistics

Stock Price (2/23/10)	\$48.48
X Shares Outstanding	39.0
Market Cap	\$1,891.3
+Net Debt (cash)	(\$563.8)
EV	\$1,327.5

P / LTM EPS	11.4x
(LTM EBITDA - CAPEX) / EV	14.9%
LTM EBIT / (NWC + NFA)	36.7%
LTM Free Cash Flow Yield	9.2%



Thesis:

The market questions the sustainability of SOHU's free-to-play online gaming business model, doesn't like the heavy reliance on a single hit game in a competitive market, and is leery of the recent slow-down in online brand advertisements. But when you subtract off the value of SOHU's 66% ownership stake in publically traded gaming subsidiary Changyou (CYOU) and the company's \$560mm in cash, we're paying only \$107mm (3.1x 2010E EPS) for all of the company's popular internet properties, online advertising, and wireless businesses. Thus we can erase the gaming risk and create the internet property stub by shorting out the CYOU exposure. The CYOU subsidiary also appears inherently cheap, based on a pharma-like runoff analysis of its upcoming games. All in all it seems we're paying very little for significant upside potential; SOHU is a Chinese growth stock trading at a value price.

Background:

Sohu.com Inc. (SOHU) is an Internet company that provides news, information, entertainment, online games, and communication services in China. In addition to the main portal page Sohu.com, the company owns a number of other properties: 1.) Chinaren.com, a Facebook-esque school and alumni social networking site; 2.) 17173.com, China's largest & most popular online game blogging site; 3.) focus.cn, a Chinese real estate site; 4.) go2map.com, a Chinese equivalent of Google Maps and 5.) goodfeel.com, a wireless site that enables ring tone and picture downloads. SOHU's revenue is comprised of 42% advertising, 47% massively multi-player online role-playing games (MMORGs) through its Changyou subsidiary which it spun off as an independent company in mid-2009, and 11% wireless services. Founded in 1996, the company is based in Beijing.

Investment Overview/Catalysts:

- **Growing advertising opportunity:** China's population is 5x the size of the U.S. with 1.4 billion people. In 2008 China overtook the U.S. in number of broadband households and has annual online household growth of 35% vs. 13% in the U.S. Despite this, Chinese online penetration is only 16% vs. 64% in the U.S. There is also a mismatch between the amount of time that the Chinese consumer spends online (23%) vs. the amount of Chinese advertising spend online (8%). As broadband penetration increases and the Chinese consumer spends more time online, online advertising will increase and accrue to popular sites like Sohu. Population aging will also help this trend, as younger generations are more computer savvy.
- **Network effects in online gaming:** Tian Long Ba Bu (TLBB) and Blade Online (BO) are two of the most popular games in China (TLBB is #2). This community is growing rapidly, and becomes more valuable as more people join. Near-term switching costs increase as gamers spend more under the free-to-play model.
- **Biggest game is early in lifecycle:** Popular online games in the past have delivered positive growth for over 6 years, and TLBB was launched in 2007. TLBB's content is updated weekly and enhanced via expansion packs each quarter. Penetration into lower-tier cities is increasing as a result of sales force efforts – TLBB and BO are proven concepts which can grow organically as internet penetration increases.
- **Investor friendly & incentivized management team:** Unlike many of its Chinese competitors, Sohu has maintained Sarbanes Oxley compliance each year since 2004 and has a shareholder friendly IR department. The company has also repurchased shares in 5 of the last 6 years

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Sohu.com, Inc. (Continued from previous page)

and has \$130mm remaining on a \$150mm buyback. Founder & CEO Charles Zhang owns 19% of shares outstanding, or \$410mm worth.

- **Undemanding valuation:** Excluding gaming (CYOU) and cash, the remaining business is priced at a P/E of only 3.1x next year's earnings, which is a huge discount to all comps. CYOU itself is priced at a P/E of 10.2x next year's earnings, and this valuation does not properly reflect the growth opportunity from 4 new games that will be introduced in 2010, one of which is a sequel to an existing popular game that is likely to be a blockbuster.

Valuation:

Using my own assumptions regarding Average Revenue Per User (ARPU) and growth in Active Paying Accounts (APA) in a pharma-like runoff scenario (not pictured here), I estimate that current games are worth 75% of CYOU's enterprise value. In other words a buyer of CYOU is paying only 25% of EV, or \$400mm, for the value creation from all future games launched after 2010. As a second technique I estimate a sum of the parts valuation for SOHU using downside, base, and bear cases depicted below. Finally, my DCF analysis suggests a price target of \$67. More importantly for a buyer of SOHU that shorts out the gaming exposure, I estimate the stub business to be worth at least twice the current valuation.

Sum of the parts valuation								
Segment	2010E Net Profit	Downside Multiple	Downside Case Value	Base Multiple	Base Case Value	Upside Multiple	Upside Case Value	
Branded advertising	\$25.8	9.0x	\$232.0	15.0x	\$386.7	18.0x	\$464.1	
Wireless	\$8.6	8.0x	\$68.9	12.0x	\$103.3	15.0x	\$129.1	
Gaming (after minority interest)	\$96.4	10.0x	\$964.2	18.0x	\$1,735.5	21.0x	\$2,024.8	
Subtotal			\$1,265.1		\$2,225.6		\$2,618.0	
Cash			\$563.8		\$563.8		\$563.8	
Total equity value			\$1,828.9		\$2,789.4		\$3,181.8	
Value per share			\$46.88		\$71.50		\$81.56	
Upside to current			(3.3%)		47.5%		68.2%	

“When you subtract off the value of SOHU's 66% ownership stake in publically traded gaming subsidiary Changyou and the company's \$560mm in cash, we're paying only \$107mm (3.1x 2010E EPS) for all of the company's popular internet properties, online advertising, and wireless businesses.”

Risk to thesis:

- Borrow may become expensive on CYOU short. Currently indicated at 88bps with plenty of inventory on Interactive Brokers.
- Ability to profitably reinvest large cash balance, and risk of transformative acquisitions.
- Content regulation from the Chinese government.
- A dramatic slowdown in the Chinese economy will hurt advertising revenues.
- If considering a straight long of SOHU, consumer preferences can be fickle and the CYOU subsidiary may not be able to maintain the popularity of old games. Barriers to entry in online gaming are low and the space is very competitive.

What multiple is the market assigning to the non-gaming business?

Q309 Sohu total revenue	\$136.6	CYOU Market Cap	\$1,849.0
Q309 gaming revenue	\$68.7	Sohu market cap	\$1,891.3
Q309 non-gaming revenue	\$67.9	CYOU value at 66% ownership	\$1,220.3
		Sohu cash	\$563.8
Q309 Sohu total EBIT margin	38.5%	Implied non-gaming market value	\$107.1
Q309 gaming EBIT margin	62.0%		
		Non-gaming 2010 revenue	\$284.9
Gaming % Rev	50.3%	Non-gaming 2010 EBIT	\$41.9
Non-gaming % Rev	49.7%	Non-gaming 2010 Net Income	\$34.4
Goal seek to non-gaming margin	14.7%	Implied earnings multiple	3.1x

Sohu.com Inc. (NASDAQ: SOHU)						
	2009	2010	2011	2012	2013	2014
Total Revenue	515.3	606.0	757.5	909.0	1,036.2	1,139.8
% growth	20.1%	17.6%	25.0%	20.0%	14.0%	10.0%
EBIT Margins	39.7%	34.0%	32.0%	31.0%	30.0%	30.0%
EBIT	204.4	206.0	242.4	281.8	310.9	342.0
Tax Rate	(14.0%)	(18.0%)	(19.0%)	(20.0%)	(22.0%)	(25.0%)
Tax	(28.6)	(37.1)	(46.1)	(56.4)	(68.4)	(85.5)
NOPAT	175.8	168.9	196.3	225.4	242.5	256.5
D&A	20.0	23.5	27.5	30.8	32.7	33.3
Minority Interest	(26.8)	(41.7)	(49.2)	(59.1)	(67.4)	(74.1)
CAPEX	(20.6)	(21.2)	(22.7)	(27.3)	(31.1)	(34.2)
FCF	148.4	129.5	151.9	169.9	176.7	181.5
Discount Rate	11.0%	11.0%	11.0%	11.0%	11.0%	
PV of FCF	148.4	116.7	123.3	124.2	116.4	
Terminal Value @ 12x 2014					2,177.8	
		% of total	% of Current EV			
NPV of 2009 and 2010	265.1	13%	20%			
NPV of 2011-2013	363.9	18%	27%			
NPV of 2014+	1,434.6	70%	108%			
Total NPV	2,063.5					
Net Debt	563.8					
Operating Value	2,627.3					
Operating Value/share	\$67.17					
Current Price	\$48.48					
Upside	38.5%					

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“The Belt & Suspenders Guys” - Tweedy, Browne



William Browne has been with Tweedy, Browne since 1978. Mr. Browne received a B.A. from Colgate University and an M.B.A. from Trinity College in Dublin, Ireland.

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Bob Wyckoff: I attended Washington & Lee University and I have a law degree from the University of Florida. I practiced law for a few years before getting into the investment business in 1980. I got my start in the investment business at Bessimer Trust Company, where I was for about five years before I moved on to a couple of other companies. When I first got in this business in 1980, one of the first books I read was *Money Masters* by John Train. In the book, there was a chapter on Ben Graham and a sub-chapter on Tweedy Browne where Train referred to Tweedy Browne as the pawn broker of Wall Street – a place where desperate sellers went to get a bid on stocks.

His description of Tweedy sounded very interesting to me. Here was a firm that owned, at least in those days, smaller-capitalization companies. They diversified with under-covered, under-researched issues. I thought that just sounded right; it made sense. A little bit later I read Buffet's article – the Super Investors of Graham and Doddsville – and it was like turning on a light bulb.

One day I tried to refer a client to Tweedy Browne, and unfortunately, Tweedy didn't get the client – they got me. That was in 1991 and I've been here ever since. I had started talking to John, Will, and Chris and

I think they thought that I was interested in this approach. As I think with most people who end up joining Tweedy, if we run into people that we think are interesting and would make a good addition to the firm, we don't have to be in the middle of a formal em-

*In Money
Masters, by John
Train, he
described Tweedy
Browne as “the
pawn broker of
Wall Street - a
place where
desperate sellers
went to get a bid
on stocks.”*

ployment search to take them on.

William Browne: I probably have a more checkered path in terms of experience prior to Tweedy Browne. Obviously I had been somewhat marinated in the value investing approach to the world by virtue of who my old man was. One of the places where I worked prior

to coming here was for a guy named Jerry Tsai, who was one of the famous go-go fund managers back in the 60's. He ran the funds up at Fidelity and made a huge name for himself.

Afterwards, he went out and started a mutual fund and raised an absolutely staggering sum of \$200 million. He would run from the ticker to the order room and I would run behind him, jotting down the justification for what he was going to do. I used to come over to Tweedy at lunch time, and I insinuated my way in over here and the rest is history. To paraphrase Buffet, “what you need in life is a good idea” and this firm has a good idea.

John Spears: I started investing at a very young age – I think about 11 or 12 years old. I saved up about a \$1000 mowing lawns and selling Christmas cards door-to-door. My grandfather introduced me to the financial pages; he taught me what an eighth was. He was an investor in stocks and I thought this was just an easy way to make money without physical effort. So, I started investing and I hung around brokerage firms. I recall spending a lot of time with the worst performing salesman – he would spend time with me and answer my questions. The first few investments that I made worked out pretty well,

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Tweedy, Browne

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even though I didn't know what I was doing. My first investment went up 50%. That was fun, but I had a few losers too.

I started reading Security Analysis and taught myself accounting in high school. I could grasp that it made sense to buy into companies selling below their net cash and you get the business for free. So, I started looking around for stocks at \$5 or less, trading below net-cash and did pretty well. I felt like a rich-kid in high school and really didn't want to finish high school, but my parents insisted on it. I got impatient and bored with it.

I learned that at the Drexel Institute of Technology, you could design your own curriculum; you didn't have to take all the liberal arts courses – you could just specialize. I set out a curriculum for myself to just take accounting and finance courses and took each one that they offered. I also went to some summer school courses at Wharton and at St. Joseph's night school, where I took a course in cost accounting. So, I basically took all the accounting and finance courses offered, primarily at Drexel.

I didn't have to go to Vietnam and I took a job as a trainee at a New York brokerage firm. I stayed at it for nine months and I got a few clients, putting them

into closed-end funds, selling at 60 or 70 cents on the dollar and just realized I didn't like selling, I didn't like the ethics of it. Anyway, I quit, but I probably would have been fired if I hadn't.

After that, I started up a

“My personal point of view is that you accept that investing is not a natural science but rather a social science.”

little investment partnership, where I put in \$3,000 of my own money and other people put in \$30,000. I drove an airport limousine at night to support myself. The fund specialized in Ben Graham type stocks – all below net-cash and way below net current assets. It did pretty well and it led to a job as a junior analyst at a firm called Berger, Kent

Associates, run by the late Bill Berger of Berger funds. I worked there for three years and learned about Tweedy Browne from Bill Ruane, who ran Ruane Cunniff, who I had met through my job as a junior analyst.

He asked what I did with my own money and I mentioned this little partnership I was running and he said, “you should really meet those people at Tweedy Browne.” And, I said, I see that name all the time in the pink sheets and the blue book – they own the same stocks that I'm interested in. That led to meeting one of our retired partners Ed Anderson and then I got a job working for Tweedy Browne in 1974 for maybe three years. Then, I got the great, great blessing to become a partner the following year – at the same time that Chris Browne became a partner. It's really been a blessing and a stroke of enormous good luck in my life.

G&D: We'll move to investment approach now. Clearly, Graham & Dodd have been a huge influence, but I'm sure there have been other influences as well – Walter Schloss or Warren Buffet. Can you talk a little bit about your investment philosophy and how you view value investing?

WB: An awful lot of ink has been used in order to

(Continued on page 16)



Thomas Shrager has been with Tweedy, Browne since 1989. Previously, he worked in M&A at Bear Stearns and as a consultant at Arthur D. Little. He received a B.A. and Masters in International Affairs from Columbia University.

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Tweedy, Browne



John D. Spears joined Tweedy, Browne in 1974. He previously worked at Berger, Kent Associates, Davic Associates, and Hornblower & Weeks-Hemphill, Noyes & Co. Mr. Spears studied at the Babson Institute of Business Administration, Drexel Institute of Technology, and the University of Pennsylvania—The Wharton School.

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find a multitude of ways to expand upon what is a simple idea that when you invest, what you are doing is buying an interest in the business. If you accept that framework and that lens, that will drive everything that you do in terms of analysis or figuring out what the business is worth if you accept the simple concept that the value of the investment is the business and not the price at which the stock is marked at on any given day. It's that concept and that drives everything else you do; you try to analyze a business. There are lots of good things that flow from that.

My personal point of view is that you accept that investing is not a natural science but rather a social science. So, it's never purely empirical; what you are trying to do is everything you possibly can to enhance your probabilities of being right more often than being wrong.

By focusing on a business, I think that you have a better chance of being right because a business, like many other things in the world, has a value. Graham originally used a statistical approach looking at net-nets or a liquidation framework. Warren Buffet's approach may have a longer look into the future, but you are essentially trying to buy the business and figure out what the business is worth.

You can look, as we do, at comparables and in order to improve your chances of being right, there are lots of different things that different people do. One of which, from our perspective is

“By focusing on a business, I think that you have a better chance of being right because a business, like many other things in the world, has a value.”

avoid highly leveraged business because at points of strain in an economy, it's the leverage that takes you down. It all comes from this basic, simple idea: figure out what the business is worth and then see if you can buy into it at a discount. Be diversified – we accept the idea of being diversified, because I think we have a very healthy sense of humil-

ity about being able to predict the future. It's not terribly complicated. I think the more difficult part of it is either you accept it or you don't.

G&D: Has your approach changed over time? You referred back to Graham's statistical approach.

WB: We were net-net guys. Going back, that's basically what we did.

JS: In the mid 70's, we had a lot of stocks that were two-thirds or less of current assets, net of all debt. A lot of those were turning – you didn't have to do much analysis of the business. If the price of inventory for a bunch of electronic vacuum tubes or ladies dresses, plus the cash and the receivables checked out, you didn't even need to make a call to the management.

WB: We had a treasure chest of those things that had been accumulated over time. We would go around and vacuum up all these cheap stocks. Lo and behold, in the mid-to-late 70's a lot of guys, and I won't mention their names, who eventually blossomed into the big leveraged buyout people in the late 70's and 80's start showing up at our door to see if they could go through the files.

JS: We did some consulting with those people.

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WB: John started saying, “what are you guys doing?” Tell us how you do it – what’s going on here; what’s the arithmetic? They sort of laid out the process and how you go about valuing a business as an operating entity and the capital structure of it. What the income stream is and what that can support. They walked us through their process – everyone knows what it is now; it’s basically what private equity guys do – it’s very simple.

JS: But, at that time, looking at a business in terms of its whole capital structure, where it’s not just simple-minded price/earnings ratio, which is after interest expense. You could have a very, very leveraged company that would be at a low price/earnings ratio. But, if you looked at enterprise value, adding in interest-bearing debt to the value of all the shares – looking at that as a multiple of operating profits after taxes, it would be a very high multiple. So, the LBO people and some of these young tycoons that we were dealing with were very instructive about that.

WB: The other thing we had early on in those years, again I won’t mention their names, were some very successful investors implementing this idea of buying a good business using the business valuation approach

to it. They were generally partnerships and a couple of them would show up; you would actually be able to sit there and listen to the two of them go back and forth with some of our old partners. They would sit there

value, with almost no debt, and was around 5x earnings. So, it was maybe 20% return on debt-free equity and a very steady earner. We looked at some deal values and it looked cheap, so we bought into that one.

“Today, a bulk of the assets are at good quality, pretty steady earning, and high return on capital businesses that do have a tendency to grow a bit.”

and debate, asking why would you want to own this piece of junk when this one actually earned something on its capital. It was very interesting to sit there and listen to that discussion.

JS: I remember Chris Browne coming up with Binny & Smith, the crayon producer - Crayolas. I think it was selling at under book

G&D: So has your investment philosophy and investment characteristics evolved over time? Have you gone from the net-net stocks and the net-current assets to focusing more on good quality companies?

WB: I would say no, not entirely. I’d say that it is still some of both. But, today, a bulk of the assets are at good quality, pretty steady earning, and high return on capital businesses that do have a tendency to grow a bit.

WB: But, the business has evolved from simply being more of a statistical process in the late 1970’s/early 1980’s into a somewhat larger view of how you go about looking at things.

TS: It was first that the net-nets disappeared and the second thing, because we learned from a number of people how to value these businesses that trade at a premium to book or net current assets.

WB: And that has resulted in us taking this approach to a global, world-wide model.

TS: But the framework

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Bob Wyckoff joined Tweedy, Browne in 1991. Prior to joining the firm, he held positions at Bessemer Trust, C.J. Lawrence, J&W Seligman, and Stillrock Management. He received a B.A. from Washington & Lee and a J.D. from the University of Florida School of Law.

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“The Tweedy portfolio tends to be a few variations on the value theme, but with a deep value orientation coupled with diversification.”

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stayed the same. There are two prices to stocks: the one using the stock market and the one you would get in a private market transaction. You still want a 30% discount from that intrinsic valuation.

BW: It's a mix, and that may be one way that we are a little bit different from some of our competitors. You will still see net-nets in our portfolio when they are available. Today, you can buy them in Japan in small-cap stocks and you will see some of those in our portfolio. You'll see very high quality business like a Novartis, J&J or a Nestle, which are pretty attractive, high quality long-term growers, and then you'll see some so-so businesses in the portfolio – sometimes it's a full-blown business appraisal, sort of LBO-type of analysis that they've been talking about. Sometimes it's a net current assets type of analysis.

Sometimes we are buying cyclical companies at a deep discount to book value and letting them go at book. The Tweedy portfolio tends to be a few variations on the value theme, but with a deep value orientation coupled with diversification.

G&D: You were talking earlier about the LBO model and you mentioned learning the tools of an investment banker at Bear Stearns. That is typically a

very DCF-type approach, but then a lot of value investors will then say DCF is actually very tricky to actually implement.

TS: We don't use DCF – there are too many variables.

WB: When you look at the multiples people have paid for businesses, I'm willing to bet that there has been, amongst all the analyses these guys do when they buy a business, there is probably a DCF analysis floating around in there somewhere, which comes and backs its way into these multiples that you are paying for businesses. But, as sort of a handy tool, a handy measure of what people have been paying, you can look at multiples.

JS: If an LBO buyer has a five-year time horizon, they'll make a guess about the terminal number and multiple that they expect. They will guess that in year five, EBIT or EBITDA will be “x” and they'll slap some sort of a multiple on it and there is your blast exit cash flow. That's your discounted cash flow model and then you've got the years in between. However, it's still human beings doing all this stuff and multiples can change in the business acquisition market.

G&D: I've read that you focus on buying companies with good capitalization and balance sheets. Is that an

important part of the investment framework?

JS: On average, in my view, looking at screens over the years a fair amount, I think that leveraged companies can be on a total enterprise basis, sometimes more expensive, in addition to being riskier. Let's say you have a debt-free value of \$100 per share, but you have debt of \$50 per share. So, you've got a net value of \$50. So, let's say you buy that at two-thirds of the \$50. That's roughly \$30, so you've got \$20 as your value spread. But, that's only 20% of \$100 total. So, if you have a leveraged capital structure and you are buying things at a one-third discount after subtracting the debt, your gross margin of safety on the debt-free amount is reduced.

WB: The other thing too is that if you're in the business and again, predicting the future is always hard, but if your business goes limp so to speak and you are not too hopped up, you'll get through that period. If you're all hopped up, particularly if you are a high fixed-cost, low variable-cost sort of business, we all know where the shareholders stack up in terms of the guys with the claim on the company and you'll end up with the short end of the stick. So, yes, leverage is important to us because that's what can lead to real problems for you.

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TS: Let me clarify something. The fact that we learned from people who are involved in LBO's, which is part of what we know, doesn't mean that we like leveraged companies.

JS: That's a very critical point. The margin of safety idea is very important. You lose 50% on something and you've got to go up 100% to recoup it, and we are investing our own money in our portfolios that are combined with our clients and separate stocks that are owned by those portfolios. So, it's real.

BW: I would just add that when you think of us and the community of value people, I tend to think of us as the belt and suspenders guys in terms of valuation. We tend to value businesses cautiously. Thus, regardless of what we observe being paid, if it seems to be escalating and seems unreasonable, we are going to haircut it. In doing our valuation work, you'll see the diversification that we use, the avoidance of overleveraged businesses for the most part. You don't see concentration.

These days, what seems to be more common in the investment world and Buffett speaks of it – is putting your eggs in just a couple of baskets and watching them very closely. More and more value investors are

running more and more concentrated portfolios and we are not doing that. So, when you think of us, the culture here is extreme price sensitive, a cautious approach to valuation, cou-

yield on the total purchase price. Then you can say to yourself, in terms of common sense, was this really a great price? Do I want to slap an after-tax 4% yield on everything? Is that sustainable as a multiple?

WB: The ownership arithmetic.

JS: Yes, the ownership arithmetic. So, during the height of easy credit of 2006/2007 when deal multiples were expanding at 20-25% of what they had been typically in prior years, if you did some of that owner's yield arithmetic, and you knew what was going on with the lending standards and easy money, easy covenants, all that stuff, it makes you a little bit cautious about slapping on these new high deal multiples. You have to look at reality, you have to look at what the market is. If we were selling a business, we would push for the highest price. You need to use common sense.

“What you are trying to do when you are looking at the business is you are trying to understand the competitive advantage.”

pled with diversification.

JS: I think you can also say sometimes that we maintain skepticism about acquisition valuations. An interesting exercise is to take a deal multiple of EBIT or EBITDA and then convert that to the yield on the total purchase price. Take the operating profit or EBIT and then apply a tax rate to it and get your operating profit after-tax and look at that as the

TS: So, what that results in as a practical method for the vast majority of companies is EBIT multiples between 9x and 11x.

G&D: We've talked a lot about valuation, but can we talk more about how you judge the quality of a business and what are the characteristics that you would like to see if you are willing to pay 11x EBIT for, versus

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9x EBIT or lower?

“But, sitting down across the table from a media trained CEO, who is impeccably dressed and more articulate than we are. Are we going to learn a lot from that?”

TS: It's really tough to put it into neat boxes. But, what you are trying to do when you are looking at the business is you are trying to understand the competitive advantage. Who are the competitors? Are there any disruptive competitors coming into the market? What is the mix between pricing and volume; do you have volume increases, followed by big price declines – what's the math there? What's the history of gross margin and why has it gone up or down? Are these things sustainable over long periods of time?

Then you look at the operating costs and you are trying to understand how efficient the company is in terms of running the business. You are trying to look at fixed to variable costs ratio. In other words, you are trying to find out if a 5% drop in sales would wipe out profitability or whether there is much more flexibility in the cost base. In order to understand all these things, you talk to the company, you talk to analysts, and you sometimes talk to customers and suppliers. So, it's like putting a puzzle together.

WB: Most of our businesses are differentiated in the mind of the customer and some businesses just aren't differentiated in the mind of the customer. If

you two guys were in here selling copper, from two different companies, all I care about is who can sell me copper at a penny a pound less. It's that simple. It's a crummy, crummy business. You try to think about businesses where there may be some characteristics to it that will enable you to compete on some basis, other than you can just bring it to me cheaper than the next guy. Whether there is a concept about it, whether there is a habit that is embedded in the customer; and, of course, whether you could open the newspaper and read that you are out of business essentially because someone has leapfrogged you.

We like to think that we've developed a level of sustainability about the business over extended periods of time. By and large, that kind of leads you in one direction, versus the other. On average, you would prefer to be in something other than a raw commodity. But, we'll buy a raw commodity if you really think it's cheap enough. On the other hand, we prefer things that you burn, smoke, eat, drink; wear out kinds of businesses.

G&D: Does management make a major impact? Are you closer to Graham, or are you closer to Buffett on management?

BW: Closer to Graham.

TS: We are concerned with whether the reputation of the business will stay intact. However, this is a broad spectrum. We make a point in every single investment we make, to talk to somebody at the company.

BW: And we try to avoid getting into bed with people who we think are going to hurt us in some way. And over the years, we have paid a lot of attention to patterns of insider buying. We like to see CEO's and CFO's in particular, buying shares right along with us. Those kinds of things interest us. But, sitting down across the table from a media trained CEO, who is impeccably dressed and more articulate than we are. Are we going to learn a lot from that?

WB: You are going to learn what you want to.

G&D: How often do you consider the macro or secular picture when you are looking at new investments?

BW: We read and we are aware, but it doesn't play a large role in our analysis. We tend to start at the bottom. We tend to start with price and relationship to value. We start with screenings of securities all over the globe. It's rare that we come up in our heads with some macro theme and decide we are going to go fish in that pond

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because of some idea we may have of where the world is heading or what this particular innovation might mean for a specific industry.

WB: We certainly don't build a macro thematic framework. One, we don't do that. Two, I suppose at the end of the day, you could probably conclude that we are optimists. We don't think that the world is going to end. I do take a certain level of comfort in the fact that we invest around the world. So, we are not locked into any particular marketplace. Now, I think inevitably you are impacted by the macro world to some extent. Businesses operate in a macro world and they are impacted. Predicting which way it is going to go at any given point in time is very difficult. I think that in sort of an indirect way, we address a lot of that by the nature of the things that we end up investing in.

We tend to be invested in, as we said, businesses that have fairly sustainable demand characteristics and have the wherewithal to get through difficult periods of time. And when they come out the other side of it, businesses that will have prospects that we expected. We are on average right, more often than we are wrong. We understand the nature of the business. While those businesses are,

no question about it, impacted to a degree by macro developments, depending on the severity of them, they aren't going to be knocked out of the game by it.

Also, if it's a pretty good business, maybe there are some guys who are knocked out of it and maybe you'll end up with a slightly better edge. Now, volatility is something that always wears a lot of people down. That's one of the reasons you see markets do what they do. But, you can't escape it.

JS: We're in the macroeconomic boat. If there is going to be inflation, we're going to have inflation. If interest rates are going to rise, they're going to rise. If P/E ratios are going to come down because interest rates are going up, we're all in that.

WB: I had a friend a while ago and he was up to his eyeballs in gold and platinum and other precious metals and he was really feeling good – he had made a lot of money. He says, I want to own hard assets. But, the fact of the matter is that when you own a business, it is a fairly hard asset. This is sort of a silly analogy, but I'm going to take you over to corporate headquarters at Diageo and bang your head against the door. I think you'll find that to be pretty hard. It's organic. There are guys waking up

every day – they've got assets, they've got capital, they're deploying it, they're making things, they're selling things, they're doing all sorts of things. To me, those are very tangible and hard assets. However, they are not inert assets. To me, that's a much better hard asset than storing away copper bars or oil in a boat, in the straits of Malacca.

JS: You get a yield on it. If someone buys Johnny Walker scotch, we make some money on every drink. People have to buy insurance every year, and we own some businesses in that field. To me, it's great to have things that produce stuff that people really need every day.

WB: There may be a corporate CEO, who wakes up one morning and looks at his wife and bursts into tears and says, "Honey, I just can't take it!" But most guys are going to wake up and say, "I've got a pile of assets. I've got a pile of capital. I've got these assets that are earning capital. I have to think about what I am going to do with them to stay ahead of the game." So, it's real; it's organic.

BW: As Will likes to say – business adapts much more quickly than governments to problems that are out in the marketplace. He also made another good statement that I think is important, that we are generally opti-

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"I think that the key to being successful as a value investor is this willingness to accept the near-term randomness that goes on in our markets."

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“Emotionally people are drawn to what they think they can control and that’s typically something in the short run. Something they think they can see an immediate result from.”

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mists. I think that the key to being successful as a value investor is this willingness to accept the near-term randomness that goes on in our markets. And to be able to emotionally deal with that and accept that that is something that goes along with investing. If you are willing to do that and able to do that and accept that kind of volatility, then the spreads that we can make and the kind of investing that we can do are much, much larger than the spreads these quants are trying to make in the short run, where they have to use a whole lot of leverage for it to make sense.

Ultimately, what we are doing, I think is a lot safer and we sleep a lot better at night, knowing that our whole business is not built upon a foundation of leverage. But emotionally, and I think this has been happening over the last 10-15 years, emotionally people are drawn to what they think they can control and that’s typically something in the short run. Something they think they can see an immediate result from.

WB: But one of the things that gives us an edge is that when we come into the office in the morning, we know what we are going to do. We’ve got a framework. A lot of these books about how we are wired as creatures are very interesting to read. And people are

not well wired for investing in many respects – we suffer from anchoring on recent news, confirmation bias, etc. and these all work against you in stress periods.

It’s very important to have an anchor. You’ve got a shot at being objective as opposed to being tossed into the panic pot. Then it’s all up for grabs – that’s when you are really going to get it wrong. Whatever it is, you’ve got to get a process where you can anchor your thinking because all of this external stuff grinds away at your objectivity – every single day in down markets. Up markets, you all just walk around thinking you are smart. But from our point of view, you’ve got to have the objectivity too, because sometimes valuations just get foolish and you’ve got to be willing to walk away.

G&D: You mentioned time horizon and how that was critically important and how it sets you apart from other investors. What is your time horizon?

BW: I don’t think we would put a number on it, but typically we own stocks for three to five years or longer. Sometimes stocks get taken away from us in takeovers. If it’s a compounder, one of these better businesses we’ve talked about where the intrinsic value is compounding over time, we can own it indefinitely. We’ve owned No-

vartis, in one form or another, for 20-25 years. We’ve owned J&J for a very, very long period of time. Because these businesses are compounding their intrinsic value, right along with their stock price over time. But, if it’s a cyclical business like we’ve talked about, we are typically buying it at a big discount to book and then trading it out at book. If it’s a net-current assets stock, we’re buying it at a discount to net-current and trading it out at net-current. But, I’d say if you made a general statement about turnover in our portfolio, its average over time at about 20% or less.

WB: There is an anomaly with average mutual fund turnover. The highest turnover is typically found in the growth fund category, which you would think, just as you go through it logically would be lower because those companies are growing and wouldn’t need to be traded out of.

BW: You’re confusing growth with momentum!

WB: No, they don’t say anything about that! The ideal stock, if you are in the unenviable position of being a taxpayer, is that you buy a stock and own it forever. Now, I’ll put words in John’s mouth - John’s time-horizon is his funeral – Buffett’s is eternity. But we don’t have a time horizon. That goes back to something I always

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found interesting. The problem with a lot of people – individual investors and I've seen it with nieces and nephews and cousins – is that they'll own four or five stocks and they'll have a stock that sits around there and it doesn't do anything for a year-and-a-half and then they'll sell it. I'll ask why, and they'll say because it hasn't done anything!

My friends are making money in all these other stocks. Regardless of what the considerations were for going in and that they haven't changed, this emotional dimension comes back in. I think one of the nice things about being diversified is that we own enough stocks – we have about 67% of the portfolio in 25 names and it sort of trails off from there. You've got enough stocks with stuff going on that you don't have to obsess over the ones where nothing is going on as long as you think the rationale for being there hasn't changed. But, with individuals, it's very amusing – “Oh, I'm sick of that stock. I want to get out of it and I'm going to get out of it right away as soon as it gets up to what I paid for it.”

JS: When you have a lot of holdings in your portfolio, you can compare things to what you already own and be reminded of the integrity of the story and why you went into something. Or when you are considering something new, you can go

through and say which ones you like. You can say you like this coke bottler at 9x earnings. It's debt-free, it's in Mexico, and they've got 85% of the market, and they have a great delivery system going to all of the bodegas, which is hard to compete with. You compare that to

people think that if you diversify, you are the market. So, how do you add value? If you look at our portfolios – despite the fact that we may own 50 or 60 stocks and sometimes even more depending upon where value is showing up, the portfolios tend to not look anything like the market index. Its multi-cap, and the weightings and industries are vastly different. So just because you are diversified by issue doesn't mean that you have a portfolio that looks like the market. And you can't simply assume that because you own a lot of stocks, you can't do well. The S&P 500 over long periods of time has beaten 80-85% of professional money managers. Probably the greatest mutual fund investor we've known or heard of over the years is Peter Lynch of the Magellan Fund and he had 1,000 or 1,500 stocks in his fund. So, don't confuse diversification by issue with a portfolio that looks like a market.

“Don't confuse diversification by issue with a portfolio that looks like a market.”

some cell phone company in a lesser developed country where prices go down at a rapid rate. You've got political instability and funny insider trading. Which one seems simpler? What grabs you more? You can do those sorts of comparative judgment exercises.

BW: I would make just one point, though. A lot of

G&D: We would like to talk a little bit about your portfolio. One of the things we noticed was that you have a lot of capital invested in Consumer Products companies. Maybe you could talk about one of the names you own or about the industry in general and how that fits the framework that you all find attractive?

TS: I think it is much more important when you look at

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consumer products companies, is to understand what is attractive. If you are talking about food, beverage, and personal care companies, which represent a big part of our portfolio, where you have to look is how many billion dollar brands they have. Because once a brand becomes big, it gets economies of scale. Your marketing may be less than it would otherwise be. You get economies of distribution. You get a number of advantages.

Second, you would have to look at categories. There are certain categories that grow and ones that don't grow. You want to have your products in those categories that grow faster than the market. These food, beverage, and personal care products grow below GDP in the developed world. For example, if you are in pet care, that grows much faster than GDP. Water, at least until a year ago, grew much faster. And it shows that things can change within the categories. Then, things like ketchup are not growing faster than GDP. So, the categories are very important.

Three, the geography - the more emerging market exposure you have, where you have a rising middle class, the better off you are going to be. Having a strong emerging market exposure is not an easy thing to achieve, because you have

to overcome the same issues with distribution, marketing, packaging - all those kind of things that are important to those markets. A very good example is Nestle, which gets more than 30% of its income from developing countries. It has

“People do, I think, on average want to buy what is perceived as a symbol of a better product.”

more than 30 billion dollar brands, and it is generally in categories that grow a little bit faster than the market. It has tremendous market share because of those brands in the categories in which it operates.

BW: I might just add that a number of these companies are reasonably priced. They tend to be steadier. Many of them are underleveraged.

And I want to emphasize Tom's point that they sell products that these aspiring middle classes that are coming up in emerging markets want to own. Companies like Coca-Cola FEMSA, which is selling coke, water, and beer to people in Latin America. Companies like Philip Morris International that is selling tobacco all over the world. You've got Novartis selling pharmaceuticals; you've got Nestle and Diageo, and if you went right on down the list and looked at the percentage of revenues that are coming from these faster growing parts of the world, it's surprising. We often like to say that if Nestle wasn't headquartered in Vevey, Switzerland, but was headquartered in Shanghai, it probably would sell at twice the current multiple. But, interestingly enough, it's benefitting significantly from growth in these emerging markets. So, it's often a cheaper and safer way to get the benefit of those markets.

WB: Generically, if you think about it, they tend to have multiple sources of income, multiple products, and they are constantly coming out with iterations of products to maintain their market share. Most of them tend to be big companies, which already have very strong holds on shelf space, which is always a hard thing for a new product to get. You couldn't

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come out with Shrager ketchup tomorrow and expect to get into A&P or Kroger.

BW: Again, they are products that are typically less discretionary. And, one of the things we do during these tough economic times is have endless discussions about trade-downs, and when people trade down, will they trade back up? Sometimes the companies will come out with various price points to sell. But, I'm telling you that the trade-down/trade-up issue was as vibrant in 1976 as it is today. People do, I think, on average want to buy what is perceived as a symbol of a better product. While nothing is given, on average they seem to have, from our point of view, better probabilities about the future than other types of businesses. As a group, they tend to have better returns on capital. They are reinvesting the capital. They have, albeit in an uneven fashion, businesses that grow. They grow with the world, they grow with the population. They find ways to squeeze costs out. There is just a multiplicity of things that they are tapping on to try and keep the business going.

G&D: One of the things we noticed in the portfolio is that there are a few businesses that are sort of in a secular decline that you own, such as Philip Morris,

Reynolds, and Axel Springer. We are curious about those types of businesses and what has led you to some investment there.

TS: The Roman Empire disappeared after the split over 1200 years. It split in 300 AD and then the Byzantine Empire disappeared in 1500 AD, which was a relatively long period of existence before the time of decline. You have to look at it company by company. There is no question in my mind that we held certain media stocks too long. Some of them were too illiquid to get out of. But, I think that we are in relatively good shape with the media companies that we own now.

I would start with Schibsted in Norway. It's a monopoly situation where there are a couple of television stations, but the most important thing is that more than 50% of operating income coming from the internet. So, they have made a transition. They have a site that is more popular than Google; they have some destination sites, including a financial website that is extremely popular in the Nordic countries. They have been able to achieve that because they started investing in the mid-1990's and because people in the Nordic countries are much more internet savvy than other regions of the world. So, they capitalized on that in order to build a very profitable internet busi-

ness.

In the case of Axel Springer, its main asset is a national newspaper called *Bild*, which is sort of a tabloid newspaper that gets sold all over Germany with local editions and they don't have any competition for that. So, it's a very unique newspaper where the circulation declines have been very, very moderate for a long period of time. They can reach a larger audience than the most popular TV program that you have in Germany by a factor of three or four. So, advertisers value that. So, it's not the number-four newspaper in a market that is already declining; it's the number-one with nobody else behind it, except some serious national newspapers that people increasingly don't read.

They also have the biggest magazine business and that by itself wouldn't be such a good business, but they are increasing the access of their magazines online. For example, they have the *Auto Bild*, which is the car magazine that they have. They have the *Auto Bild* site, which is the most viewed automotive site. If someone wants to buy a car, they are much more likely to go to their site. They have the second best real estate online site, which they developed from their newspaper pages. So, they have successfully expanded outside of Germany, where they have done very well,

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Tweedy, Browne

“For the traditional portfolio, we want at least a 30%-40% discount off of our cautious intrinsic value calculation.”

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unlike other companies. Overall, it's a very special type of situation.

G&D: And, you are compensated in the form of the price?

TS: Yes! You are buying at a big discount; these businesses will generate a lot of cash, they will pay dividends of 5-6% in some of the instances. So, you are getting well compensated. With a dividend of 5%, you need to compound at just another 5% to get double-digit returns.

G&D: It also seems that there are a number of pharmaceutical names in the portfolio and that's certainly a space where there is potential governmental interference. How much does that play into your analysis and what are your thoughts around that?

TS: There has been governmental interference around this industry forever. The question is whether there will be more in the future or not. The election in Massachusetts has made it less likely. That's the only thing I would say. On one hand, when you are investing in the pharmaceutical or health care industry, you have the wind at your back because the population is getting older. For someone who is 85 years old, you are going to spend six-or-seven times more than on someone who

is 55 years old. Thus, as the population is aging, the demand for medical services and pharmaceutical products will grow. The question is in what way will the government try to limit cost increases.

This is a very, very complex issue because there are so many vested interests that are trying to protect themselves. With rational reform, pharma companies should see an impact but only a small impact in a purely rational environment. However, doctors groups are very powerful. Nurses unions are very powerful. And a number of different interest groups within this entire system want their little piece of the pie. Union companies want their piece and pharma companies want their slice. How all this plays out is going to be interesting. All I know is that the products of these companies will be needed in the future and you need to have a way in which you still give them an incentive to produce.

BW: I would just add that the death of health care and pharmaceutical companies has been announced many times in the past. Thinking back to when the Clintons proposed health care – that drove down the stock price of the pharmaceutical companies and we got a chance to buy Johnson & Johnson around 1993 or 1994 at about 12x earnings, which was a terrific price. Today,

you are being given another opportunity to buy these pharmaceuticals at attractive prices. There are all these patent roll-offs that you have to pay attention to and understand, but one of the characteristics of at least two of the pharmaceuticals that we own is that they have significant consumer products businesses attached with their drug business. That's the case with J&J and that is becoming the case with Novartis. That part of the business is steadier.

TS: But it is a lower margin business – so you are not getting the 30%-40% margin that you are getting with pharmaceuticals.

G&D: Are there any recent investments you would like to talk about or an investment idea that you are thinking about? It would be great to hear your thoughts on the analytical approach you use and comments on the thesis.

BW: We have a dividend fund here. It uses the same valuation approach that we practice, but we have a portfolio that couples our valuation work with stocks that pay above average dividends. One of the recent stocks we purchased about three months ago was Exelon, which is the nuclear utility company.

Dave Krasne: It's the nation's largest merchant nu-

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clear fleet in the country and nuclear is among the large sources of electricity and the lowest-cost source of power. There was a transaction in December 2008 with EDF purchasing a 50% interest in Constellation's nuclear assets. This gives a very interesting post energy bubble deal multiple – it was an all-cash deal, knowledgeable buyer, arms-length transaction. They bought 49.99% because the government won't let any nuclear entity be more than 50% owned by a foreign corporation.

The price paid would imply roughly \$55 per share for Exelon's nuclear assets. Pile onto that, Exelon's two regulated utility businesses, which given that they are allowed to earn a regulated rate of return, should be approximately book value. But if you use a 20% haircut to book value, that adds another \$11 per share, which gets you to \$66. It was essentially a more than 20% discount to intrinsic value on what seemed to be a very conservative and reasonable valuation.

BW: For the dividend portfolio, we don't require as deep of a discount as we do for the traditional portfolio. For the traditional portfolio, we want at least a 30%-40% discount off of our cautious intrinsic value calculation. But, for the dividend portfolio, something that is trading at 15%-20% off its intrinsic value, with a

really attractive yield that is growing over time is sufficient. In this case, Exelon is not a traditional deep discount, but then Exelon also has a kicker associated with it.

DK: If there is any type of a carbon regime, because nuclear power does not have any exposure to carbon, it would essentially be all additive and go straight to the bottom line, straight to margins. It would increase the cost to their competitors and because of that, the price to consumers. The price increases, but the costs associated with the new policy wouldn't increase for Exelon. That would potentially add another \$15 per share of incremental value if there is some type of carbon regime and even if no carbon regime gets implemented by the legislature, the EPA is also pursuing its own path that would also regulate CO₂. Thus, even if Congress cannot get its act together, the EPA can essentially do it itself.

G&D: Are Exelon's assets similar to the nuclear portfolio that was bought from Constellation in 2008?

DK: You can argue about location. Probably about 40% of their assets are in comparable, desirable locations, and then there is another 60% of their assets that are in Illinois, which don't have the same market characteristics in terms of

power pricing that they have in the Mid-Atlantic. But, as far as purchasing unencumbered nuclear assets, the value per kwh of assets that you are buying are actually at a discount to what they can spend to uprate the capacity at the plants. So what they spend on maintenance capex, and to some extent growth capex, that increases the capacity of the plant, which is very economic to them at about \$2,500/kwh. The current price of Exelon's stock – especially now – is at a pretty steep discount to that. The dividend yield is close to 5%. When the market looks at it, they see earnings staying essentially flat for the next several years, so from the market's standpoint, there is nothing to get excited about. It's also a utility, which typically has its own investor base.

BW: We typically don't own a lot of utilities in the dividend portfolio, but this was a special situation.

DK: Power is a commodity business and generally we don't like commodity businesses. But, it has a structural competitive advantage as the lowest-cost producer of that commodity that no one else can match.

G&D: What does Tweedy think about the current market?

BW: There is no question that the number of opportu-

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Mario Gabelli '67 and Bill Ackman at the 2009 Graham & Dodd Breakfast.

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nities that we see has slowed pretty dramatically over the past several months. We still see opportunity and we are looking at about a half-dozen things right now. But, if you went back a year-or-so ago, there were two-dozen things in the hopper that we were working on. And, there have been significant changes to the portfolio over the last year or year-and-a-half, but not as many over the past several months with the markets doing what they've done.

We ended up exiting pretty early in a number of instances in late 2007, early 2008 in a number of financial stocks that we owned, where as Tom likes to say "as the onion was being peeled" and disclosure became clearer. Things became murkier and we let go of almost all the bank stocks. We then took that money and redeployed it and bought some high-quality industrial companies here in the US that we had not had a chance to buy in 20 years – companies like 3M or Emerson Electric. These stocks have come up pretty dramatically, but we were buying these things in 4Q08 and 1Q09. We bought the railroad stocks, such as Burlington Northern, Union Pacific, Norfolk Southern.

For the first time in a long time, we bought oil stocks as oil prices came down –

we bought Conoco Phillips, Devon Energy, Total in France. We bought some quality growth companies that we had not been able to buy in the past – companies like Henry Schein, which is the dental distributor and a great company;

***"If you're
optimists like we
are, then you
think the next ten
years have to be
better than the
last ten years."***

one of the most recession resistant businesses ever. We bought some Cintas and we also own some other uniform businesses. We had a chance at some Ben Graham statistical type bargains, we had a real estate holding company in Hong Kong, which was trading below cash.

We also bought some European companies that we had owned in the past and sold.

But when the crisis hit, these things came back down in price and we had a shot to get back in. These were companies like Linde, the German industrial gas company, a company called Kronos, which makes beverage equipment for the beverage and beer industry, a terrific company. So, we did a lot, but many of those stocks have risen and bargain hunting has slowed.

TS: But in the last couple of weeks there are more ideas coming.

JS: We are doing a few net-nets in Japan or Korea most of which are two-thirds or less of net current assets and 3x-5x peak earnings, although earnings are depressed. Two of them are priced around net-cash. Great balance sheets and there is tremendous optionality in these things. They once sold at more than book value and I think if you put together a bunch of them and look out five years, I bet you'll get a chance to sell some of them at book or more.

G&D: Considering your view that opportunities are slowing down, what is your position on cash?

BW: Cash is residual, but we typically have some cash. We tend to think of ourselves as fully invested and today we are about 95% invested today.

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TS: We've had 20% cash, but it's not as if we are waking up one day in the morning and saying "we should go into cash." This is not what's happening. If we have more companies that reach intrinsic value, then we sell, and if we have fewer opportunities to invest, then we wind up with more cash.

JS: The great thing about these companies that you think are going to grow while you sleep at night, is that when they get up to what you thought they were worth, maybe they'll chug along. So you may not have another thing to buy when you sell it. So, it gives you a bit of a luxury, owning some of these things that seem like they are going to increase in value while you sleep even if they're not beautifully and cheaply priced.

BW: One thing that is characteristic in this market is that the bounce that we had since March last year – and I'm being very general in what I'm about to say – all of the stuff that cratered the worst in 2008 and early 2009 are the stocks that came roaring back in late 2009. So, to a certain degree, when you have a bounce off of a recession low like we've had, the leveraged companies, non-dividend paying companies, the crummier businesses have gone straight to the moon and the higher quality

businesses, companies that are globally diversified, that may have stronger balance sheets, that may pay a dividend, haven't participated to the same degree as these lower quality businesses.

So, we took a look at that and one of our young fellows here took a look at the S&P 500 for instance and looked at the world index and took a simple metric – do you pay a dividend or you don't pay a dividend. And, in the S&P 500, there were roughly 370 companies in the S&P 500 that paid some form of a dividend last year and 130 that did not. The 370 that paid a dividend were up, on a weighted-average basis, about 27%, which is pretty attractive rate of return. The 130 companies that didn't pay a dividend were up on average 82%. For the global index, you ended up with comparable statistics. When you look at your top 25 holdings at Tweedy, the P/E for the top 25 names are anywhere from 14x-16x current run-rate earnings. But, at lower multiples, is where we think underlying earnings power is, even though current multiples are higher. So, as John was saying, we like what we own and we are comfortable with our holdings.

JS: We liked them better when they were cheaper!

BW: We closed to new business in 2005 and we reopened in 2008 and we'll

probably stay open here for a while.

G&D: Do you have any parting words for MBA students?

JS: Persevere! Just persevere and realize that when you get rejected, it's not personal. Many money management firms only occasionally, and very randomly, hire people. Our turnover has been so low and I couldn't tell you when we will add to the analyst heap.

BW: We just did! I would just add that there seem to be huge headwinds out there. The macro picture looks pretty bleak, but it's been that way in the past often and we've just gone through ten years of flat-to-negative returns in every market. So, that doesn't happen very often. If you're optimists like we are, then you think the next ten years have to be better than the last ten years. We don't know that obviously, but I think if you can get in now, if you can find your way into a shop that does something you're interested in, it's probably going to be a decent future.

JS: I think small-cap and neglect – less liquid – that's an area of opportunity. As you manage more and more money, there tends to be some abandonment of that.

G&D: Thank You.

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which he evaluates investment opportunities. Naturally, Mr. Buffett replied that it had not. While he explained that any potential new laws would be unlikely to prevent future bubbles because of an inability to legislate human nature, Mr. Buffett followed up by noting that, “This recession has changed human nature as much or more than anything I have seen. When the Reserve money market fund broke the buck, \$3.5 trillion was scared very fast. People get scared fast and together. They regain their confidence slowly and one at a time.”

And in case that assessment was not cheery enough, Mr. Buffett later explained that the United States current account deficit means that we are transferring liabilities against our future output to the rest of the world, and China now has more than two trillion dollars in foreign exchange reserves.

“If our bonds retain their value, we will have to send over goods at some point in the future. If the world wants goods instead of interest payments, we won’t be able to consume all of our output. This is a problem when our children will only be able to consume ninety-seven percent versus the current one hundred and two percent. The most likely outcome is printing more money. Most countries that are big spenders

can’t issue bonds denominated in their own currency, and we are headed in that direction. This is not the number one problem right now, but it must be addressed.”

**“People get
scared fast and
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BYD

Although the price that Berkshire Hathaway subsidiary Mid-American Energy paid for its stake in BYD turned out to have been quite attractive, one student wondered how Mr. Buffett justified the purchase of a foreign technology company in an industry undergoing a rapid rate of change, given Mr. Buffett’s previous aversion to such investments and preferred holding period of ‘forever’.

While acknowledging that most of the due diligence

had been performed by long-time business partner Charlie Munger and Mr. Munger’s friend, Li Lu (BA/JD/MBA ‘96), Mr. Buffett explained that Mid-American’s investment was a strong endorsement of BYD’s CEO Wang Chan Fu.

“BYD is a remarkable company run by a remarkable guy who started with \$300,000 in 1995 and is now the second largest cell phone battery maker in the world. BYD also has the best-selling car in China on a monthly basis. [Mid-American Energy CEO] Sokol has never seen a better manufacturing operation than BYD. BYD makes everything except the tires and glass to maintain quality control.”

Not only does Mr. Buffett see Wang Chan Fu as a remarkable businessman, but also a man of integrity. “It took eleven months for the transaction to be approved. BYD could have backed out of the deal terms – the price had run up to HKD 40 from HKD 8 – but Wang Chan Fu did not. I don’t understand the product, so I am betting on the man.”

“I’m always interested when I hear the words, ‘no one else can do it.’”

While Mr. Buffett generally spends a great deal of time explaining the principles and philosophy behind his investment process, convinc-

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ing him to divulge much about the practical implementation of his strategy is notoriously difficult. However, that did not stop one Columbia student from trying.

The topic of the question was Mr. Buffett's 1995 acquisition of R.C. Willey. Specifically, how was Mr. Buffett able to agree to a deal so quickly, and what did he focus on when reviewing the three years of financial history he requested? Without going into specifics of R.C. Willey, Mr. Buffett outlined four things he considers before committing capital to any investment. First, Mr. Buffett asks himself whether he can understand what the competitive dynamics are likely to be ten years into the future.

Second, he seeks to understand what the economics of the business are likely to be like over ten years. Third, Mr. Buffett relates the current price to those economics because, "There is no sense in studying something for a month only to find out the price is too high." Finally, Mr. Buffett asks if he can trust management's ability and integrity.

Summing it all up, Mr. Buffett explained, "Investing is laying out money today to get more money in the future. Aesop's 'bird in the hand is worth two in the bush' is what you spend

money to learn at business school. Of course, you also need to know how long and what interest rates, but 'bird in the hand' is the general idea."

Mr. Buffett then took the opportunity to describe

**"I'm always
interested when I
hear the words,
'no one else can
do it.'"**

what characteristics he looks for in a business with a few examples from Berkshire's portfolio.

When Craig Ponzio called to sell his business to Mr. Buffett, he explained, "Larson Juhl sells custom wood frames to 18,000 independent framers, calls on our customers five times per year, and guarantees next-day delivery for any order placed before 3pm, and no one else can do it," and Mr. Buffett is always interested when hears the words, "no one else can do

it." Customers cannot stock every frame in their shops, and all the picture owner cares about is getting a nice frame back fast. Mr. Buffett pointed out that it would be almost impossible to create a new competitor to call on Larson Juhl's 18,000 customers, so the company will do very well in its niche, even if it will never become very big.

Another favorite example that Mr. Buffett often cites is Coca Cola, which "has share of mind in the world that cannot be matched." Rattling off numbers, Mr. Buffett explained that there are 1.6 billion 8-ounce servings of Coke sold every day, and that number has grown every year since 1886. A one-penny price increase is worth six billion dollars per year to the company.

Berkshire owns more than 130 million servings, so I don't care if you drink it, just open the can and pour it on the person next to you." Mr. Buffett also noted that he always asks himself if he were handed one billion dollars, would he be able to kill the business, and clearly with Coke the answer is a resounding 'No.'

Mr. Buffett then drew the parallel between Coke and Berkshire Hathaway's See's Candies subsidiary. See's has raised prices every year since Mr. Buffett acquired the company in 1972. Explaining why this is possible,

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Mr. Buffett pointed out, “Who wants to hand their wife or sweetheart a box of candy and say, ‘I caught the low bid?’ If you only buy something one time per year, you generally don’t know or care what the price was last year. You just want a happy experience because it is an important gift to a loved one.”

Mr. Buffett then divulged the company’s highly effective marketing strategy, “Women plan ahead, but men wait until the last minute. That’s why See’s has their busiest day on the day before Valentine’s Day. So, we always have ads on the radio making men feel as guilty as possible.”

Newspapers and Mickey Mouse’s Agent

The conversation then turned to another business that Mr. Buffett bought into around the same time as See’s. According to Mr. Buffett, when he purchased his initial stake in the Washington Post, he was buying \$400 million of value for only \$80 million, but today he would not choose to own any newspaper businesses in his personal account, since the moat has disappeared. Although

newspapers have suffered from the effects of increased competition over time, Mr. Buffett then took the opportunity to describe a business where the moat has not eroded.

When he purchased five percent of Disney for \$4 million in 1965, Mr. Buffett was buying a company with, “no debt and rights to hundreds of successful past movies written down to zero. Constructing the Pirate ride for the theme park alone cost \$17 million at the

“You can’t get a great price in a negotiated deal between interested parties, but auction markets can lead to crazy prices.”

time. They recycled Snow White every seven years at a higher price even though there was no cost the second time around, and the Mouse didn’t have an agent! ESPN is their big business now and no one can go after it.

Cable operators hate them, because they charge such a high price – \$4 per sub per month plus ad sales – even though they have one fifth the viewership of CBS and NBC, which aren’t worth

anything. Control of important content leads to pricing power. Subscribers would reach for their pitchforks if the cable company tried to take away ESPN. I was against buying the remaining 20% of ESPN when I was on the board of Cap Cities. That decision probably cost the company \$5 billion.”

Where to look for investment opportunities

As any investor is aware, making the most efficient use of one’s time spent identifying and researching investments is a critical factor for success. Mr. Buffett emphasized this point by explaining his approach in his early years. “I went through all three thousand pages of the Moody’s manual, but I didn’t look at anything unless it was obvious. On page one thousand four hundred and thirty-three, I found Western Insurance Securities, which earned twenty-one and twenty-nine dollars in each of the past two years when it sold between three dollars and thirteen dollars.

At that point you just need to know if there is anything wrong. You interview agents and read the state insurance filings. You don’t need a 120 IQ. I bought twenty-nine dollars of growing earnings for sixteen dollars. I do not want to have to be smart. Small stocks sometimes sell at ridiculous prices. You can’t get a great

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price in a negotiated deal between interested parties, but auction markets can lead to crazy prices.”

“Never start a price war, and never lose one.”

Beer is a topic near and dear to many business students’ hearts, and given Mr. Buffett’s investment in Anheuser-Busch prior to its acquisition by Inbev, it was no surprise that the subject came up. Mr. Buffett heaped praise on the “brilliant” Jorge Paulo Lemann and current CEO Carlos Brito, who will “run the company as smart as anyone in the world.”

Mr. Buffett went on to discuss the dynamics of the beer business, explaining that with only a couple of big beer companies left, price behavior is very important, given the huge effect pricing has on profits. The most desirable situation is to have a big company that raises price every year and all of the others follow, which is why one rule Mr. Buffett has for Berkshire Hathaway’s businesses is to never start a price war and never lose one.

Managing Risk

Another Columbia student asked Mr. Buffett about how he analyzes risk. Mr. Buffett noted that as the CEO of Berkshire Hathaway, he is also the company’s chief risk

officer, and he would never offer any insurance policy or make any investment that risks the company. As chief risk officer, he dreams up scenarios worse than any other risk manager considers, thinking “like someone that runs a big casino, I care about the probability that all deals entered into have correlation.”

Mr. Buffett then went on to recount how Berkshire Hathaway insured the one billion dollar Pepsi challenge, where a lucky contestant had a one in one thousand chance of winning one billion dollars of payments with a present value of two hundred million dollars. A monkey made the drawing as twelve Berkshire Hathaway employees looked on. Originally, Pepsi had wanted Mr. Buffett to draw the winning number, but he jokingly offered to participate only if he could bolster his investment in Coca Cola by saying, “I am only doing this because Pepsi can’t be trusted.”

Bringing the discussion back to a more serious example, Mr. Buffett pointed out the history of Long-Term Capital Management, the failed hedge fund that nearly caused the collapse of Wall Street in 1998. “Here was a group of guys that had an average IQ of one-seventy, but they didn’t get it about risk – that human beings are involved. They operated with their own money, worked hard, and still went

broke.

To know that their concept was flawed, you only had to read financial history. Look at the thirty-year on-run, off-run treasury bond trade. In 1998 a ten basis-point spread was a two-sigma event, so everyone was in the trade, but the market went crazy and the spread went to thirty basis-points. The only way a smart person can go broke is by using borrowed money, but traditionally, risk analysis has been used to determine how much you can borrow.”

Parting Wisdom

Towards the end of the meeting, Mr. Buffett offered an explanation of what he has tried to accomplish through Berkshire Hathaway. “Ninety-eight point five percent of my net worth is in Berkshire stock, and it’s all going to charity. My goal is for my last check written in the world to bounce. Berkshire is my canvas, a platform for laying out my ideas for how businesses should be run.” As for the future, Mr. Buffett explained, “I have never had more fun than during 2009. Every day is like a treasure hunt. I don’t know about 2010, but there will be something. Having no called strikes is a huge advantage.”

This article was contributed by Matthew Gordon, MBA ’10.

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First Annual Moon Lee Prize for Excellence



Pictured: Bruce Greenwald, Jon Friedland '97, Alex Porter, Aaron Kuperman, Inder Soni, Anurag Dhanwantri, Grant Bowman '10 (1st Place), Sidney Gargiulo (2nd Place).

Finalists of the Moon Lee Prize For Excellence

1st Place	Grant Bowman	Short Avery Dennison Corp.
2nd Place	Sidney Gargiulo	Long Interactive Brokers Group
Runner-Up	Brad Doppelt	Long Cowen Group
Runner-Up	Matthew Lilling	Long Jos. A. Bank Clothiers

Over 100 alumni of the Applied Value Investing (AVI) Program gathered on December 8, 2009 for a reception and final presentations for the first annual Moon Lee Prize for Excellence.

The award is given in memoriam of Moon Lee, a dedicated value investor with Porter Orlin, LLC. In his honor, his friends at Porter Orlin initiated this competition for outstanding students in the AVI Program. The students competed for

cash prizes of \$15,000 and \$5,000 and the submissions were judged on the quality of their research and the concise presentation of a strong investment thesis.

The Moon Koo Lee Prize is given as a tribute to a respected colleague and a remarkable person. Moon worked at Porter Orlin from 2003-2008 and demonstrated a tireless ability to identify and analyze deep value opportunities where few could see.

Moon graduated Magna Cum Laude from Harvard College and received his MBA from Harvard Business School. During his MBA studies, Moon received the prestigious Dean's award for co-founding a Junior

Achievement mentoring program at a local public high school.

The program grew to 70 students and 60 MBA volunteers and impacted numerous lives. Moon loved to laugh and built strong ties to so many people. He is survived by his wife Martine, his parents, his sisters and countless devoted friends.

The four finalists, Grant Bowman, Brad Doppelt, Sidney Gargiulo, and Matthew Lilling were selected from a group of 24 contestants. At the reception, each student presented their analysis to the judges from Porter Orlin, including Alex Porter and Jon Friedland '97.

Following a sequence of insightful presentations and vibrant Q&A, the judges awarded first place to Grant Bowman for his *short* recommendation on Avery Dennison Corp. (AVY) and second place to Sidney Gargiulo for her *long* on Interactive Brokers Group (IBKR).

The competition was a success for everyone involved and as Mr. Porter commented, "All of us at Porter Orlin who read the written presentations were greatly impressed by the caliber of work submitted. They were thoughtfully conceived and then presented in an articulate way. We are honored to be part of the process."

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Please also share with us any suggestions for future issues of *Graham and Doddsville*:

Graham & Doddsville 2009 / 2010 Editors



Matthew Martinek is a second year MBA student and a participant in the Applied Value Investing Program. This summer he interned with William von Mueffling at Cantillon Capital. Prior to Columbia, Matt worked for three years with the small-cap value team at T. Rowe Price. Matt received a BBA in Finance and Accounting from the University of Wisconsin-Madison in 2005.



Clayton Williams is a second year MBA student and a participant in the Applied Value Investing Program. This summer he interned at Brandes Investment Partners in San Diego. Prior to Columbia, Clayton worked for four years in fixed income research and portfolio management at Martin & Company, a regional investment management firm in Knoxville, TN. Clayton received a BS in Finance and Accounting from the University of Tennessee in 2003.

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