# STOCKS 2008 

The Investor's Guide to the Year Ahead

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## Introduction

BY BILL MANN (BILLM@FOOL.COM)

## DEAR FOOLISH READER,

If you're as passionate as we are about investing, you will (if you haven't already) eventually find yourself in one of those cocktail party conversations, talking about stocks. When people find out that I pick stocks for The Motley Fool's small cap and international newsletters, they get pretty excited to tell me what they own. It usually goes something like this:
"I got a little nervous recently, so I dropped my KGO, LTIN, and ORFP and picked up shares in VJV, LGBF, MFOR, SBLU, and EXPS - you know, to play China. What do you think?"

Now, I'm generally the polite sort, so I don't say what I'm really thinking, which is, "I'd like to buy a vowel." You see, even though I make my hay in the stock market, a steady stream of tickers is usually little more than gibberish to me. There are thousands of publicly traded companies, each of them nearly infinitely complex. When someone mentions that he's bought and sold eight stocks in the last week, I simply want to scream "Based on what?!?"

On the other hand, if a serious investor rolls up his sleeves and researches a company inside and out - I mean, really tears into the numbers, evaluates management practices, looks at insider ownership, and so on - and finds an extremely compelling investment story, that makes for a much more interesting conversation (even without the help of extra party punch).

## SPIKE YOUR RETURNS

With that, I'm pleased to introduce the latest edition of one of The Motley Fool's most popular products, our annual stock-picking guide, this year charmingly rechristened Stocks 2008: The Investor's Guide to the Year Ahead. (My vote for Stocks 2007: The Reawakening was not well received.)

This guide represents some of the best thinking among our smartest stock pickers. If you subscribe to one or more of The Motley Fool's investing newsletters, many of these names will be well-known to you: David Gardner, Tom Gardner, James Early, Jim Gillies. Some names you might not recognize. But trust me, you should get to know them, because they're going to help make someone lots of money. Might as well be you.

As you thumb through the pages of this report and discover some of today's best investment opportunities, keep in mind that the authors did not interact or compare notes with one another. They weren't instructed to build the best portfolio. Each had a more straightforward task: Find the best company you can for 2008. As Shaquille O'Neal might follow up, "P-U-R-E-U-D."

So, that's what you're holding in your hands: not a fully formed portfolio, but rather, an amalgamation of great stocks. This is important, because it speaks to how we feel Stocks 2008 will be most valuable for you. What you're holding is a menu. And unless you're like my old college buddy who could walk into a diner, look at the menu, and say "I'll take it," you're best off choosing one or two items that look most appetizing to you. Anything more, and you're likely to leave with a doggie bag.

The following pages feature a smorgasbord of companies from an international beverage-making giant to a famed comic book enterprise to all-you-can-eat crab legs. The wide range of businesses offered here mimics the different themes of our investing services, from international to income-generating to the ultimate in growth. Still, if you carefully buy only one, Stocks 2008 could pay off for you many times over.

## A GLIMPSE INTO THE FUTURE

2007 has been an exciting year. The housing market, which, for years, pundits predicted would come to its demise, finally hit the wall. Financial investors worldwide were left holding the bag of mispriced mortgages that their own appetites for yield helped create. Oil ran up to nearly $\$ 100$ per barrel, and the dollar continued to collapse against currencies around the globe. Famed investor Warren Buffett let it be known that he had bought a huge stake in the Brazilian real in 2007 - an amazing occurrence when you consider the tendency of Brazil's currencies to devalue to confetti.

And yet, the U.S. stock market had a fine year, marked by some extremes in volatility absent in recent years. I believe fully that five years from now, the U.S. economy will be stronger and more powerful than it is today. So, as we look forward to 2008, it's important that we keep a long-term outlook beyond just one year, lest we miss out on the economic gains of 2013.

The market always gives us something to worry about, but investing in the right companies enables us to sleep soundly along the way. It's why we at The Motley Fool focus so many of our efforts on finding great stocks and allowing the wiggles and waggles to take care of themselves.

Enjoy Stocks 2008. More importantly, best of success in 2008!
Foolishly,


# Brinker International: A Tasty Investment Opportunity <br> BY CHARLY TRAVERS (CTRAVERS@FOOL.COM) 

## BRINKER INTERNATIONAL

| NYSE: EAT <br> www.brinker.com 6820 LBJ Freeway <br> Dallas, TX 75240 <br> 972-980-9917 |
| :---: |
| FINANCIAL SNAPSHOT |
| Share Price: . . . . . . . . . . . . . . . . . . . . $\$ 24.55$ |
| Shares Outstanding: .......... 105.3 million |
| Market Cap: . . . . . . . . . . . . . . . . $\$ 2.6$ billion |
| Cash: . . . . . . . . . . . . . . . . . . . . $\$ 78.9$ million |
| Debt: . . . . . . . . . . . . . . . . . . . $\$ 954.8$ million |
| Enterprise Value:. . . . . . . . . . . . . $\$ 3.5$ billion |

(Current as of 11/9/07)

## WHY BUY?

Pull up a chair, grab a fork, and bring your appetite for solid investments: When it comes to serving up an impressive performance, Brinker International (NYSE: EAT) delivers. It's one of the world's largest casual dining companies, run by a top-notch management team with decades of industry experience. A massive operation, it still has significant growth opportunities ahead of it, particularly in international markets. Outside of its ubiquitous Chili's Grill \& Bar chain, Brinker's portfolio also contains a small domestic footprint with room to increase store counts several times over.

The stock is trading near its 52-week low and is very attractively valued both relative to its peers and via a discounted cash flow methodology. Now is an excellent time to buy shares of this established industry leader.

## CORPORATE FACTS

Brinker was founded in 1975 and has more than 1,800 restaurants worldwide that generate annual revenue north of $\$ 4$ billion. These include several popular and successful chains, such as Chili's, Romano's Macaroni Grill, On the Border Mexican Grill \& Cantina, and Maggiano's Little Italy. Chili's is the company's flagship brand and accounts for $75 \%$ of Brinker's total restaurants.

| Restaurant Distribution |  |  |  |
| :--- | :---: | :---: | :---: | :---: |
|  | Total | Company-Owned | Franchised |
| Chili's | 1,361 | 921 | 440 |
| Macaroni Grill | 241 | 218 | 23 |
| On the Border | 158 | 132 | 26 |
| Maggiano's Little Italy | 41 | 41 | 0 |
| Sol |  |  |  |

Source: Brinker (as of June 27, 2007)
During its 2007 fiscal year, Brinker opened more new restaurants than any other casual dining company ( 149 company-owned, plus another 46 opened by its franchise partners). The brisk pace of new openings will carry over into the company's 2008 fiscal year, with 148 to 175 restaurants expected to open their doors.

The costs of opening and running a new restaurant are going up. But Brinker has already addressed this issue by shifting its mix of company-owned stores to franchised ones, thereby passing all of the costs to the franchisee. At the end of its 2007 fiscal year, $27 \%$ of Brinker's stores were franchised. Management's goal is to have $35 \%$ of its stores franchised by the end of fiscal 2008, with that number expanding further to $40 \%$ by 2010 .

Another company advantage is Brinker's CEO, Doug Brooks, who has been at the helm since 2004. Don't let that short tenure fool you. Mr. Brooks is a seasoned restaurant industry executive with an almost 30 -year tenure at Brinker, and he's spent much of this time working his way up the leadership ladder at Chili's. It's fair to say that he knows this business inside and out, and I have the utmost confidence in his ability to lead the company.

## INVESTMENT THESIS

With more than 1,800 locations, Brinker is a large and stable operation. But this doesn't mean that its growth story is over. Even though it's one of the largest players, it has only $3.2 \%$ market share in the heavily fragmented casual dining segment, so there's still ample room for growth.

Plus, you don't need to look far to see the hungry demand for casual dining services (like Brinker's) in the U.S.: How many times have you gone to a restaurant during prime time dinner hours and been stuck in a long line for 30 to 60 minutes, or more? You try another restaurant - but it doesn't help much, because they're all packed!

Brinker also has significant growth potential outside of the U.S., as it's only in the beginning stages of its international expansion. We are catching this movement as it happens, and Brinker is sitting in an excellent position as one of the top three companies focused on casual dining internationally. (Darden (NYSE: DRI) and Applebee's (Nasdaq: APPB) are the other two.)

Furthermore, Brinker's management team is focused on delivering returns to shareholders. The company generates cash flow in excess of its capital needs and returns that capital to shareholders via a quarterly dividend. It's also repurchasing millions of shares with the proceeds from divesting assets. (The diluted share count has dropped by $19 \%$ in the last three years.) It speaks well of management's capital allocation priorities to use this money to buy back shares instead of throwing it away on dubious empirebuilding acquisitions.

Casual dining is a very competitive industry, but one in which Brinker has thrived. Its popular brands and experienced management team should contribute to continued long-term performance. And, so far, the numbers speak for themselves: Despite a difficult macroeconomic environment for casual dining companies (thanks to factors like high gas prices and U.S. housing concerns), Brinker was still able to increase earnings per share by $14 \%$, fatten its dividend by $35 \%$, and repurchase 18.6 million shares during its 2007 fiscal year. Management has been authorized by the board to repurchase up to another $\$ 300$ million worth of shares, or roughly $10 \%$ of the outstanding stock at current prices.

## VALUATION

Many restaurant stocks have been hammered this year, and Brinker has fallen with them. Its shares are trading near their 52-week low, even though the company's financials are holding up well. At current prices, we are getting more than a $20 \%$ discount to where the company bought back shares this year. (From March through May, Brinker repurchased 10.9 million shares at an average cost of $\$ 31.76$.) The company appears to be attractively valued on both a relative and intrinsic basis.

It's also the second-largest publicly traded casual dining company, trailing only Darden, which operates the Olive

Garden and Red Lobster chains, among others. Brinker's shares are trading at just 13.4 times its trailing 12-month earnings. The company also sports an enterprise value of just 6.5 times EBITDA. These both suggest that it is valued at a significant discount to competitors Applebee's and Darden.

Ruby Tuesday (NYSE: RT) has a more comparable valuation. But this is despite Ruby Tuesday's flat operating income and earnings per share (EPS) for three years running, whereas Brinker's operating income is up slightly during the same period, with EPS nearly doubling.

Even if you break the numbers down further, Brinker still looks to be the bargain of the bunch when compared to its casual dining peers. It could very easily trade at $\$ 40$ if its multiples came in line with some of these other firms.

| Casual Dining Comps |  |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Brinker | Applebee's | Darden | Ruby Tuesday | P.F. Chang's |  |
| Ticker | EAT | APPB | DRI | RT | PFCB |  |
| Market Cap | $\$ 2,584.4$ | $\$ 1,900.9$ | $\$ 5,694.2$ | $\$ 763.1$ | $\$ 724.1$ |  |
| Enterprise Value | $\$ 3,460.2$ | $\$ 2,004.7$ | $\$ 6,317.4$ | $\$ 1,307.8$ | $\$ 863.2$ |  |
| Revenue | $\$ 4,402.7$ | $\$ 1,354.6$ | $\$ 5,675.0$ | $\$ 1,418.4$ | $\$ 1,054.7$ |  |
| EBITDA | $\$ 528.6$ | $\$ 202.0$ | $\$ 786.3$ | $\$ 230.1$ | $\$ 105.1$ |  |
| Net Income | $\$ 220.0$ | $\$ 67.9$ | $\$ 218.8$ | $\$ 81.2$ | $\$ 33.8$ |  |
| Cash from <br> Operations | $\$ 469.0$ | $\$ 181.6$ | $\$ 651.4$ | $\$ 179.2$ | $\$ 133.9$ |  |
| Diluted Earnings <br> Per Share | $\$ 1.84$ | $\$ 0.90$ | $\$ 1.48$ | $\$ 1.45$ | $\$ 1.30$ |  |
| Price-to-Earnings <br> Ratio | 12.9 | 24.3 | 15.2 | 10.2 | 21.5 |  |
| EVIEBITDA | 6.5 | 9.9 | 8.0 | 5.7 | 8.2 |  |

Data from trailing 12-month period. Dollar amounts in millions except for diluted earnings per share Source: Capital IQ

I calculated the company's value based on its ability to generate free cash flow: Brinker estimates that its capital expenditures for the 2008 fiscal year will be between $\$ 380$ million and $\$ 405$ million, a slight decrease from last year. I took the midpoint of this estimate, or $\$ 392.5$ million, and then backed out the amount the company plans to put toward opening new restaurants (roughly \$262.5 million). That leaves Brinker with around \$130 million to spend on maintaining and remodeling its existing stores.

When I subtract that from the cash the company will generate from operations in fiscal 2008 (I estimate this to be around $\$ 480$ million), I get free cash flow of $\$ 350$ million. This calculation assumes no growth from building additional restaurants. Using a discount rate of $11 \%$, which I feel is appropriate given Brinker's capital structure and size, the company is worth $\$ 27$ per share if its existing stores show zero growth in perpetuity. I don't know about you, but I think that's a pretty low hurdle to cross. If Brinker could generate just $3 \%$ annual growth from these stores, the stock would be worth around $\$ 38$ per share.

Furthermore, the company's management team is committed to investing in projects that deliver returns to shareholders. That
includes everything from divesting underperforming concepts such as its Corner Bakery chain to deciding not to invest further in the Macaroni Grill concept to shifting its mix of company-owned to franchised stores. This makes me confident that Brinker's investment in domestic growth and plans for international expansion will create value for shareholders. If I'm right, there will be additional upside in excess of the values I've calculated.

## CATALYSTS

Although the company's strategy in the U.S. has shifted from increasing store count to growing same-store sales, international markets are wide open for expansion. According to Brinker, the casual dining markets are not as competitive internationally, which gives this financially strong and experienced firm a leg up over its smaller U.S. brethren in moving into these markets. Franchise growth is driving the increase in international store count, and the number of Brinker's international locations is expected to double by 2010 .

There's also Brinker's decision to divest its Macaroni Grill chain in June 2008. With 218 company-owned locations up for grabs, this could bring a significant windfall. Using the proceeds from sales of Chili's to franchisees within the last year as a guide, the sale of all 218 Macaroni Grill restaurants should be able to fetch somewhere between $\$ 260$ million and $\$ 320$ million. Management's track record for the past few years suggests that such a windfall would be used to buy back a significant number of shares. At current prices, this would be approximately $10 \%$ of the shares, and this fits in nicely with the board's authorization to buy back $\$ 300$ million worth.

## RISKS

The casual dining space is extremely competitive, with many quality companies fighting for the diner's dollar. In Brinker's last annual report, Doug Brooks wrote about how the U.S. had one restaurant for every 1,000 people 30 years ago. Today, that ratio is one for every 526 people, which is great for consumers but hard on the businesses.

In addition, the restaurant business is sensitive to economic conditions - when times get tight due to rising fuel or housing costs, restaurants are an obvious item to cut out of the family budget. Brinker is feeling some of the impact of that difficult macroeconomic climate, and declining guest traffic triggered a modest decline of $2.7 \%$ in same-store sales across all of its brands in fiscal 2007. Geographical diversification via expansion
into Asia, India, the Middle East, and Europe could alleviate some of this risk in the future.

There's also the issue of inflation, a double whammy for restaurants: Not only does it reduce consumers' discretionary income, but it can also result in higher food prices that a restaurant may not be able to pass on to its customers through price increases. This can have a noticeable impact on the company's margins as it gets squeezed on both its sales and expenses.

Lastly, Brinker is very dependent on the continued success of its Chili's brand, since Chili's accounts for $75 \%$ of the company's total restaurants and $78 \%$ of its total profits. If the chain were to fall out of favor or have operational difficulties, that would have a significant impact on Brinker's financials. However, this does not appear to be an issue right now, as Chili's is Brinker's fastest-growing brand.

## SELLING CRITERIA

Barring any significant changes to Brinker's business and the goals management has laid out, I recommend selling if shares get into a range of $\$ 40$ to $\$ 45$ within the next 24 months. Of course, if major changes suddenly improve Brinker's prospects, that price target would get thrown out the window, and we'd need to re-evaluate the company based on the new information.

If Chili's comes under increasing pressure from competitors or economic factors to the point where there is a prolonged period of same-store sales declines, you may want to reconsider owning the stock.

Management has a solid track record of making smart strategic decisions, such as selling off underperforming assets and shifting its mix of company-owned stores to franchised ones when economic conditions make it prudent to do so. So, a change in management would be grounds for considering a sell.

## THE FOOLISH BOTTOM LINE

Brinker has a very experienced management team, a large number of restaurants in its portfolio of well-known brands, exciting international expansion opportunities, solid growth, and good margins. The stock is trading at a very attractive price from which investors can expect to make $30 \%$ if management can execute its strategy. An investment in Brinker at current prices should provide returns that trounce the market in coming years.

At the time of publication, Charly Travers did not own shares of any company mentioned in this write-up.

# Canadian Imperial Bank of Commerce (CIBC): Big Profits in Loonie Land <br> \author{ BY JAMES EARLY (JEARLY@FOOL.COM) AND JIM FINK (JFINK@FOOL.COM) 

}

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## FINANCIAL SNAPSHOT

Share Price:. ......................... \$102.14
Shares Outstanding: ........... 334.6 million
Market Cap: . . . . . . . . . . . . . . . . . $\$ 34.2$ billion
Note: Cash, Debt, and Enterprise Value not shown due to lack of applicability to banking firms.
(Current as of 11/9/07)

## WHY BUY?

What a great time to be Canadian! The Canadian dollar — nicknamed the "loonie" after the duck-like creature on the back of the country's 11 -sided dollar coin — recently traded at a 31-year high of $\$ 1.04$ against the U.S. dollar (above parity!). The commod-ity-based Canadian economy is booming in conjunction with record-high prices of crude oil, metals, and agricultural products. Unemployment is at a 33-year low, and the government's budget surplus for fiscal 2006/07 came in at a whopping $\$ 14$ billion, $50 \%$ higher than expected. Even better, the Organisation for Economic Co-operation and Development (OECD) expects Canada to be the only G-7 country to post a government surplus in both 2007 and 2008. Did we mention that debt is at its lowest level in 14 years? Best of all, this economic juggernaut shows absolutely no signs of slowing down anytime soon.

That brings us to the important question: How can we profit from these economic fireworks? Money is the linchpin of a strong economy, so if you want to take advantage of Canada's economic boom, banks are the perfect place to start. That's especially true in the case of Canadian Imperial Bank of Commerce (NYSE: CM), more commonly known as CIBC.

CIBC's impressive performance speaks for itself: In 2006, the company's total shareholder return was $25.6 \%$, highest among all of the major Canadian banks. CIBC churned out an astounding $142.8 \%$ total return for the past five years, including quarterly dividend growth of $112 \%$. Want to go back further? In the past 10 years, CIBC's return clocked in at $120 \%$, beating the S\&P/TSX Composite Index return by $215 \%$. In addition, the company has increased its dividend in nine of the past 10 years. No matter what timeframe you look at, CIBC is a top performer.

## THE BIG WHO?

It's also one of Canada's Big Five Banks. If you're an investor residing in the U.S., you might think this designation just means that CIBC is large, but Canadians know that it means much more. You see, the banking systems in Canada and the U.S. are like night and day: Whereas U.S. law promotes the creation of small, local banks, Canada has always valued the stability of having only a few nationwide banks that are wellcapitalized, provide a full range of financial services other than just retail banking, and have many branch locations throughout the country. In other words, Canada's banking system is a protected oligopoly with little competition, and CIBC is in this elite club. The Big Five Banks in descending order of market cap are:

[^0][^1]The Canadian government has resisted calls to let the Big Five merge, but the disparity in size between banks outside of Canada (which have been allowed to merge) and Canadian banks has grown wider, leading to renewed calls for merger approvals: In the past few years, everyone from the OECD to Bank of Canada Governor David Dodge (Canada's version of Fed Chairman Ben Bernanke) have presented cases for why bank mergers would be in the country's best economic interest.

Mergers among Canada's Big Five will take place eventually. When that happens, you'll want to own the smallest members of that group (i.e., the acquisition targets). CIBC and Bank of Montreal are the two smallest, and their shareholders would likely be offered a hefty premium in any acquisition.

Another possibility for a takeover premium involves the elimination of a cap that currently prevents an individual shareholder from owning more than $20 \%$ of a bank's voting shares. (The cap really throws a wrench in things if your firm wants to acquire a large Canadian bank, for example, because having only $20 \%$ of the voting rights wouldn't enable you to control the bank, which kills the mood for making the acquisition.) According to Desjardins Securities, if the Canadian government lifts this cap, CIBC is one of the most likely acquisition targets. Getting in now before these regulatory changes occur could be highly profitable.

## CORPORATE FACTS

Just calling CIBC a bank doesn't quite give it enough credit. It's a financial services conglomerate with more than $\$ 300$ billion in assets, more than 1,000 bank branches, around 3,800 ATMs (see chart below for scintillating details) and two divisions: (1) CIBC Retail Markets; and (2) CIBC World Markets.

## CIBC RETAIL MARKETS

The retail division is the flagship business centered in Canada (with a little Caribbean spice), servicing more than 11 million

## Retail Branches and ATMs



Source: September 2007 CIBC investor presentation
customers and offering retail banking, securities brokerage, mortgage lending, private wealth management - and credit cards.

Why did we put that Captain Kirk-like pause before the credit card part? Because CIBC is Canada's market leader in credit cards, with an $18 \%$ share of card loans outstanding. Being the leader is a good thing, especially now, because Visa, the largest credit card network in the world, is converting from a private membership association including 20,000 financial institutions to a stock corporation. Member banks like CIBC have received stock in the new corporation in proportion to their share of Visa cards, and CIBC is the biggest beneficiary among Canadian banks. On Nov. 9, it announced that it had received almost \$500 million dollars in Visa stock.

CIBC is also expanding its retail banking franchise geographically, having increased its holdings in FirstCaribbean International Bank, a 100-branch bank with $\$ 12$ billion in assets, from 43.7\% to a controlling $91.5 \%$ interest. Headquartered in Barbados, FirstCaribbean provides CIBC geographic diversification that should serve it well given the relatively mature Canadian market.

## CIBC WORLD MARKETS

The World Markets division is centered in Canada and the U.S. and offers investment banking services (advisory, capital markets, research, and trading), merchant banking, and commercial lending. In Canada, it leads in several investment banking categories:

- No. 1 advisor by number of deals for six consecutive years
- No. 1 in deal value among Canadian advisors for six consecutive years
- No. 1 in equity underwriting issues from 2000 to 2006
- No. 1 in structured product underwriting since 2000

Not too shabby, eh? In the U.S., World Markets is not one of the big boys, but it is a profitable niche player, focusing on smalland mid-cap corporate clients (see pie chart below).

## THE GOOD, THE BAD, AND THE UGLY

It all sounds great so far, but as we learned from Harry Potter, every good story has its dark side. CIBC ran into some trouble starting in 2003. The company couldn't turn a profit with

C|BC's Farnings Before Taxes


Source: Capital IQ

Oppenheimer \& Co., the U.S.-based securities brokerage it had acquired in 1997, so it sold the business to Fahnestock for less than half what it paid six years earlier. This followed CIBC's decision to pull the plug on its money-losing Amicus online banking venture with the Winn-Dixie and Safeway supermarket chains.

A couple of scandals also proved costly for CIBC: The U.S. Securities and Exchange Commission (SEC) fined the company $\$ 80$ million for helping Enron commit fraudulent accounting and banned its World Markets division from engaging in structured finance underwriting for three years. Plus, prior to being sold off, Oppenheimer had gotten involved in the late trading and market timing mutual fund scandal. CIBC agreed to pay a $\$ 125$ million fine to the SEC in 2005 to settle the mutual fund charges. That same year, it agreed to settle a class action lawsuit over its involvement with Enron for $\$ 2.4$ billion.

Bottom line, retail banking in the U.S. was no picnic for CIBC. The company's market cap ranking fell from second to fourth place among the Big Five Banks, and in November, CIBC agreed to sell off its U.S. investment banking, equities, and leveraged finance businesses to Oppenheimer Holdings for a deferred amount based on the next five years' financial performance.

## EXTREME MAKEOVER

The cleanup and rejuvenation of the bank is attributable to Gerald McCaughey, who took charge of the then-troubled CIBC World Markets in February 2004 and became CEO of the entire company in August 2005. Under his tutelage, CIBC is now a model of corporate virtue. In September 2007, the company was recognized by the Canadian Coalition for Good Governance in both executive compensation disclosure and shareholder communication. CIBC is one of the few companies to report the individual financial goals that comprise the CEO's compensation, and it awards the CEO bonuses one year in arrears so that the board can consider any post-year-end adverse events (e.g., financial reversals caused by accounting shenanigans).

Good corporate governance is important to the investment thesis for CIBC. A 2003 joint Harvard and Wharton study entitled "Corporate Governance and Equity Prices" found that companies with sound corporate governance generated superior future returns, higher profits, and sales growth. Since McCaughey has only been in charge since 2005, these benefits are just starting to show in CIBC's stock price, and the stock will continue to benefit from this shareholder-friendly phenomenon in the future.

## FINANCIALS

CIBC is also an incredibly profitable bank. In the U.S., a return on equity (ROE) in the low $20 \%$ level is considered "best of breed." But CIBC's ROE is in the high $20 \%$ level and moving toward the unheard of $30 \%$ mark (see chart in upper right corner).
The decline in 2005 was an anomaly due to the $\$ 2.4$ billion Enron lawsuit settlement. The trend is undeniably up and should only strengthen given that the company is buying back its own

C|BC's Return on Equity


Source: Capital IQ
stock. In April 2007, CIBC's board authorized the repurchase of up to 10 million shares through October, and the company repurchased 3.1 million shares at an average price of around $\$ 100$ per share. In November, the board authorized a new repurchase of up to 9 million shares (approximately $2.7 \%$ of shares outstanding) through October 2008.
Thanks to cost control and efficiency improvements, CIBC's earnings per share have grown at a $31.4 \%$ compounded annual rate during the past five years. Even better, CIBC is dedicated to returning its excess cash to shareholders. The company's policy for its dividend payout ratio is between $40 \%$ and $50 \%$ of net income. Its earnings are growing so fast that it's had to increase its quarterly dividend to keep up, and even after the increase, the payout ratio is $37 \%$, still lower than the company's target range. Consequently, we expect more dividend increases. Also, academic research has shown that the stocks of dividend-paying companies outperform the general market. Stocks of companies that increase the dividend perform even better.
Plus, CIBC has another advantage: Whereas some of the other Big Five Banks are spending like crazy, expanding outside of their core Canadian markets (e.g., Toronto-Dominion's recent offer to acquire Commerce Bancorp (NYSE: CBH) for $\$ 8.5$ billion and Royal Bank's plan to acquire Alabama National (Nasdaq: ALAB) for $\$ 1.6$ billion), CIBC is playing it cool and conservative, focusing on its top-notch Canadian operations and limiting foreign ventures to add-on investments in companies it already knows well (e.g., FirstCaribbean). Return on capital is the key to increasing value, and that is where CIBC shines by focusing investments on its core business.
The last important metric to look at involves capital liquidity and loan quality. CIBC's Tier 1 capital ratio (which determines whether a bank is adequately capitalized under regulatory agency definitions) is a healthy $9.7 \%$, higher than the Big Five average, above the company's own target of $8.5 \%$, and far above the regu-
latory requirement of $7 \%$. In addition, the loan-to-deposit ratio is only $70 \%$, which leaves CIBC with room for highly profitable loan growth financed with its low-cost deposits.

## INVESTMENT THESIS AND VALUATION

If the key to a good investment was simply a great business, we could just stop now and tell you to buy CIBC stock. But CIBC's market-leading position, excellent corporate governance, high profitability, earnings growth, and plump capital cushion wouldn't mean squat if the stock was overvalued. Fortunately, it is significantly undervalued. According to our excess returns valuation model, CIBC is currently worth $\$ 138$ per share, more than $30 \%$ above its current price despite our conservative assumptions. Although the bank's ROE is $28 \%$, heading toward $30 \%$, we model in $21 \%$ initially with a quick descent to $17 \%$.

A multiples analysis also reveals CIBC to be undervalued:

|  | CIBC | Royal Bank <br> of Canada | Bank of <br> Nova Scotia | Toronto- <br> Dominion Bank | Bank of <br> Montreal | Competitors' <br> Average |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| TTM P/E | 11.4 | 13.5 | 13.2 | 14.5 | 14.0 | 13.8 |
| TTM $=$ Trailing 12 months <br> Source: Capital IQ |  |  |  |  |  |  |

If CIBC traded at the price-to-earnings $(\mathrm{P} / \mathrm{E})$ ratio of TorontoDominion, it would be trading at $\$ 133$, pretty close to our excess returns valuation of $\$ 138$. Take into account CIBC's higher earnings growth, and one could argue that its $\mathrm{P} / \mathrm{E}$ ratio should be even higher. When you combine CIBC's undervaluation with a dividend yield of $3.3 \%$, investing in the company right now looks mighty attractive.

## CATALYSTS

CIBC's undervaluation is partly based on fear that the regulatory problems the company faced in the past could reoccur. As time passes and investors realize that Gerald McCaughey is the real deal when it comes to ethics, the "Enron discount" will disappear. Secondly, there is fear concerning CIBC World Markets' $\$ 1.7$ billion exposure to U.S. mortgages. Due to the housing market crisis, CIBC had to write down the value of its investments in residential mortgages to the tune of $\$ 300$ million in the third quarter. It has announced an additional $\$ 490$ million in write-downs in the fourth quarter.

Investors fear that even more write-downs are yet to be announced. If they don't materialize (and we don't expect they will, given that the company has already written off $44 \%$ of its U.S. residential mortgage portfolio, and less than $60 \%$ of CIBC's total mortgage exposure is subprime-related), the stock could rally significantly.
Finally, if new elections were to take place that gave free-market Conservative Prime Minister Stephen Harper the political
mandate needed to allow bank mergers or foreign takeovers, our valuation of CIBC's shares would increase substantially.

## RISKS

The Canadian economy is so strong that there is the risk that it can't get any better or could even reverse. This would especially hurt CIBC, because its conservative business model relies more on the domestic Canadian market than its globetrotting peers do.

For U.S. investors, currency risk is always present. With the Canadian loonie at a 31-year high against the U.S. dollar, a reversal that strengthens the U.S. dollar would definitely hurt.

If the Conservative Party loses the next election, the chances of bank merger reform would disappear, and any merger-based speculation built into CIBC's share price would be wrung out. Also, if the credit losses CIBC World Markets suffered from the subprime crisis are worse then expected, the stock could drop. Finally, the U.S. arm of the investment banking division is a niche player that has struggled in the past and could be a drag on future profits.

## SELLING CRITERIA

Gerald McCaughey has been such a critical and driving force behind CIBC's emergence from scandal that we would seriously consider selling if he were to step down. Any additional ethical problems at CIBC World Markets would also be a deal breaker for us, because it would mean that McCaughey wasn't as on the ball as we think he is. We'll also be watching the company's profitability very carefully for further improvement, because, given CIBC's lower-than-average revenue growth, cost control is critical for earnings growth. Lastly, if the stock were to shoot above our fair value estimate, we'd consider selling.

## THE FOOLISH BOTTOM LINE

The world's best investments in the past five years have included Canadian banks, and the reasons for this remain in place with no reversal in sight. CIBC is the most profitable of the Big Five Banks, with a leading share in the Canadian market, yet the stock is selling at the cheapest multiple of the group. Furthermore, "good guy" McCaughey gives the company the integrity and management strength to convince investors that scandals are a thing of the past. Now is a perfect time to snap up shares of this Canadian powerhouse before the Street realizes that it deserves a premium valuation.

> At the time of publication, neither James Early nor Jim Fink owned shares of any company mentioned in this write-up. Bank of Nova Scotia is a Motley Fool Income Investor recommendation.

## STOCKS 2008

# Charlotte Russe Holding: A Sweet, Cheap Stock Idea <br> BY ALYCE LOMAX (ALOMAX@FOOL.COM) 

## CHARLOTTE RUSSE HOLDING


(Current as of 11/9/07)

## WHY BUY?

"Charlotte russe" is a dessert that incorporates Bavarian cream and ladyfingers. Pretty sweet, eh? Even more important, Charlotte Russe Holding is a retailer of inexpensive, fashionable clothing for teens and young women, with a swift turnaround that helps give it a competitive edge.

Recent events have led to the kind of opportunity Foolish investors love to see - the company's shares trade at what looks like a ridiculously low valuation, particularly when compared to many of its retail peers. Its value-priced merchandise and continuing expansion into new markets in the U.S. make Charlotte Russe an extremely attractive investment idea.

## CORPORATE FACTS

Charlotte Russe unveiled its first store in Carlsbad, Calif. in 1975. For the next 20 years, the company slowly grew its base to 35 stores, all situated in Southern California. But in 1996, Bernie Zeichner and private equity firm Saunders, Karp \& Megrue acquired the retailer from its founders. From there, the company began its significant expansion in the United States.

Who is the typical Charlotte Russe customer? According to the company, it's a hip, trendy teenager, or a young, fashionable working woman who's looking for office-worthy attire. In sum, they're young women who want to dress up and stay current with trends without breaking the bank - a category that potentially includes millions of females.

But beyond having a vast target market, Charlotte Russe also has a major competitive advantage: It's a "fast fashion" retailer, which means that it brings its high-fashion apparel, footwear, and accessories to its stores faster than the competition. In the company's annual regulatory filing, Charlotte Russe boasts of its "active inventory management," which enables it to provide fast turnaround, principally because it deals with domestic vendors. Plus, most of the merchandise the company carries comes from its own proprietary brands: Charlotte Russe, Refuge, and Blue Chic.

Like its customers, Charlotte Russe is also smart when it comes to preserving its moola. The company strategically seeks out key locations in busy areas of desirable malls to save money on marketing expenditures. At the end of June, it had 408 stores in the U.S. and Puerto Rico, and it plans to have 432 by the end of 2007.

## INVESTMENT THESIS

Charlotte Russe has a market cap of just $\$ 338.9$ million, so in case you were looking for a small-cap stock that provides growth and value, this could be the one for you. And, considering the fact that it has cash on its balance sheet, it's got an enterprise value of $\$ 251.4$ million.

The company's ability to provide trendy items quickly and at reasonable prices already puts it in a sweet spot, but the retailer also sees room for more growth, forecasting the potential for owning 600 Charlotte Russe stores. It will likely reach this target in the next couple years, barring any unforeseen roadblocks to its expansion.

Charlotte Russe is also a financially well-managed company. It doubled its operating income in fiscal 2006 compared to fiscal 2005 levels. In addition, it has been enjoying increasing returns on assets (ROA), capital (ROC), and equity (ROE), all of which are at impressive double-digit levels. Just look at how it stacks up against the retail sector:

|  | Charlotte Russe | Retail Sector |
| :--- | :---: | :---: |
| Return on Assets | $10.3 \%$ | $7.7 \%$ |
| Return on Capital | $18.2 \%$ | $11.8 \%$ |
| Return on Equity | $19.3 \%$ | $17.3 \%$ |

Data from past 12 months
Source: Capital IQ
The company has been able to fuel its expansion with cash on hand, and it currently has $\$ 87.5$ million in cash, or $\$ 3.44$ per share, and no long-term debt. (However, like many retailers, it does have long-term obligations in the form of operating leases.) It's also a free cash flow positive company, generating $\$ 44.7$ million in free cash flow last year.

Even better, Charlotte Russe is returning some of that cash to shareholders in the form of a $\$ 25$ million share buyback, which will take place over the course of the next year. Most Fools know that buybacks aren't always the be-all and end-all, and they can destroy shareholder value if the stock is overvalued. But for Charlotte Russe, which appears to be extremely undervalued, this seems a logical way to benefit shareholders with its cash.

## VALUATION

As is usually the case when a stock becomes a bargain, there are a few reasons why this one is cheap. In July 2007, although the company nearly doubled net income in the third quarter, Charlotte Russe warned that its profit would drop in the fourth quarter, and that it would have flat same-store sales for the period. (Charlotte Russe's fourth quarter ends in September, before the critical holiday season, although it does include back-to-school results.) That certainly wasn't good news, but the beating this stock has taken seems overdone given that the company is expected to report double-digit earnings growth for the next several years. Consequently, this temporary setback has given us an excellent opportunity to buy at a cheap price.

When Charlotte Russe reported its fourth-quarter results, its profit dropped as expected, but the company did better than Wall Street analysts had anticipated, even in such a difficult macroeconomic environment (it hasn't been a cheery year for retail in general), a notable achievement. Although management is being conservative with first-quarter guidance, it said that quarter-to-date, its comps are tracking positively, which is also a big positive with so much near-term concern about consumer spending.

And the shares look darn cheap. Even after a surge from the company's fourth-quarter earnings results, the stock still trades at 11 times trailing earnings and just nine times forward earnings. Its PEG ratio, which compares its price to its five-year expected
growth, is a mere 0.53 , and its price-to-sales ratio is 0.49 . It's rare to see a retailer with such multiples (unless it's one that has illustrated protracted struggles and financial deterioration, like Pier 1 Imports (NYSE: PIR) or Wet Seal (Nasdaq: WTSLA)), but that's just what has happened to Charlotte Russe shares, even though the company doesn't have these problems.

You'll find several retailers trading at much higher valuations, and many of them possess far less exciting - and in some cases, maybe even doubtful - prospects. For example, take Hot Topic (Nasdaq: HOTT): The company has struggled for several years, reported dwindling earnings, sales, and same-store sales, and yet, that stock still trades at a bubbly 23.5 times earnings. In comparison, lower expectations are built into Charlotte Russe's stock, even though the company appears to have a brighter future. Should the Street suddenly discover the error in this evaluation, investors who buy now will enjoy a handsome profit to put toward their next Charlotte Russe shopping excursion.
And, of course, there's also its growth rate to consider. Charlotte Russe is expected to report growth of $18.25 \%$ per annum for the next five years. That growth rate isn't accounted for in its current multiples, reinforcing the idea that this stock has simply gotten beaten up too badly.

## CATALYSTS

Although Charlotte Russe has many stores in the Southern regions on both coasts (especially California, Texas, and Florida), it has very few in the Northwest (the Seattle area, for example) and the Northeast (particularly Massachusetts). The company is currently working to move into these untapped markets, and it still plans to expand in existing ones as well.

Meanwhile, some of the struggles its rivals are experiencing might benefit Charlotte Russe: Wet Seal has been suffering decreasing earnings several years running, and it has struggled with comps, showing that maybe it's lost touch with its customers. Forever 21 has been hit by lawsuits from several retailers and designers who are accusing it of outright copying fashions. One wonders whether the negative press might drive some young women away from Forever 21 and into Charlotte Russe.

Nobody wants to see an economic slowdown, and, of course, all retailers can face hardship if consumers close their wallets. As 2007 draws to a close, the word is that the housing slowdown will continue to pinch many consumers next year. A retailer that helps young women dress fashionably for less should be fairly insulated and do well regardless of macroeconomic trends, as long as it keeps the fashions fresh and the prices tantalizing, and Charlotte Russe is adept in this area.

Finally, the company launched its e-commerce site this past summer. OK, that's kind of behind the times, but better late than never. Web shops help retailers make better connections with customers, and they can function not only as shopping portals but also as relatively inexpensive marketing. I did some

Googling of Charlotte Russe and noticed that the buzz (anecdotal as it may be) from young women in the blogosphere and retail review sites appears to be positive, with goodwill surrounding its inexpensive price points; so having a fully functioning Internet presence is a grand idea.

## RISKS

The company faces stringent competition, since so many companies target the lucrative youth demographic, particularly teens. And, of course, teens are generally much more concerned with being fashionable than they are with macroeconomic conditions. Drill down deeper into fast, inexpensive fashion, and there's not just Wet Seal and Forever 21, but you could argue that discount retailer Target (NYSE: TGT) is also a formidable competitor, given its ability to provide inexpensive yet chic fashions for hip, budget-minded women of all ages.

Speaking of rivals, though, I'll be the first to admit that this company doesn't get nearly as much attention as many other hot retailers like, say, Abercrombie \& Fitch (NYSE: ANF) or J. Crew (NYSE: JCG). Those, of course, make good financial press, given their splashy brands and charismatic CEOs. And while buzz and unbridled optimism can often pump retail stocks to artificially expensive levels, lack of buzz can sometimes mean that a stock languishes despite good results.

Rivals are a normal risk for any retailer, of course. However, one chapter of Charlotte Russe's history is worth noting: In 1998, the company acquired a concept called Rampage, which also sought to provide fashions for young women. Rampage's business trends rampaged south in fiscal 2004, and in fiscal 2006, Charlotte Russe sold some of the 64 Rampage stores to fastfashion rival Forever 21 and converted others into the Charlotte Russe format. In 2003, it shut down another ancillary concept, Charlotte's Room, which sought to provide accessories to teens and 'tweens. Of course, not every business acquisition turns to gold, and I'm glad to see that in both cases, Charlotte Russe was wise enough to cut an ailing business in order to focus on the ones that work.

It might be nice if the company did have an additional growth vehicle (many successful retailers offer several concepts), especially considering that it looks like Charlotte Russe will reach its 600 -store target in a couple years unless it has to slow expansion for some reason. However, those two shutdowns provide some food for thought. Would the third time be the charm?

Last but not least, this bit comes straight from the company's risk factors in its annual regulatory filing: Charlotte Russe has just
two distribution facilities, and both are in California (Ontario and San Diego). Although the company's roots are in California (and a fair amount of its stores are concentrated in California and the Southwest), the conservative side of me would like to see a little diversification there (not to mention, one major California earthquake could potentially cause major disruption to its business; and this year, we've seen the state's vulnerability to other natural disasters, like wildfires.) For this reason, I'm glad to see that the company is gearing up to expand across the U.S.

## SELLING CRITERIA

Charlotte Russe is an excellent, value-priced stock to buy now and hold on to for the next several years. For the very long term, investors will need to keep an eye on future developments. The company is relatively close to its limit for the number of stores it believes it can sustain with the Charlotte Russe chain. Will it attempt, once again, to either acquire or start a new concept in order to have an additional growth vehicle? If it does, will it be able to make a more successful go of it than it did with Rampage and Charlotte's Room?

Over the next year or two, investors will also need to watch how successful the company is in the new regions where it plans to open stores. Young women in these regions may have little idea of its brand and mission, and while its value proposition and fashion sense have brought it success elsewhere, entering into new markets may present some challenges.

Part of the reason I feel Charlotte Russe is a great investment is its strong balance sheet. However, I've seen in the company's conference calls that analysts have asked about its capital structure and its lack of debt. Personally, I prefer debt-free companies, and if Charlotte Russe ends up taking on onerous levels of debt, I would find it a far less attractive investment.

## THE FOOLISH BOTTOM LINE

I follow the retail industry closely, and there are few occasions when a retailer gets this cheap without having a serious problem. In fact, oftentimes still-struggling retailers get mighty pricey as investors get ahead of themselves expecting a turnaround. That's why Charlotte Russe holds so much profit potential for investors. There doesn't appear to be any serious problem with its business, just some temporary sluggishness that often hits retail stocks. Charlotte Russe may not have as high a profile as other teen retailers, but the super reasonable valuation makes up for the lack of buzz.

At the time of publication, Alyce Lomax did not own shares of any of any company mentioned in this write-up.

# FARO Technologies: A Company That Measures Up 

BY STAN HUBER (SHUBER@FOOL.COM)

## FARO TECHNOLOGIES

## Nasdaq: FARO

www.faro.com
125 Technology Park
Lake Mary, FL 32746
407-333-9911

## FINANCIAL SNAPSHOT

| Share Price: | \$27.06 |
| :---: | :---: |
| Shares Outstanding: | .. 16 million |
| Market Cap: | . $\$ 433$ million |
| Cash: | \$98.2 million |
| Debt: | . $\$ 0.3$ million |
| Enterprise Value:. . | \$335.1 million |

(Current as of 11/9/07)

## WHY BUY?

Whether you need to design a car, restore an old building, or map a crime scene (think of those snazzy 3-D laser systems you see on CSI), these and numerous other tasks require precise measurement - and FARO Technologies (Nasdaq: FARO), the world's leading manufacturer of 3-D measurement systems, stands at the frontlines of this demand.

The market for FARO's products is still in its infancy and appears poised for widespread adoption. Furthermore, the company recently raised additional cash through a secondary equity offering. Its valuation may not look attractive at first glance shareholders who have held on since the dark days of 2002 have already claimed a 20-bagger. However, FARO is still a small-cap company with market leadership in an extremely underpenetrated industry. Investors with a long-term horizon should be amply rewarded for making it a core holding in 2008.

## CORPORATE FACTS

FARO was founded in 1982 and serves a market known as CAM2, which stands for computer-aided manufacturing measurement. If you can imagine all of the industrial, construction, manufacturing, and forensic applications that require careful measuring, you'll get an idea of where CAM2 fits in. For example, if a company needs to design an aircraft, satellite, medical device - even a nuclear power plant - it can use CAM2 technology to measure each piece and component along the way.

The growing popularity of CAM2 is a huge boon for FARO, since the company is a leading supplier of CAM2 equipment. FARO also uses computer-aided design (CAD) software, the standard for designing the mechanical components for everything from cars to tiny integrated circuits. We're up to two acronyms already, so here's an example of how it all works:

## MEASURED TO PERFECTION

Imagine that your company wants to create a new line of widgets. Your staff spends several months drafting the design with numerous mechanical drawings. Once you finally build the widgets, you discover that the design contains some flaws. Bummer, huh?

Now envision a scenario in which you have CAD, software that efficiently generates 3-D images of the widget that you can lay out and design right on the screen. It works faster and more cheaply than your mechanical draftsmen, and the changeable 3-D image makes it easier to pinpoint design flaws before you begin to build.

Meanwhile, you use CAM2 technology to carefully measure every aspect of the design along the way. You compare that data with the CAD data to make sure everything will fit before it's all assembled. By the time you're ready to gear up production, you've already reduced scrap, improved quality, and minimized your costs.
CAM2 systems are expected to follow the adoption cycle of CAD and become widely used throughout the manufacturing industry over the next decade. Aside from designing and building things from scratch, an increasing number of customers are also turning to FARO's product line for modeling and analysis of completed structures. (If, for
example, a 50-year-old pump needs to be replaced, and its manufacturer no longer exists, a company can use FARO's equipment to reverse engineer the pump and make an identical copy.)
Lastly, demand for FARO's products is being driven by modern manufacturing methodologies such as total quality management (TQM) and Six-Sigma. These methods aim to greatly reduce defects and strive for continuous improvement, and they require measurement at every step of the manufacturing cycle. Traditional measurement techniques can't address many of these steps - but FARO's can.

## A PEEK INSIDE FARO'S PRODUCT PORTFOLIO

FARO's main products include the FaroArm, ScanArm, Gage, and LaserTracker. Each of these measurement devices comes with a computer and associated software. The smallest, cheapest, and most accurate device is the Gage, which is mounted on a lab bench and used to measure smaller parts made by computer-controlled milling machines. The portable FaroArm and ScanArm are used for precision measurement of medium-sized objects. The LaserTracker can measure objects up to 230 feet in length with extreme accuracy using an ultra-precise laser beam.

To spread its wings further, FARO purchased a small German company in 2005 called iQvolution. The company made this strategic move in order to enter broader 3-D measurement markets. The product it obtained in the acquisition, the FARO Laser Scanner, can be thought of as a 3-D digital camera capable of taking a picture of an entire room. It creates a "cloud of dots," which can be manipulated by a computer into an extremely accurate model of a 3-D space. This is used in building restoration and reconstruction, various forensic crime scene analyses, and for modeling large structures. The company is also developing software to address a wide range of applications to promote future growth opportunities.

## INVESTMENT THESIS

The worldwide manufacturing community is just beginning to adopt CAM2 technology, and portable CAM2 technology is gradually replacing the mature fixed measurement market. FARO is one of two major suppliers of this equipment and has proven itself capable of competing effectively for this new business. It has grown revenue in excess of $20 \%$ annually for the past five years and remains confident in its abilities to continue to maintain $20 \%$ to $25 \%$ revenue growth for the foreseeable future.

FARO's path to success has had its fair share of bumps, as well as some significant changes. One is the replacement of top corporate management. The company's two founders have retired from operational executive positions and have been replaced with top-notch leaders who have laid the groundwork to take the company to the next level of growth. They will achieve this by expanding into the mainstream manufacturing market beyond the early adopters of FARO's products and by developing applications for 3-D measurement beyond the factory floor.

In addition, the company's internal focus on productivity, its maturing sales force, and its move away from purely missionary sales should result in incrementally increasing margins, propelling earnings growth to a figure in excess of the $20 \%$ to $25 \%$ annual sales growth. Here's why:

## IT'S WHO YOU KNOW

FARO is beginning to receive higher-volume recurring orders from its large customers, who, for the most part, were the early adopters and now have fully qualified and integrated the FARO measurement arms into their manufacturing processes. These include companies such as Boeing, Caterpillar, Daimler-Chrysler, and Volkswagen.

Sounds great already, right? But it gets better: When FARO first sold its products to these companies, they were completely new, based on a new way of doing things. Each sale required a formal demonstration at the customer's facilities, a week or two of loaned equipment for evaluation, and often a second demo for others in the purchasing decision hierarchy. While necessary for such a revolutionary new product, it was a costly sale. As FARO's equipment makes it onto the approved lists at these large companies, sales become routine as these businesses upgrade other production lines or find new applications for the technology.

## BETTER WITH AGE

In addition, the positive effects of the maturing sales force are just now beginning to show themselves. In 2005, FARO made some major investments in staff and infrastructure to fuel future growth. These included the decision to increase sales and marketing staff by $75 \%$ in a single year, which stemmed from an increased focus on Asian business, as well as the desire to get more feet on the ground everywhere. It takes a new salesperson about 12 months to become effective in selling these rather complex products. Additionally, for the first nine months, salespeople are paid a straight salary in addition to commissions. After that time, they are paid strictly on a commission basis, so they make money only on sales. This investment is now maturing, and sales and marketing as a percentage of revenue is declining as the new hires gain traction.

## ONWARD AND UPWARD

Furthermore, FARO has always enjoyed stellar gross margins, which have been in the $54 \%$ to $62 \%$ range for the past 11 years. Recently, the top end of this range has been the norm, and I expect that to continue. Many supply agreements have been renegotiated, economies of scale are playing into the mix as volumes increase, and new CEO Jay Freeland has implemented a program called Power of One, the impact of which will be felt over the next several years.

With Power of One, Freeland has challenged each FARO employee to find a way the company can save $\$ 2,000$ over the course of a year. It must be outside of the employee's immediate
area of responsibility and encourage broad involvement in the overall company. Participation is the important goal, and each manager is evaluated as to whether his or her employee base reaches $85 \%$ participation. This initiative should help keep gross margins up and lower operating expenses.

## TYING UP THE PAST

Finally, for the past three years, FARO had been involved in an acrimonious patent infringement case with its largest competitor. The case has finally been settled with no damages inflicted, and the enormous legal expenses involved are now a thing of the past.

All of these factors will allow FARO to continue on its way to $15 \%$ operating margins and permit earnings growth in excess of revenue growth, making this company a compelling investment.

## VALUATION

The settlement of a self-reported discretion in its new Asian operation (more on that shortly), as well as lower-than-expected revenue growth in its latest quarter, have brought down FARO's share price, creating an attractive buying opportunity. The company has always represented growth at a reasonable price, but it's now also sitting in value territory with a nice margin of safety. Plus, CAM2 has only penetrated an estimated $5 \%$ to $10 \%$ of the traditional fixed measurement market. As the technology becomes mainstream, growth should accelerate. In addition, the company has bulked up its R\&D program and developed new applications for the 3-D technology, which will add growth areas in the future.

I am expecting 2007 earnings of at least $\$ 1$ per share when the fine is factored in. Under an assumption of $27 \%$ annual growth in owner earnings, derived from the belief that earnings and free cash flow growth will outpace the company's expected revenue growth due to the leverage argument explained above, I would expect FARO to achieve a market cap of $\$ 1.6$ billion by 2012. Under the same scenario, FARO should provide $25 \%$ to $30 \%$ compounded annual share price growth over the next few years. A higher multiple isn't out of the question, but since these growth assumptions are somewhat aggressive, I'll leave that eventuality as potential upside.

Using the same five-year growth assumptions, dialing back growth to $12 \%$ in years six through 10 and then assuming a $3 \%$ terminal growth rate, a discounted cash flow calculation produces a current intrinsic value of around $\$ 45$. That gives us a margin of safety of $40 \%$ from the current price.

## RISKS

The primary risk with FARO is the "two smart guys in a garage" concern, a common theme when investing in the technology sector: There is always the possibility that a better measurement technique will be developed. The constant consideration with technology is obsolescence. In the case of 3-D measurement, companies don't face the rapid changes seen in other sectors
(cell phones, anyone?), and any new approach would likely have a long adoption cycle. The broader the acceptance of CAM2 becomes, the less of a concern those two guys become.

FARO's customers operate in notoriously cyclical industries. The company has acted to mitigate this effect through geographic diversification and by entering new industries at a rapid rate. This diversification will buffer the company against any regional slowdown or problems in a specific industry. However, a larger global recession would adversely affect FARO as its customers pull back from capital spending to ride out the cycle.

FARO has also had its share of legal actions to deal with. The most significant of these was the aforementioned patent infringement case brought against it by a subsidiary of its main competitor. That has been settled with no damages to FARO, and its associated costs are now history.

But two actions are left to be resolved: The first one concerns the Foreign Corrupt Practices Act. As FARO began expanding into China at a rapid pace, sufficient internal controls had not been put in place. The company discovered that some of its employees had made illegal referral payments to certain Chinese customers. FARO voluntarily disclosed this fact to the Justice Department and the SEC. Several employees were terminated, and the company continues to cooperate fully with the investigating authorities. FARO has already established a reserve for the expected fine, and this is not likely to affect future business. There is also a longstanding class action lawsuit pending against the company. It has taken quite a while to put together a complaint that a judge would even agree to hear. I anticipate that it will eventually be heard, and although FARO insists there is no merit to the claims, the outcome of such a proceeding is never a sure thing.

## SELLING CRITERIA

When investing in a company like FARO that depends on sustained growth, I focus on the year-over-year revenue trends and the company's ability to sustain margin performance. The order flow can be lumpy in a business like this despite the company's diversification, so a single quarterly hiccup would not be cause for alarm. However, the sustained inability to garner quarterly revenue growth in excess of $20 \%$ or a sudden decrease in gross or operating margins would make me take a hard look at the causes. When investing in a growth stock such as FARO, execution is paramount, and when that falters, it's time to reassess the thesis.

I look for sustained gross margins in the $57 \%$ to $62 \%$ range and operating margins continuing to climb toward $15 \%$. Performance below this would be cause for concern. Because FARO is still a relatively small company, I anticipate further challenges in managing growth. The company recently completed an equity offering, and I expect its cash balance to approach $\$ 100$ million by the end of 2007. How this money is allocated to spur additional growth is one of the key challenges the company faces. FARO has made one acquisition in the last few years to gain entrance
into broader 3-D measurement markets, and that effort is proceeding at an acceptable rate. I would carefully scrutinize future acquisitions and how management goes about integrating them. The new management has not proven itself yet in this aspect, and a misstep here would also be a reason to re-evaluate your position in this stock.

## THE FOOLISH BOTTOM LINE

With FARO, you have the opportunity to benefit from an investment in the leader of a new, rapidly growing industry. Penetration of the CAM2 market has only begun, and FARO has put an internal infrastructure and sales force in place to take advantage. As its sales staff matures and the market develops, the company will be able to leverage its operating expenses across an increasing revenue base, and profits will grow in excess of
sales. That means that current results are somewhat masking the earning power within this company.
FARO is also embarking on a strategic thrust to move into 3-D measurement applications beyond the factory floor. These are myriad, and any successful future applications serve as additional growth drivers on top of an already compelling story.

The company has plenty of sustained growth ahead of it, which makes it a great choice for long-term investors who want to add to the higher risk/higher reward portion of their portfolios. FARO has the chance to grow into a large measurement company over the next decade, and while the days of buying this company at a dirt-cheap price may be over, returns from today should be sufficient to warrant an investment in 2008 and beyond.
Stan Huber is an associate advisor for Motley Fool Hidden Gems and Hidden Gems Pay Dirt. At the time of publication, he owned shares of FARO Technologies.

# Fomento Economico Mexicano S.A. de C.V. (FEMSA): Returning to Mexico 

BY SETH JAYSON (SJAYSON@FOOL.COM)

## FOMENTO ECONOMICO

 MEXICANO S.A. DE C.V. (FEMSA)\author{

NYSE: FMX <br> www.femsa.com <br> General Anaya No 601 PTE Colonia Bella <br> Vista Monterrey 64410 <br> Mexico <br> 52-81-8328-6000 <br> | FINANCIAL SNAPSHOT |  |
| :---: | :---: |
| Share Price: . | . . ${ }^{\text {3 }} 33.07$ |
| Shares Outstanding: . | 357.8 million |
| ADR Ratio: . | 1 ADS: 10 common |
| Market Cap: | \$11.8 billion |
| Cash and Short-Term |  |
| Investments: | . \$994.6 million |
| Debt: | . . $\$ 3.7$ billion |
| Enterprise Value: . | . . \$14.5 billion |
| *Shares trade as ADSs | n the NYSE. |

(Current as of 11/9/07)

## WHY BUY?

Leading up to the production of this report, the global stock markets went a bit goofy. "Drunk with optimism" might be a better description. Everything went up. In some cases, way up. A lot of it later crashed, but not the stuff I liked! As I watched several of my prospective Stocks 2008 picks reach and outrun my estimates of intrinsic value, I ticked them off my list one by one, and tried not to get frustrated. See, I don't like recommending that you buy fully priced stocks in a risky economy - no matter how much I like the company. So, I went back to stocks I love to see if any of them were trading at discounts, and I found a doozy.

Fomento Economico Mexicano S.A. de C.V. (NYSE: FMX), known by the acronym FEMSA, has been a solid performer since I recommended it a year and a half ago in our Motley Fool Blue Chip report, and it's a stock I'm happy to own for myself. In reviewing the numbers, I found that it's still trading at a very nice discount. So, here's hoping that great minds are thinking alike, and that you, dear reader, don't mind another trip back to the well for a second dip in what is a true global powerhouse.

FEMSA is, in a phrase, one of the best-run companies on the planet. It operates CocaCola (NYSE: KO) bottling and produces a variety of other soft drinks, juices, and beers. It's the No. 1 soft drink distributor in Mexico, Colombia, Venezuela, Brazil, and Central America. It's No. 2 in beer in Mexico, and No. 3 in Brazil. It also runs Mexico's leading convenience store chain.

While the shares are no longer as cheap as they were just weeks ago, they give us a solid opportunity to diversify internationally by purchasing one of Mexico's - and Latin America's - best-run companies. Through growth at home and in neighboring markets, FEMSA offers blue chip exposure to some of the economies that will be among the most vital in the world, with more limited downside risk than is usually associated with investments in emerging economies.

## CORPORATE FACTS

I usually prefer companies that do only one thing, and do it well. (Yeah, I'm simple like that.) But I'm ever more convinced that FEMSA's triple threat (beer, soda, and convenience stores) provides a very interesting opportunity. After all, the production and distribution of beer and soft drinks have a lot in common, and they are, I would argue in FEMSA's case, a natural fit with the firm's large convenience store chain, Oxxo.

FEMSA traces its roots all the way back to 1890 , with the founding of a brewery called Cervecería Cuauhtémoc Moctezuma. Today, it is much more than beer, though its 12 breweries produce well-known beers such as Tecate, Sol, and Dos Equis, some of which are exported to the U.S. and Canada in increasing quantities. The company operates 30 bottling plants through Coca-Cola FEMSA and thousands of Oxxo convenience stores.

FEMSA, by the way, keeps excellent English-language investor information on its website at www.femsa.com/en. I recommend that anyone interested in the stock spend some time there. In addition to finding out about the dizzying array of share classes (for simplicity, I use the common denominator of "units" in this write-up), you can peruse
detailed information about all the firm's businesses and brands. Here's a brief summary of the key segments:

## FROM SIPPING TO SHOPPING

(Each segment's percentage contribution of revenues and operating profits is shown in parentheses as of the end of fiscal 2006.)

- Coca-Cola FEMSA ( $45.7 \%, 54.4 \%$ ) owns just more than $63 \%$ of voting stock of Coca-Cola FEMSA as of May 31, with the remainder trading on the New York Stock Exchange as an ADR with the ticker KOF, or held by Coca-Cola. Coca-Cola FEMSA is the second-largest Coke bottler in the world, producing and distributing familiar brands such as Coca-Cola, Coca-Cola Light, Sprite, Diet Sprite, Fanta, and many others (more than five dozen total). It sells these products through much of Mexico, as well as in Guatemala, Costa Rica, Nicaragua, Venezuela, Brazil, and Argentina.
- FEMSA Beer $(28.2 \%, 34 \%)$ operates 12 breweries that produce myriad beer brands. My absolute favorite (I just love the name) has to be "Noche Buena," Spanish for Christmas Eve, but the company deals in brands that are even familiar to us gringos, such as Tecate, Tecate Light, Sol, and Dos Equis.
- Oxxo ( $28.1 \%, 9.2 \%$ ). This convenience store chain is the largest in Latin America, with more than 4,800 locations. And it still has room to grow, as Mexico's convenience store culture is much different from what we're used to here in the U.S. (Those who've traveled to Mexico and are familiar with the numerous small corner stores there know what I'm talking about.)

Oxxo exclusively stocks FEMSA beers and almost exclusively sells Coke beverages, creating a home for FEMSA products and important distribution efficiencies. This is a key competitive advantage. Beer and soft drinks comprise upwards of $30 \%$ of Oxxo's sale volume, and the chain moves about $9.9 \%$ of FEMSA's beer output. By selling so many beverages, it also provides FEMSA with valuable and timely industry intelligence, which can be used for everything from inventory and mix management to product development ideas. While the chain has been growing, same-store sales growth has also been robust, clocking in at $8.2 \%$ for 2006.

- Strategic Business Division. I won't spend much time here, except to point out that this segment comprises two separate support entities for FEMSA, producing labels and commercial beverage refrigeration units, along with logistics management for FEMSA and outside customers.


## FINANCIAL PERFORMANCE

FEMSA's growth during the past few years has been very impressive. The figures I get from Capital IQ show compound annual growth rates (CAGR) for revenue, cash from operations, and free cash flow (FCF) of $19.2 \%, 9.9 \%$, and $9.4 \%$, respectively, in the past five years. Net income's CAGR in the same period came in at $13.5 \%$.

Here's the tale of the tape:

|  | FY 2002 | FY 2003 | FY 2004 | FY 2005 | FY 2006 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Revenues | $\$ 5,341.3$ | $\$ 7,597.5$ | $\$ 9,422.8$ | $\$ 10,281.2$ | $\$ 11,643.4$ |
| Net Income | $\$ 285.5$ | $\$ 313.9$ | $\$ 590.4$ | $\$ 531.0$ | $\$ 609.9$ |
| EBITDA | $\$ 1,353.3$ | $\$ 1,721.4$ | $\$ 2,008.9$ | $\$ 2,130.1$ | $\$ 2,266.4$ |
| FCF | $\$ 617.2$ | $\$ 496.8$ | $\$ 1,191.9$ | $\$ 963.1$ | $\$ 973.2$ |

Figures in millions
Source: Capital IQ, translated into U.S. dollars in current, constant dollars
In fiscal 2006, revenues increased by $13.2 \%$ while net income increased by almost $15 \%$. In a year when energy and commodity price increases continued to pressure FEMSA, the firm held the line on costs and turned in a strong performance. This is important, as price pressures for things like oil (used to make plastic resin) and sweeteners is likely to continue in the near future. Despite these successes, investors need to remember that overall margins will continue to decline as the lower-margin Oxxo business takes up more of the top and bottom lines.
Here's the longer-term picture on margins, which illustrates that point.

|  | FY 2002 | FY 2003 | FY 2004 | FY 2005 | FY 2006 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Gross Margin | $50.2 \%$ | $48.2 \%$ | $47.0 \%$ | $46.7 \%$ | $46.3 \%$ |
| Operating Margin | $17.6 \%$ | $15.8 \%$ | $14.6 \%$ | $14.7 \%$ | $13.8 \%$ |
| FCF Margin | $11.6 \%$ | $6.5 \%$ | $12.6 \%$ | $9.4 \%$ | $8.4 \%$ |

FCF margin = cash from operations, less capital expenditures, divided by revenues
Source: Capital IQ
If you're wondering about the dip in the bottom line from fiscal 2004 to fiscal 2005, nice catch. It's mostly due to a much lower tax rate for 2004. And therein, we find another lesson: As a result of the vagaries of tax accruals and differences between Mexican GAAP and U.S. GAAP, for the remainder of this analysis, you'll see me relying more on cash flow figures, which are usually better translated between the two accounting schemes. Moreover, cash flows get us closer to the bottom-line profitability that I think should be our primary focus. Finally, note that Mexico is currently overhauling its business tax laws, which, in theory, will lower rates, although just who qualifies for which rates and when is something that's not yet clear.

FEMSA's balance sheet is strong. Net debt as of the end of the June 2007 quarter was $\$ 3$ billion. That's just 1.4 times the past 12 months' EBITDA. Easily manageable, in other words. Moreover, management reports that most of that debt carries fixed rates, so we're not likely to see any nasty surprises.

Returns at FEMSA are healthy, and generally stable. Return on invested capital is rebounding after having faded a bit over
the past couple years. (The fade came from a variety of factors, including FEMSA's increase in invested capital for the expansion of Oxxo, a lower-margin business than plain old beverage making and distributing.)

## INVESTMENT THESIS

I wish there were a sexier investment story here, something the analysts have overlooked, maybe a brilliant future-focused observation that I could offer. But the thesis is embarrassingly simple, just as it was a year and a half ago: Based on current prices, expected free cash flow, and very (perhaps overly) conservative growth estimates, FEMSA appears to be cheap. Better than that, the synergy between its dominant brands and retail chain create a potent engine for ongoing scale and efficiencies, providing what I believe is a strong backstop for the stock's price. In short, lots of upside opportunity with minimal risk to the downside.

## VALUATION

With companies like this one, which operate relatively stable businesses that analysts know pretty well, we're on pretty firm ground for a simplified discounted cash flow (DCF) analysis. As anyone who's done a DCF knows, for all the appearance of mathematical precision, the resulting "intrinsic value" figure is no more reliable than the educated guesses you put in at the beginning.

For my valuation model, I use a required rate of return of $11 \%$ and calculate baseline free cash flow by multiplying a five-year average FCF margin by trailing 12 month revenues. For FEMSA, I find analyst estimates for five-year growth in the $18 \%$ range. That's a bit high. Although I'm normally more comfortable taking a full third off those estimates when I create a three-stage DCF (for years one to five, five to 10 , and terminal), in this case, I hacked off more than half. Being very conservative, I assume FEMSA will achieve growth of $5 \%$ for 10 years, then a $3 \%$ terminal rate. According to this model, FEMSA shares have a current fair value of about $\$ 52$ each, implying a near $40 \%$ margin of safety from the recent share price of about $\$ 32$.

Even then, I think that model may be overly conservative given that the growth rate I calculate (based on return on equity and payout ratio) comes to $12 \%$. Calculating with three-stage growth rates of $10 \%, 5 \%$, and $3 \%$ yields a fair value of nearly $\$ 64$ per share, for a $50 \%$ margin of safety.

## CATALYSTS

## INCREASING BEVERAGE VOLUMES

It's not always that easy to get people to drink more of your flagship beverages. Just ask Anheuser-Busch, Coca-Cola, or Pepsi. But as the Latin American economies and populations where FEMSA does business expand, I foresee some natural increases in consumption coming along with expanding populations and increasing affluence. Moreover, FEMSA has shown some degree
of success in marketing new brands, differentiating product "presentations" and varying serving sizes.

## OXXO EXPANSION

Oxxo is already a chain of more than 4,800 locations, with more than 600 new stores opened in the past fiscal year. But, as I noted earlier, FEMSA believes there is plenty of room for future growth in store count. The company hopes to keep at it, and, on the high end, sees the opportunity to triple its existing store base over the next decade. Keep in mind, however, that this still looks like good quality growth.

As I mentioned, Oxxo's same-store sales - an important metric for anyone watching a retailer - grew at an $8.2 \%$ clip in the last fiscal year. Though this growth is crucial to the investment thesis, investors should remember that as the lower-margin retail business expands more quickly than the higher-margin bottling biz, the effect on overall margins will be a downward drift. As such, going forward, we'll need to judge the health of the parts before we draw conclusions about the whole. The important factor to remember is that growth in the Oxxo chain means growth in the distribution of FEMSA's core products.

## ACQUISITIONS

I am usually pretty wary of companies that grow through acquisitions. It's often the strategy of last resort for a firm that's desperate to maintain the growth credibility it previously established via organic expansion. And even when acquisitions seem to make sense, we've all seen too many of them falter for lack of execution. FEMSA, however, is one of those rare companies that I trust to pursue this strategy. Its past acquisition successes, and its measured approach to the Kaiser purchase a couple years back (which could be summarized as "don't expect earnings right away, we're working for the long term here") gives me confidence that it will stay on the lookout for growth opportunities via business combinations. (The Kaiser turnaround is still in its early stages, with two brands relaunched. Sales seem healthy, and the unit turned in a small loss for 2006, in line with expectations.)

## RISKS

## COMPETITION

There's competition in every one of FEMSA's markets, from soft drinks to juice to beer, where Grupo Modelo, maker of Corona, is the market leader. That means FEMSA will have to keep on its toes.

## THE GOVERNMENT

Given its dominant position, FEMSA sometimes attracts unwanted scrutiny from the Federales in its countries of operation. An old nemesis is the Mexican Antitrust Commission. It currently objects to FEMSA's planned acquisition of Jugos del Valle. In the past, the Commission ordered the halt of alleged
exclusive distribution agreements, a decision that was reversed in FEMSA's favor. Incredibly, the Commission simply lodged the same complaint again, made the same finding, and imposed a $\$ 6$ million fine. FEMSA, naturally, appealed again. The status of the latest redo is currently unknowable, pending a decision by Mexico's Supreme Court. I'm confident FEMSA will prevail once more, but should the decision go the other way, the company could be ordered to change distribution terms in ways that would be less favorable.

## COMMODITIES AND PRICING

Like any business that makes a product and then sells it, FEMSA is exposed to risk from rising costs of "ingredients" and the ability - or inability - to pass on those costs through price increases in the end product. The past couple of years haven't been easy as prices for things like sugar, energy, metals (for cans) and oil (for plastics and transportation) have been on the rise. FEMSA has passed on some slight price increases so far, and the firm engages in forward contracts to hedge price risks, but this situation still bears watching.

## ECONOMY AND CURRENCY RISK

As FEMSA does business in a variety of countries, there is always some currency risk. Keep in mind that more than $75 \%$ of consolidated revenues are denominated in Mexican pesos, with the currencies of Brazil, Venezuela, and Colombia representing revenues in the mid-to-high single-digit range.
Not only is economic risk inherent in each of these countries, fluctuation of the Mexican peso against the U.S. dollar can have a substantial influence on operating results, such as changing the value of FEMSA's dollar-denominated debts. But this risk is fading, as
dollar-denominated debt is down to $21 \%$ of total debt, and risk attached to that debt has been hedged with currency swaps.

## SELLING CRITERIA

With a strong, consumer brand-oriented firm like this, I can only think of a couple reasons to get rid of the shares. The first would be if they reached a crazy valuation. If the shares doubled in say, a year or two, I might well think about cashing in some chips.
The only other obvious reason to sell would be evidence of management failures that look detrimental to the firm's long-term health. We should, of course, expect a few bumps along the road - especially with commodity prices - but if these become so frequent and violent that they knock the wheels off the cart, we may need to say "Adios."

## THE FOOLISH BOTTOM LINE

As is my usual tack in choosing stocks for these special reports, I'm not suggesting that you purchase anything I wouldn't own myself. I am eating my own cooking here, having bought these shares a while back. I am not one of those investors who believes in "buy and hold forever." I frequently sell good companies when they reach my estimates of intrinsic value. I only hold when I think there are even better times ahead, and that's exactly why I have not parted with a single share of FEMSA. If things don't work out, I'll be taking my lumps the same as you. But if they do, as I expect they will, we'll profit together. I say we meet on the beach somewhere and crack open a cold one.

At the time of publication, Seth Jayson owned shares of FEMSA. Coca-Cola and Anheuser-Busch are Motley Fool Inside Value recommendations.

# Intuit: Hooray for Tax Season! <br> \author{ BY ANDY CROSS (ANDYC@FOOL.COM) 

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| INTUIT |
| :---: |
| Nasdaq: INTU www.intuit.com 2700 Coastal Ave. Mountain View, CA 94043 650-944-6000 |
| FINANCIAL SNAPSHOT |
| Share Price: . . . . . . . . . . . . . . . . . . . . . . $\$ 29.73$ <br> Shares Outstanding: ........... 335.3 million <br> Market Cap: . . . . . . . . . . . . . . . . . . . $\$ 10$ billion <br> Cash: ................................. . $\$ 1.3$ billion <br> Debt:................................... . $\$ 1$ billion <br> Enterprise Value:................. . $\$ 9.7$ billion <br> (Current as of 11/9/07) |

## WHY BUY?

I love doing my taxes. OK, that may be a slight overstatement. Let's say I don't cringe each April when preppin' for the tax man. Thanks to TurboTax, I can now easily, quickly, and efficiently file my federal and state taxes while watching March Madness. As a taxpayer and college hoops fan, what could be better? Well, how about investing in the company that has simplified my life: Intuit (Nasdaq: INTU)?

Each year, Intuit sells millions of TurboTax units to U.S. taxpayers looking for a better way to pay (or collect from) Uncle Sam. But TurboTax is just one part of Intuit's profitable business. The company also sells the well-known Quicken software that helps customers manage their personal finances and the QuickBooks financial management software for small businesses. Plus, thanks to its recent $\$ 1.3$ billion acquisition of Digital Insight, Intuit now provides online banking services to nearly 25 million individuals and 8 million small businesses.

Investors didn't take kindly to the acquisition and fled Intuit's stock this year. I think they acted a little hastily, but I'll gladly take the cheaper price. Now is a great time to buy shares in this company, which operates with a very defined competitive advantage and is just starting to leverage its prowess into online banking. Five years from now, when we start thinking about our tax planning for 2012, we're likely to be sitting on a hill of profits from this stock.

## CORPORATE FACTS

Intuit's mission is simple and audacious: to revolutionize people's lives by solving important problems. Currently, the company tackles tax preparation, small business accounting, and online banking. But who knows what's in store? Based on the company's pedigree, I'm eager to be part of that journey.

Intuit started in 1983 when founder Scott Cook, frustrated with balancing his checkbook (if you're older than 35 and remember those do-it-yourself days, you know that feeling), sought out a superior solution by recruiting Stanford student Tom Proulx to write a simple check-balancing program. From those humble beginnings in Tom's dorm room, Intuit was born. Cook applied his brand experience from Procter \& Gamble (NYSE: PG), his consulting skills from Bain \& Co., and his rabid passion for customer service to grow Intuit into a business with annual revenue north of $\$ 2.6$ billion. Today, he is chairman of the executive committee and the largest individual shareholder with nearly $8 \%$ of the company, valued at almost $\$ 850$ million.

## INSIDE INTUIT

Intuit has six business segments: QuickBooks, Payroll and Payments, Consumer Tax, Professional Tax, Financial Institutions, and Other.

As you can see from the table on the next page, the company's bread n' butter comes from its flagship TurboTax, Quicken, and its various QuickBooks brands, which collectively generate more than $80 \%$ of Intuit's revenue. These products are synonymous with tax preparation, personal finance organization, and small business bookkeeping, respectively, and they generate fierce customer loyalty from their users (including me).

| Segment | Share of 2007 Revenue | Share of 2007 Operating Profit | Description | Brands and Products |
| :---: | :---: | :---: | :---: | :---: |
| QuickBooks | 22\% | 15\% | Simplifies bookkeeping and business management for small and medium-sized businesses with a simple, easy-to-use system | QuickBooks (Simple Start, Pro, Premier, Enterprise Solutions, Point of Sale) and financial supplies (checks, envelopes, deposit slips, tax forms, etc.) |
| Payroll and Payments | 19\% | 18\% | Payroll and payment systems for small and medium-sized businesses who want to do it themselves | QuickBooks Payroll (various versions) and Merchant Services (credit, debit, and gift card processing, Web-based transactions, etc.) |
| Consumer Tax | 31\% | 43\% | Industry-leading tax preparation software for individuals requiring various degrees of assistance | TurboTax (Basic, Deluxe, Premier, Business) and electronic filing |
| Professional Tax | 11\% | 13\% | Tax software and services for accountants and tax preparers | Lacerte (complex returns for full-service firms), ProSeries (for less complex tax needs) and EasyACCT Professional Series (creates financial statements and tax forms for users) |
| Financial Institutions | 6\% | 3\% | Digital Insight business: provides outsourced online banking software products that deliver on-demand services to small and medium-sized financial institutions | Consumer banking (applications available to individual customers like you and me) and business banking (applications available to corporate clients of Intuit) |
| Other | 11\% | 8\% | Quicken software | Personal finance software to balance checkbooks, track investments, reconcile statements, etc. |

Sources: Company filings and Capital IQ

Once a user enters his information, learns the systems, and regularly uses them, he is not likely to switch to a different brand of software just to save a few bucks. This allows Intuit to keep its customers and also to tactically, and carefully, increase prices over time. In investing parlance, the competitive moat for these products is deep and infested with alligators.

The Financial Institutions segment (aka Digital Insight) looks healthy, but it's one that investors don't quite seem to recognize yet. Consumer online banking continues to gain acceptance, but among the banks that use Digital Insight today, only $21 \%$ of their customers use online banking features. Furthermore, Digital Insight claims only about $11 \%$ of the 16,000 U.S. financial institutions as clients, so there is an opportunity to steal market share. In addition, Intuit has combined its suite of software products with Digital Insight's online banking solutions to create Personal FinanceWorks, an online banking system with an extra competitive edge that will pay off when going after banking businesses.

And increasing revenue is vital for Intuit, because its asset base swelled by $50 \%$ after swallowing Digital Insight. Unfortunately, the steep $\$ 1.3$ billion price tag clipped the company's overall returns on invested capital (ROIC), a metric I like to use to evaluate the amount of money a company earns on each dollar that has been invested in its business. The chart below juxtaposes Intuit's recent ROIC results against its revenue and asset base growth. Ideally, I like to see ROIC and revenue growth high and increasing, with asset growth low or shrinking.

By the looks of things, you're probably thinking that the Digital Insight acquisition didn't create much shareholder value revenue grew by $16.6 \%$ in fiscal 2007, but ROIC fell to $18.5 \%$

|  | $\mathbf{2 0 0 3}$ | $\mathbf{2 0 0 4}$ | $\mathbf{2 0 0 5}$ | $\mathbf{2 0 0 6}$ | 2007* |
| :--- | :---: | :---: | :---: | :---: | :---: |
| ROIC | $25.2 \%$ | $29.7 \%$ | $33.5 \%$ | $31.9 \%$ | $18.5 \%$ |
| Revenue Growth | $21.7 \%$ | $12.8 \%$ | $10.6 \%$ | $15.0 \%$ | $16.6 \%$ |
| Asset Growth | $(4.7 \%)$ | $(2.1 \%)$ | $(0.5 \%)$ | $2.0 \%$ | $53.5 \%$ |

*Fiscal year ends July 31
Sources: Analyst calculations and Capital IQ
(incidentally, still exceeding the company's cost of capital). As you might suspect, this one metric doesn't tell the whole story.

The Digital Insight acquisition closed in February 2007, about halfway through Intuit's fiscal year. So, only a few months of revenue has been generated from this acquired business, but the entire $\$ 1.3$ billion still factors into the cost of capital calculation. In the last quarter of this fiscal year (the first complete one to include Digital Insight), customers using the service increased by $27 \%$ versus the same quarter last year. Given the potential market size, I expect better growth rates in the next several years as Intuit starts selling its FinanceWorks package aggressively to new clients. Ultimately, this should push the company's ROIC back above $20 \%$.

## INVESTMENT THESIS

We often read in business publications about the importance of a company's sustainable competitive advantage, or economic "moat," as Warren Buffett and other bright investors call it. As Buffett opined in a 1998 issue of Fortune:
"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather, determining the competitive advantage of any given company and, above all, the durability of that advantage. The products and services that have wide, sustainable moats around them are the ones that deliver rewards to investors."

This is my favorite feature of Intuit's business - the economic moat it's built over the years. TurboTax, Quicken, and QuickBooks operate as practical monopolies in their fields and have created very loyal customers. This gives Intuit a degree of pricing power that other companies should envy.

Plus, this year, Intuit is enticing new customers by offering its entry-level QuickBooks Simple Start product for free (down from $\$ 99$ last year) while boosting the price of its QuickBooks Online product to $\$ 24$ per month (from $\$ 19$ per month) and

QuickBooks Premier to $\$ 499$ from $\$ 399$. We see similar patterns over at TurboTax, where management will offer a free basic online version and charge for more sophisticated versions and additional services (like audit defense).

Combine these products with a new market - online banking and through FinanceWorks, I fully expect Intuit to take advantage of the huge opportunity this presents for the next decade.
I also love the company's light and effective business model, consisting of recurring revenues, zero inventory, high operating margins, and upfront cash collections. This enables it to spit out copious amounts of free cash flow (FCF) that it invests back into the business - or even better, passes on to shareholders. I like to invest in companies that produce free cash flow in excess of reported net income, because it tells me that more cash is available than is reported on the income statement. Here's a look at Intuit's ratio, which has averaged 1.4 over the past five years:

|  | 2003 | 2004 | 2005 | 2006 | 2007* |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Net Income | $\$ 343$ | $\$ 317$ | $\$ 381.6$ | $\$ 417$ | $\$ 440$ |
| FCF | $\$ 692.9$ | $\$ 455.8$ | $\$ 469.7$ | $\$ 419.3$ | $\$ 595.6$ |
| FCF/Net Income | 2.0 | 1.4 | 1.2 | 1.0 | 1.4 |
| *Fiscal year ends July 31. Dollar amounts in millions |  |  |  |  |  |

Finally, having founder Scott Cook as chairman of the executive committee and the largest shareholder is a huge advantage to investors. This man lives, eats, and breathes Intuit, and he has long championed its products and strategies. He remains involved in setting the overall tone for the business and will serve as a confidant to newly minted CEO Brad Smith. Smith, after spending the past few years growing Intuit's small business division, will take the company reigns at the beginning of 2008.

## VALUATION

As an Intuit client and a stock analyst, I've long been an admirer of the company's core businesses, but I always considered the stock too richly priced. Even the best businesses, purchased at unreasonable levels, can be downers in your portfolio. But this year, after the stock fell below $\$ 30$ per share, I started to take notice again.
Intuit now sells at attractive sales and earnings multiples compared to recent years, mostly because investors are concerned with the Digital Insight acquisition and a shift in management ranks. As you can see, the current price-to-earnings multiple is just about the cheapest it's been, on average, in the past five years.

|  | $\mathbf{2 0 0 3}$ | $\mathbf{2 0 0 4}$ | $\mathbf{2 0 0 5}$ | $\mathbf{2 0 0 6}$ ** | Current |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Enterprise Value-to-Sales* | 5.1 | 4.1 | 3.6 | 4.0 | 3.6 |
| Price-to-Earnings | 51.7 | 31.4 | 26.3 | 28.8 | 23.9 |

* Enterprise Value = market cap + debt - cash
** Average for the year
Source: Capital IQ. Data based on trailing 12-month period
But because Intuit generates those rich cash flows I discussed earlier, the current multiple is even more attractive if we compare the enterprise value to free cash flow rather than earnings (about

17 times versus 24 times). Paying 17 times trailing free cash flow for a company of this caliber, with its ingrained products and long-term growth expectations, sure seems good to me. Looking out over the next few years, I think we'll see a stock selling north of $\$ 40$ per share, or a market capitalization of nearly $\$ 14$ billion, as the company starts to make good on its Digital Insight acquisition, product enhancements, and other small business growth opportunities.

## CATALYSTS

Intuit has plenty of exciting opportunities for the next halfdecade, and I mean more than just FinanceWorks, which certainly is a differentiating factor for the company.

First and foremost, the company's commercial business still has plenty of room to grow. More than 26 million small and medium-sized businesses reside in the U.S., and many do not yet use QuickBooks or Intuit's Payroll systems. So, extending the company's reach to those who want to keep their accounting or payroll systems in-house will be important going forward. I expect we'll see long-term annual growth rates in the low teens for QuickBooks and at least high single digits for Payroll.

Markets outside the United States contributed less than 5\% of Intuit's total revenues, so overseas clients also offer lots of growth potential. The various accounting and bookkeeping intricacies make it difficult to build market-specific products. But over the next decade, I expect Intuit to start pushing QuickBooks web services into certain countries, specifically, China and India, which have almost four times as many small-to-medium-sized businesses, according to management. An aggressive push certainly won't happen overnight, but I'm confident it will happen eventually.

## RISKS

The obvious biggest risk is that the $\$ 1.3$ billion Intuit shelled out to acquire Digital Insight ends up wasted. My estimations say it won't. The market seems ready for a new businessfocused online banking product that ties together banking, payroll, and accounting. Intuit is just starting to introduce FinanceWorks to its clients, so the benefit will hit the books later this year and into next year. It's a unique product that has the industry and analysts abuzz.

The competitive landscape in the online software business is fierce. No matter who you are or where you go, the names Microsoft (Nasdaq: MSFT) and Google (Nasdaq: GOOG) always seem to pop up. Microsoft has a long history with Intuit, both as a competitor in personal finance and tax preparation software and as a partner trying to purchase the company back in the 1990s. So far, Intuit has been able to fend off the Redwood giant with superior products and services, but the $\$ 288$ billion company is always in the rearview mirror.

Intuit is not shy about issuing tons of stock options to its employees. During the past three years, employees exercised 36.1 million shares in options while the company granted nearly 32 million options. Intuit buys back $\$ 500$ million to $\$ 800$ million worth of stock each year to minimize the dilution effect, but it's still worth noting that the board and management put a lot of faith in issuing stock options.

## SELLING CRITERIA

I'm on the lookout for five situations that would sound the "sell" alarm:

1. Management can't generate the returns from FinanceWorks to justify the huge outlay of cash. If customers don't take to the product, sales and margin growth will languish.
2. I want operating margins to creep towards the high $20 \%$ range as revenue grows by low double-digit rates. If small business sales stagnate, we may have trouble reaching these levels. Keep an eye open.
3. Management makes another bold (read: expensive) acquisition. Although Intuit has demonstrated in the past that it is adept at making small, tactical acquisitions, it still needs to work through the Digital Insight purchase before opening its checkbook again.
4. Scott Cook decides to walk away from the board. Even if he doesn't immediately sell his $8 \%$ stake, I would consider this a potential sale signal.
5. Finally, if the valuation creeps back to levels seen earlier this decade (more than 40 times earnings), I suggest taking your chips off the table. By then, you'll be able to record capital gains in your TurboTax software.

We're not likely to see these situations emerging in the next few years, but we definitely need to be prepared for such events.

## THE FOOLISH BOTTOM LINE

You don't need to enjoy doing your taxes (or watching NCAA basketball) to appreciate an investment in Intuit. This market leader, led by founder Scott Cook, is poised for a bright future as it integrates the Digital Insight business, builds out its software packages, and continues penetrating the corporate market. The company generates a ton of cash flow, and shares are on the cheap side, so opening a position in the low $\$ 30$ level is a good way to pad your portfolio for the next few years.

At the time of publication, Andy Cross owned shares of Microsoft. Microsoft is a Motley Fool Inside Value recommendation.

# Marvel Enterprises: Make It Yours <br> BY DAVID GARDNER (DAVIDG@FOOL.COM) AND TIM BEYERS (MILEHIGHFOOL@YAHOO.COM) 

## MARVEL ENTERPRISES

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## FINANCIAL SNAPSHOT

Share Price: . . . . . . . . . . . . . . . . . . . . . . . . . . 27.26
Shares Outstanding: . . . . . . . . . . . . 80.5 million
Market Cap: . . . . . . . . . . . . . . . . . . . . $\$ 2.2$ billion
Cash: . . . . . . . . . . . . . . . . . . . . . . . . . \$21.6 million
Debt: . . . . . . . . . . . . . . . . . . . . . . . \$241.6 million
Enterprise Value: . . . . . . . . . . . . . . . $\$ 2.4$ billion
(Current as of 11/9/07)

## WHY BUY?

Most investors consider Marvel Enterprises (NYSE: MVL) too risky a stock to own. Too bad. We've done the math, and it turns out that every one of the company's films since the 2000 debut of $X$-Men would have been a huge moneymaker for Marvel had it been produced in-house.

As fate would have it, the company has started to produce its movies in-house. That means that for each blockbuster that blazes its way onto the silver screen, those massive heaps of money will fall straight into Marvel's coffers. And we believe the company's winning film streak will continue, beginning with the May 2008 release of Iron Man, which has the look of a hit in the making, and the second Incredible Hulk movie, which could perform well enough to earn yet another sequel.

Meanwhile, Marvel's core businesses - licensing, publishing, and toys - continue to perform as well as they ever have, producing ample cash flow and creating a hulking balance sheet capable of protecting investors in the event of a flop at the box office.

But we don't believe it will come to that. Instead, we see Marvel standing at the dawn of a new phase of growth - one that will earn $27 \%$ or better average annual returns through 2010 for those who invest at less than $\$ 27$ a share.

## CORPORATE FACTS

Ask Marvel executives about their firm, and they'll call it a "character-based entertainment company," which is true: More than 5,000 characters populate the Marvel Universe. But that wasn't the case in October 1939, when the first issue of Marvel Comics went on sale and featured Namor the Sub-Mariner and the jungle lord Ka-Zar. DC's Action Comics No. 1, known for its first mention of a certain "man of steel," had made its appearance just 16 months earlier.
Despite their almost simultaneous debuts, DC would rule the comics world for the next two decades. Marvel wouldn't rise to prominence until the early 1960s, when writer Stan Lee unleashed a new idea: Put superheroes in the real world. Make them act like the rest of us do. You already know the results: an incredibly profitable gaggle of characters that includes the Amazing Spider-Man, the Incredible Hulk, the Fantastic Four, and on and on.

Lee's idea, brought to life by the creative genius of artists including Jack Kirby and Steve Ditko, contrasted sharply against the fantasy realm that was the DC Universe. (Superman's Metropolis is one concrete example.) And yet, it's a theme that's proven timeless. In the past year, Marvel has enjoyed a spike in sales for its Civil War comic book series, in which heroes fight over the U.S. government's desire to register their powers. Captain America is among the conflict's casualties.

On the downside, controversy and tragedy aren't just the stuff of legend; for Marvel, they're too often real. During the '80s, for example, the company was bought and sold multiple times before billionaire Ron Perelman took ownership in 1989. Marvel would go public two years later, but by 1996, the firm was overcome with debt and forced into bankruptcy.

Current CEO Isaac Perlmutter and business partner Avi Arad, owners of the Toy Biz enterprise that Marvel once used to produce action figures of its characters, would assume power the next year after bidding $\$ 400$ million for the company. A new management team went to work shortly afterwards, and soon, an emphasis on licensing emerged. Movie deals followed. A renaissance was in the making, culminating in 2002's megahit, Spider-Man.

## INVESTMENT THESIS

But the transformation wasn't complete. Top managers like Arad watched with dismay as Sony (NYSE: SNE) took in hundreds of millions at the box office from the first two Spidey flicks. Marvel's take? Less than $\$ 75$ million, according to Business 2.0 estimates.

Top Marvel executives couldn't let that stand. So, in April 2005, the company declared its intent to become a producer. Viacom's (NYSE: VIA) Paramount Studios agreed to be its distributor.

This deal stands to make Marvel a lot of money. More money than anyone on the Street expects. Here's why:

| Movie | Domestic Box Office | Production Budget | Est. Profit Contribution |
| :---: | :---: | :---: | :---: |
| Spider-Man | \$403.7 | \$139.0 | \$316.7 |
| Spider-Man 2 | \$373.6 | \$200.0 | \$225.6 |
| Spider-Man 3 | \$336.5 | \$258.0 | \$151.9 |
| X-Men: The Last Stand | \$234.4 | \$210.0 | \$130.5 |
| X2: X-Men United | \$214.9 | \$110.0 | \$124.3 |
| X-Men | \$157.3 | \$75.0 | \$96.7 |
| Fantastic Four | \$154.7 | \$100.0 | \$71.4 |
| Hulk | \$132.2 | \$137.0 | \$57.3 |
| Fantastic Four: <br> Rise of the Silver Surfer | \$131.9 | \$130.0 | \$53.5 |
| Ghost Rider | \$115.8 | \$110.0 | \$34.8 |
| Daredevil | \$102.5 | \$78.0 | \$30.9 |
| Blade II | \$82.3 | \$54.0 | \$29.8 |
| Blade: Trinity | \$52.4 | \$65.0 | \$24.2 |
| The Punisher | \$33.8 | \$33.0 | \$16.4 |
| Elektra | \$24.4 | \$43.0 | \$10.4 |
| TOTALS | \$2,550.4 | \$1,742.0 | \$1,374.4 |

Numbers in millions
Sources: Box Office Mojo, Marvel, TMF estimates
These are estimates based on an Aug. 10, 2006 presentation Marvel gave to analysts. In it, management explains exactly how a self-produced movie would add to the company's operating profit. Our projections are based on that process. (Download the presentation here, and take a peek at Slide 22 for details.)

Could we be wrong? Possibly. But in a March presentation, Marvel executives theorized that 10 self-produced films with an average budget of $\$ 130$ million and an average domestic box office of $\$ 200$ million would generate $\$ 1.14$ billion in operating income in a seven-year period. Our table above covers 15 Marvel films in a seven-year period, and the numbers aren't far off.

So, let's assume that we are mostly correct. Notice how well the low-budget films do for Marvel. Or, better yet, look at Hulk, which was widely considered a bust and yet could have been a decent earner for Marvel as a self-produced film. That suggests a margin of safety in moviemaking that analysts don't yet see.

Furthermore, management appears to be juicing on Cap's super serum when it comes to producing returns from its available capital:

|  | Q4 2006 | Q1 2007 | Q2 2007 | Q3 2007 |
| :--- | :---: | :---: | :---: | :---: |
| Return on Capital | $20.4 \%$ | $82.4 \%$ | $41.2 \%$ | $43 \%$ |
| Source: Capital IQ |  |  |  |  |

Why should you care? From 2002 to 2006, Marvel's annual return on capital surged from $10 \%$ to $21.1 \%$. The stock has since quadrupled. Excelsior!

## VALUATION

But is it still cheap? Absolutely. Take a look at the company's historic multiples to adjusted cash from operations:

| Historic Operating Cash Flow Multiples | 2004 | 2005 | 2006 |
| :--- | :---: | :---: | :---: |
| High | 22.2 | 19.6 | 13.3 |
| Low | 11.3 | 11.8 | 7.1 |
| Average | 16.8 | 15.7 | 10.2 |

Sources: TMF estimates, Value Line
Marvel trades for 15.6 times adjusted cash from operations as of this writing. Clearly, there's room for this stock to grow like GiantMan, especially with the amount of cash Marvel is producing:

| Components of Adjusted <br> Cash from Operations | 2004 | $\mathbf{2 0 0 5}$ | 2006 | TTM |
| :--- | :---: | :---: | :---: | :---: |
| Reported Net Income | $\$ 124,877$ | $\$ 102,819$ | $\$ 58,704$ | $\$ 123,895$ |
| Depreciation and Amortization | $\$ 3,783$ | $\$ 4,534$ | $\$ 14,322$ | $\$ 9,758$ |
| Amortization of Financing Costs | $\$ 3,446$ | $\$ 1,660$ | $\$ 4,980$ | $\$ 4,980$ |
|  | $(\$ 6,063)$ | $(\$ 6,093)$ | $\$ 140,087$ | $(\$ 17,118)$ |
| Deferred Revenue | $\$ 0$ | $\$ 0$ | $(\$ 15,055)$ | $(\$ 196,629)$ |
| Film Production Costs | $\$ 0$ | $\$ 25,800$ | $\$ 7,400$ | $\$ 211,678$ |
| Borrowings from Film Facility | $(\$ 3,586)$ | $(\$ 4,289)$ | $(\$ 16,286)$ | $(\$ 4,192)$ |
| Capital Expenditures | $\$ 122,457$ | $\$ 124,431$ | $\$ 194,152$ | $\$ 132,372$ |
| Adjusted Operating Cash Flow |  |  |  |  |

TTM = Trailing 12 months. Numbers in thousands
Sources: Company filings and press releases
Notice that Marvel is growing well in this area. Notice, too, that the company is still very much on track for the $\$ 150$ million in adjusted cash from operations that Tim predicted in May.

Our point? There's a very healthy business here that's undervalued at current prices. We can only imagine what the stock will do when Marvel is a full-fledged movie studio.

Actually, let's imagine. Marvel's operating profit has improved by an average of $24.9 \%$ annually since 2002, but has bounced back and forth since 2003. Meanwhile, adjusted cash from opera-
tions, though it stumbled in the most recent quarter, shows that this company is raking in serious amounts of cash.

Let's be conservative and say that operating income from Marvel's current businesses - licensing, publishing, and toys - crawls forward at just $7 \%$ annually through the end of 2010. That's $\$ 267.5$ million, to which Marvel says we should add $\$ 215$ million for its movies. Doing so results in $\$ 482.5$ million in combined operating profit in year three, which we'll tax at a normalized rate of $40 \%$. That gives us ... (key punching sounds) ... \$289.5 million in 2010 net income.

Now, assuming its diluted share count - which has fallen dramatically in recent years - remains stable at 80.5 million, the "new" Marvel could produce $\ldots$ drum roll please $\ldots \$ 4.28 a$ share in 2010 earnings.

What would that be worth to investors? Let's look at history. Marvel's stock has traded at between 14 and 44 times earnings since 2005, according to Capital IQ. Using the same ratios pegs the company's January 2011 value at between $\$ 60$ and $\$ 188$ a share, with a median price of $\$ 124$.

So, at worst, Fools who buy below $\$ 27$ now stand to realize a minimum $27 \%$ annualized return in three years. But we think there's a reasonable chance of doing even better than that.

## CATALYSTS

You're probably already aware of the films on which Marvel is working. Iron Man, starring Robert Downey Jr. and Gwyneth Paltrow, debuts on May 2. We've seen the trailer, and all we'll say is that it ... looks ... awesome. Director Jon Favreau could have a big winner on his hands. The Incredible Hulk, starring Edward Norton and Liv Tyler, follows on June 13. We're not sure how well this one will do, but again, we're not worried. We've run the numbers. We know Marvel does well even with its worst movies. (Elektra, anyone?)

What's more, Marvel's mighty license machine is still hard at work. Lions Gate Entertainment (NYSE: LGF) begins shooting The Punisher: War Zone, a sequel to 2004's The Punisher, this fall, and it, too, will come to theaters in 2008. Meanwhile, X-Men spin-offs Wolverine and Magneto are expected to begin shooting in November and January, respectively. (Release dates point to at least 2009.)

Plus, the company just unveiled an online digital library that features 2,500 classic and recent comic books. Fans pay a monthly fee to access the library, and editors plan to expand it by at least 20 new titles per week. This should give a boost to operating income and cash flow.

## RISKS AND SELLING CRITERIA

Now for the cold shower. Movies are a risky business. It is possible that Marvel will make a string of box office losers that have no commercial appeal. Were that to occur, it would have far-
reaching effects. DVD sales would suffer. Toy sales would suffer. Merchandising revenue would suffer. And studios would be far less likely to work with Marvel on future projects.

In addition, Marvel is leaning on a $\$ 525$ million credit facility to produce its films. If it defaults, it loses the movie rights to 10 of its characters, including Hulk, Iron Man, sorcerer supreme Dr. Strange, and Captain America. Frankly, after having crunched the numbers, we don't see this happening. But it still bears mentioning.

We'd be more afraid of these risks materializing if Marvel hadn't already produced a string of successful sequels: Blade, SpiderMan, X-Men, and Fantastic Four have all been given a second shot and did well. The Incredible Hulk and The Punisher get their turns next. We expect even more in the years to come.

We're also reassured by the fact that Marvel's business is far more diverse today than it was three years ago:

| Revenue Contribution by Segment | 2004 | 2005 | 2006 |
| :--- | :---: | :---: | :---: |
| Licensing | $41.8 \%$ | $58.9 \%$ | $36.2 \%$ |
| Publishing | $16.7 \%$ | $23.7 \%$ | $30.8 \%$ |
| Toys | $41.4 \%$ | $17.4 \%$ | $33.0 \%$ |

Source: Capital IQ
And yet, Marvel remains the fourth-largest licensor in the world, according to LICENSE magazine. A forthcoming theme park in Dubai, to be built by the Al Ahli Group but applying Marvel's name and characters, bears witness to its extraordinary brand power. Such deals will continue to feed Marvel's cash flow machine and enhance what is already a sterling balance sheet.

Finally, let's not forget that comic books have been an American staple since the ' 30 s and have remained popular in the 70 years hence. And even before there were comics, there were the Knights of the Round Table, Robin Hood, and our blessed muse, William Shakespeare. Classic tales of heroism, bravery, and sacrifice have always made for great theater. Celluloid only makes them better.

Still, as the comedian-turned-pundit Dennis Miller might say, that's just our opinion, and we could be wrong. If the public takes to Iron Man like a toddler takes to lima beans, we'll worry. If The Incredible Hulk also bombs, we'll sell and suggest that you do the same.

And if it's a mixed bag? Wait. Remember our first chart. Marvel needn't have every movie be a hit in order to be a stock market success.

So, if Iron Man wins, and The Incredible Hulk loses, study the movies in the pipeline, watch the trailers when they become available, talk with moviegoers, and keep your eyes focused on Marvel's adjusted cash from operations and returns on capital. So long as most of those metrics point north, the stock should follow.

## THE FOOLISH BOTTOM LINE

We're huge fans of Marvel. Tim was a comic book collector for years. David follows Marvel's movies as if he were scouting for the next batch of Oscar winners for the Academy of Motion Picture Arts and Sciences.

In short: We're geeks; we admit it. But, as investors, we also plan to be very rich geeks. With a growing publishing business, a record of making successful flicks, and a very reasonable valuation, Marvel is exactly the sort of business that should help us get there. That's why we own shares today, and it's why we recommend that you open a position if you don't already have one.

As Stan Lee might say: Make Yours Marvel!
David Gardner, co-founder of The Motley Fool, is also the chief advisor for Motley Fool Rule Breakers and co-author of Motley Fool Stock Advisor with his brother and Fool co-founder, Tom. At the time of publication, David owned shares of Marvel.

Tim Beyers is a regular contributor to Rule Breakers, as well as The Motley Fool's online content and special reports. His other works with David include selections for Stocks 2005, Stocks 2006, and Stocks 2007. At the time of publication, Tim owned Marvel shares and LEAP options. Marvel is a Motley Fool Stock Advisor recommendation.

# Portfolio Recovery Associates: Collecting Debts Without Cracking Skulls 

BY JIM GILLIES (JIMG@FOOL.COM)

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## FINANCIAL SNAPSHOT


(Current as of 11/9/07)

## WHY BUY?

What's your vision of a debt collector? Do you imagine large men in trench coats and fedoras carrying tire irons? Somewhat distasteful and quasi-legal methods of enticing debtors to pay up or perhaps suffer unfortunate kneecap "incidents"?

Meet Portfolio Recovery Associates (Nasdaq: PRAA), the new breed of debt collector, with the motto, "giving debt collection a good name." That means rigid compliance with all legislation, strict adherence to shareholder-friendly operating principles, and no broken kneecaps.

Oh, and it offers strong, steady growth, the best management in the industry, gobs of cash generation (heck ... the business is cash generation), and a cheap stock price. What more could we want?

## CORPORATE FACTS

Americans are financing consumption with ever-greater amounts of consumer debt $\$ 2.47$ trillion as of the end of August. That includes $\$ 915$ billion of revolving credit (think credit cards), a number growing by nearly $4 \%$ annually in the past five years. Sometimes, however, people get in over their heads and default on that debt for reasons spanning the innocent to outright fraud. What happens then?

Lenders don't just sit around waiting for those who can't - or won't - pay their bills. After cajoling, pleading, and threatening (and perhaps using a collection agency or two), it's often simpler to just cut their losses and write off the bad accounts. But, there's still value left in the paper that can be extracted by a dedicated collection effort, even though this isn't generally within the skill set or interest of most lenders.
That's where companies like Portfolio Recovery Associates (PRA) come in: PRA offers to buy the charged-off debts from these lenders - usually for pennies on the dollar and it uses its own collector workforce and various legal strategies to recoup its investment, earning a nice return on its capital.
If you want to be successful in this business (remember, these debts have already been worked on by several parties before you, and the originators are willing to hand them over for pennies on the dollar), you need to do three things well:

- Price prospective debt purchases (portfolios) appropriately for your cost structure and collection capabilities.
- Buy portfolios intelligently - at or below a price that will provide a targeted return.
- Collect diligently on these portfolios using all legal and ethical means available while keeping your cost structure down.
Overpaying for debt is akin to burning money, and excellent pricing ability isn't of much use if collectors can't get debtors to pony up.


## FROM \$3 MILLION TO \$191 MILLION

PRA was formed in 1996 by four guys who had been doing similar buying and collecting at Household Financial (now part of HSBC (NYSE: HBC)). That year, PRA
purchased just over $\$ 3$ million of charged-off debt, and in its first full year (1997), it bought a total of $\$ 7.7$ million. In the most recent 12 months, it bought $\$ 191$ million.

In addition, a trio of small, fee-for-service businesses operate under the PRA umbrella, contributing nearly $\$ 33$ million to the last 12 months of cash receipts: Anchor Receivables Management, a contingent debt collector (that is, it provides collections expertise for debt owned by others, earning a collection fee in the process); IGS Nevada, which specializes in "asset location" (i.e., it traces collateral backing; say, auto loans); and RDS, which collects delinquent taxes owed to local, state, and federal governments.

The "accounts receivable management" industry (to use the more politically correct term) is fragmented. Annual revenue is estimated at $\$ 15$ billion, yet the four largest public companies, including PRA, account for only about $\$ 800$ million of this total. They're joined by more than 6,000 other collection companies, most of them tiny ( $\$ 8$ million or less in annual revenues).

Debt purchases are made across the charged-off spectrum. The longer it's been since the charge-off, the more difficult it generally is to collect. The more difficult it is to collect, the lower the price that account will fetch. PRA buys portfolios of all ages but generally favors older paper. Its core business is the purchase and collection of charged-off credit card debt, but the company also buys smaller amounts of charged-off auto loans, telecom, utility bills, and health care/medical debt. In addition, it buys and collects on bankrupt accounts where the debtor has agreed to a repayment plan and the lender is seeking to monetize its position.

Most debt purchases are priced to target a return of 2.5 to three times the price paid over the subsequent seven years, while bankrupt accounts are priced to return about two times the purchase price over a somewhat shorter period. Profitability for both types of accounts is similar.

PRA assesses portfolios for their potential cash-generating abilities using two statistical models created from the company's entire buying and collections history. Such modeling, done well, improves performance over time as it winnows out the occasions when PRA overpays for a deal and cuts down the number of poor-performing portfolios.

## PRA PLAYS IT STRAIGHT

Also, some rather ugly accounting rules define how cash collections translate into familiar financial terms such as "revenue" and
"earnings." Highlighting how this works uncovers another reason to like PRA: When considering a purchase, the company uses its models to conservatively forecast the amount of cash it will rake in. Collections never match initial expectations, and here's where things get tricky.

If a company collects more than it initially expected, and management believes this happy circumstance will continue, accounting rules allow the company to revise upward its portfolio's forecasted internal rate of return (IRR), which also pushes up the portfolio's total estimated collections (TEC) multiple (the ratio of all expected collections to the security's purchase price). This is a fancy way of saying that when management makes these upward revisions, they throw off some important accounting ratios, which makes revenues and profit margins look better on paper.

Because management sets these initial expectations, there's implicit opportunity for financial shenanigans. Companies could make a practice of overestimating TEC and report elevated revenues and earnings $\ldots$ at least, initially. Eventually, persistent overestimation will need to be corrected. A company does this by taking impairment charges, which decrease the balance sheet value of the portfolio and lead to lower reported revenues and earnings. That crimps future results and will likely result in a lower valuation based on the market's distrust of management.

Fortunately, PRA is a conservative estimator and only begins increasing TEC after portfolios prove themselves. Consider the snapshot at the bottom of this page, which shows recent portfolio buying and the pattern of rising TEC as portfolios age.

## MANAGEMENT AND LEADERSHIP

PRA also scores high in the area of management: The guys who founded the company, notably, CEO Steven Fredrickson and CFO Kevin Stevenson, still run it. And they're well-aligned with shareholders. There are ownership requirements for all executives, right down to the department heads. Fredrickson must own shares worth 13 times his annual salary; Stevenson eight times. Option compensation is largely shunned - the last grant, a mere 20,000 options, took place in 2004 in favor of modest restricted stock grants. Management is granted no special perks, and most incentives - at all levels - are paid in cash and are fully transparent to shareholders. Management's statement of operating principles, reproduced in every annual report, specifically cites careful investment; simple, low-cost operations; shareholder honesty and disclosure; and significant management stock ownership as requirements.

| Expected Collections - Multiple of Price Paid - Non-Bankruptcy Portfolios |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Year Purchased | 2002 | 2003 | 2004 | 2005 | 2006 | 2007-Q3 |
| 2002 | 261\% | 292\% | 328\% | 360\% | 383\% | 393\% |
| 2003 |  | 249\% | 271\% | 311\% | 344\% | 370\% |
| 2004 |  |  | 228\% | 254\% | 283\% | 311\% |
| 2005 |  |  |  | 221\% | 232\% | 243\% |
| 2006 |  |  |  |  | 225\% | 226\% |

Source: Company filings

## INVESTMENT THESIS

It was Charlie Munger who taught Warren Buffett the value of paying up for quality. So while there are cheaper companies among publicly traded debt collectors, buying the best is a recipe for long-term investing success.
Fortunately, we're not exactly paying through the nose for quality. For reasons both external and internal to the company, PRA's stock price fell dramatically after the company's secondquarter 2007 earnings report; a perceived "soft" third quarter provided no impetus for it to rebound.

Externally, any businesses with a "financial services" label even companies like PRA, which have little or nothing to do with the subprime mortgage mess - were the proverbial babies tossed out with the bathwater. There's also a high short interest in the stock (nearly $50 \%$ ), which undoubtedly has provoked the question, "What do the shorts know that we don't?" After considerable digging into the company, I'm of the opinion that the large short position is due more to other market participants using PRA as part of a hedging scheme for other investments in the debt-buying space, rather than any perceived fault on behalf of PRA.

Internally, cash collections fell sequentially in the second quarter but grew again in the third quarter. There were whispers that the amortization rate used to derive revenue and earnings was too low - a low amortization rate increases revenue and earnings numbers, so the implication is that management reached to "make" its numbers, a charge easily debunked for those who have long followed the company. Separate from that, its newest call center in Jackson, Tenn., is still ramping up. Collector productivity (measured in cash collections per person per hour) there is not yet on par with the rest of the company, crimping operating margins. This is a short-term problem that should work itself out in time. A longer-term view of the financial metrics (shown below) reveals a model of steady consistency and growth.

The market is worried, but the seeds of salvation are already apparent. Recent purchases of new debt have been massive and big spending today should translate into ever-greater cash collections tomorrow. Portfolio vintages thought to have been underperforming in years past (2003 and 2004) are now exceeding the upper side of management's lifetime collection target of 2.5 to three times purchase price. And more recent portfolios
deemed underperformers (2005) are beginning to head towards the target range.

I have good reason to expect the company's TEC to continue to ramp up as cash collections outperform management's initial conservative estimates. In the 169 "vintage quarters" since PRA went public, only twice has TEC been revised downward for a particular portfolio, and in both cases, the very next quarter saw a reversing upward revision.

## VALUATION

If you're stalking the proverbial 10-bagger in five years, PRA ain't it (though we all can dream). Rather, I expect strong and steady annualized gains in the $20 \%$ range, plus whatever dividend management throws at us from time to time.

To get a better idea of what this company is worth versus what the market thinks it's worth, I ran PRA's numbers through not one, not two, but three different valuation ratios: (1) the familiar price-to-earnings (P/E) ratio; (2) an enterprise value (EV) ratio versus the trailing 12 months of cash collections (TTM CC); and (3) an enterprise value ratio versus total expected remaining collections (ERC). My findings? Relative to its own history, this company is cheap no matter how you look at it:

|  | P/E | EV/TTM CC | EV/ERC |
| :--- | :---: | :---: | :---: |
| Current | 12.7 | 2.34 | 0.87 |
| Median* | 20.6 | 3.31 | 1.52 |
| Minimum* | 14.7 | 2.62 | 1.02 |
| Maximum* | 29.5 | 5.22 | 2.23 |

*Since December 2002. Calculations made on a rolling 12-month basis using month-ending prices Source: Author's calculations based on company filings

Not a numbers geek? That's OK. I'll still let you in on why this is such a big deal: If PRA just collects what it owns today and never buys another portfolio, it will still bring in more money than the value the market has placed on it.

And if you are a numbers geek (10-second nap for those who aren't; I'll be right back), I should point out that in the EV/ERC ratio, the three fee-for-service businesses are accounted for in the numerator, but not the denominator, which means that the story could be even better than the ratio reveals. Based on the revenues those three businesses brought in over the past year, I estimate their value at $\$ 75$ million. When I include that value in the

|  | 2002 | 2003 | 2004 | 2005 | 2006 | TTM (Q3-07) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Cash Collections | \$79.3 | \$117.1 | \$153.4 | \$191.4 | \$236.4 | \$255.8 |
| Amortization Rate | 32.1\% | 30.1\% | 30.7\% | 29.6\% | 30.9\% | 29.7\% |
| Collections Recognized as Revenue | \$53.8 | \$81.8 | \$106.3 | \$134.7 | \$163.4 | \$179.8 |
| Fee-for-Service Business Cash Revenue | \$1.9 | \$3.1 | \$7.1 | \$13.9 | \$25.0 | \$32.6 |
| Total Revenue Growth | 72.7\% | 52.1\% | 33.5\% | 31.0\% | 26.8\% | 18.9\% |
| EPS (Diluted) | \$0.94 | \$1.32 | \$1.73 | \$2.28 | \$2.77 | \$3.06 |
| New Purchased Receivables | \$43.0 | \$62.3 | \$59.8 | \$145.2 | \$105.8 | \$190.8 |
| Operating Margin | 37.5\% | 40.6\% | 39.6\% | 40.1\% | 38.2\% | 37.7\% |

TTM = Trailing 12 months. Dollar amounts in millions
Sources: Company filings and author's calculations
denominator for a more accurate calculation, I get a ratio of 0.78 , which reinforces the notion that the market is undervaluing PRA.

I also maintain a fairly detailed valuation model for PRA, based on appraising the company as a giant time-value-of-money problem. Without regurgitating too much mind-numbing detail, my pessimistic estimate of fair value today is $\$ 54$. Relaxing some of the gloominess suggests that fair value exceeds $\$ 60$.

Finally, PRA's business allows for fairly reasonable forward estimates. Looking out a year, I believe the company will be sitting on earnings per share (EPS) of around $\$ 3.60$, meaning that PRA trades at about 10.8 times my forward estimate. That's simply too low.

## CATALYSTS

I typically shun big, life-changing catalysts in favor of multiple smaller catalysts (or "opportunities," if you prefer) that, combined with a reasonably cheap stock, can produce very satisfying results.

The first opportunity I see is simply continued business performance (yawn ... ). No, really. PRA's stock has risen and fallen with the vagaries of the market. Yet, stepping back from the quarterly earnings imperative, we see that the company has returned about $21 \%$ annualized since its November 2002 IPO. This performance follows an extremely challenging period in which debt prices were higher than at any point since the company's formation, and with the stock trading close to a relative historical low.

A second catalyst I see is a re-acceleration of cash collections. In the first three quarters of 2007, new debt purchases eclipsed every full-year total in the company's history. These purchases will spur greater cash collections in upcoming quarters.
Third, while the new Jackson call center's productivity has disappointed to date, management has made a top priority of making improvements to align with the rest of the company. I believe they'll be successful (PRA has had similar past disappointments, notably soon after purchasing IGS Nevada - a business now firing on all cylinders). As productivity improves, operating margins will widen. There's also continued anecdotal evidence that industry pricing is softening, which will increase PRA's future profitability.
Finally, if it's fireworks you crave, you may see some if that short interest ever gets rapidly unwound. A stampede of buying-to-cover could be worthy of pulling up a comfy chair, grabbing a bag of popcorn, and sitting back and watching the stock ticker.

## RISKS

I have great faith in PRA's management. And while they've developed some excellent bench strength with their hiring at the non-executive management levels in the past couple of years, it's not a stretch to suggest that PRA's competitive advantage walks out the door every day at 5 p.m. I hope they look both ways before crossing the street (though, in fairness, the company would retain the historical pricing knowledge built up over time, and non-compete agreements are in place with vital management).

PRA is gradually broadening the debt classes that it will buy and collect in bulk (it's long dabbled in numerous types of chargedoff receivables - just not in amounts sufficient to affect reported results). I want to see continued prudent caution as they ramp up purchase volume of other debt types (medical/health care, for one, has been prominently mentioned). We have an unfortunate example from competitor Asset Acceptance Capital (Nasdaq: AACC), which took significant impairments on big purchases of wireless telecom paper in 2005 that subsequently didn't collect as it had modeled; that stock arguably continues to suffer from this bad decision. While I consider PRA management the best in the industry, there's no guarantee that it can't make a similar pricing mistake.

Perversely, perhaps the biggest risk I see is overenthusiasm for the industry. With little barrier to entry, when new capital seeks to capture some of the fat profits of PRA and its ilk, demand for charged-off debt rises, taking prices with it. The best period for disciplined, long-term debt collectors was in the wake of the 1999 blowup of the then two largest debt collectors (Creditrust and CFS - which overleveraged and ironically went bankrupt themselves). The cumulative IRR on PRA's portfolio purchases from 1996 through 1999 was in the low $40 \%$ range.

Implosion of CFS and Creditrust scared off new capital, and, coupled with the tech wreck and recession, meant that considerable debt "supply" matched depressed debt "demand." Prices fell, and the disciplined buyers made hay. The cumulative IRR on portfolios purchased between 2000 and 2003 ranged from $51 \%$ to $60 \%$ ! Since 2004 , debt prices have been very high as considerable capital has entered the industry (predominantly hedge funds lending money to private collectors). And while anecdotal evidence suggests that prices are moderating, renewed enthusiasm would translate to higher prices for debt and lowered financial results for PRA going forward.

## SELLING CRITERIA

PRA is a company I'm content to hold for the long term, provided that it just keeps on doing what it's always done. However, the following might make me re-evaluate my position:

- The loss of key management personnel; though presumably, the historical knowledge built up in the debt pricing database would remain in their absence.
- A demonstrable failure of pricing models with new asset sources (or, though unlikely, old asset sources). A gaffe comparable to Asset Acceptance's wireless telecom buying would knock down my valuation and might cause me to exit.
- The stock reaches an excessive valuation. PRA has spent most of the last four years trading at a P/E of between 17 and 23. If it rose well above this range - say, above 28 times earnings, without concomitant massive new debt purchases offering the promise of
substantially increased future earnings, it might be time to lighten our exposure.
- The supply of charged-off debt "raw material" falls dramatically as people start to shun consumer debt and pay all their bills. Yeah ... never gonna happen.


## THE FOOLISH BOTTOM LINE

PRA offers the total package. It's the paragon of virtue in an industry often looked down upon. Its vaunted pricing discipline has it refusing to overpay for charged-off debt, but, as evidenced by the last 12 months, it will spend big money if suitably priced
opportunities present themselves. Its financial results have been a modicum of consistency even as cash collections have more than tripled since PRA went public. The company's operating principles require management to be significant shareholders. And the stock trades at a very reasonable price.

At the time of publication, Jim Gillies owned shares of Portfolio Recovery Associates. He is also short the March $2008 \$ 45$ and \$50 Portfolio Recovery put options (a bullish strategy). Portfolio Recovery Associates is a Motley Fool Hidden Gems recommendation. Asset Acceptance Capital is a Hidden Gems Pay Dirt recommendation.

# Spectra Energy: It's a Gas <br> \author{ BY JIM FINK (JFINK@FOOL.COM) 

}

## SPECTRA ENERGY

## NYSE: SE

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Houston, TX 77056-5310
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## FINANCIAL SNAPSHOT

Share Price: . . . . . . . . . . . . . . . . . . . . . . . . . . $\$ 24.77$
Shares Outstanding: . . . . . . . . . . . $\mathbf{6} 15.65$ billion
Market Cap: . . . . . . . . . . . . . . . . . $\$ 135$ million
Cash: . . . . . . . . . . . . . . . . . . . . . . . $\$ 8.59$ billion
Debt: . . . . . . . . . . . . . . . . . . . . . $\$ 24.11$ billion
Enterprise Value:. . . . . . . . .
(Current as of 11/9/07)

## WHY BUY?

Got gas? No, not the kind that needs Rolaids, but the energy kind. If you do, you may have received it courtesy of Spectra Energy (NYSE: SE), one of the United States’ premier natural gas pipeline companies. Spectra is a gatekeeper: It charges a distancebased fee every time an energy company uses its pipeline to transport gas, and this fee stays the same regardless of energy prices. With crude oil skyrocketing to nearly $\$ 100$ per barrel for the first time, natural gas is becoming a more wallet-friendly alternative fuel source. That advantage continues to drive demand, and Spectra is a pure play on gas usage that should be part of every investor's portfolio.

## NATURAL GAS: THE OIL OF THE 21ST CENTURY

How big is Spectra's market? Natural gas provides a quarter of the United States' annual energy needs: It goes toward $45 \%$ of home heating, $31 \%$ of petrochemicals used in agriculture and industry, and 14\% of electricity generation. During the 1990s, more than $90 \%$ of all the new U.S. power plants were natural gas-fired, so as electricity demand increases, demand for natural gas will, too. The U.S. Department of Energy (DOE) projects that rising demand for natural gas in the electric power sector will increase total U.S. consumption from 22 trillion cubic feet in 2007 to 26.1 trillion cubic feet in 2030, with much of the growth expected by 2020.

But demand isn't just increasing in the U.S.; it's growing worldwide. In Europe, the market share of natural gas used to generate electricity is expected to rise from $18 \%$ in 2007 to $29 \%$ in 2030 . And demand is growing more than twice as fast in emerging markets as it is in the developed world. According to the DOE, gas consumption in China will grow by an estimated $7 \%$ per year through 2025, five times the rate in the U.S. and the highest rate of any major industrial power. India and South Korea are also consuming large quantities at accelerating rates as their economies develop.

This demand is sustainable because the planet isn't running out of natural gas anytime soon. In terms of energy output, the world's known gas reserves equal more than $90 \%$ of its known petroleum reserves. Hampshire College professor Michael Klare has pointed out that the world consumes only $1.5 \%$ of the remaining gas supply each year compared to $2.5 \%$ of the remaining oil supply, so gas supplies will remain ample for a much longer period. In addition, the industry website www.naturalgas.org provides data that suggests that nearly 60 years' worth of natural gas consumption remains from U.S. supplies alone. No doubt about it, Spectra's pipelines will be used for decades to come, probably near full capacity.

## CORPORATE FACTS

Spectra was spun off from electric utility Duke Energy (NYSE: DUK) in January 2007. It's the largest pure-play "midstream" natural gas pipeline company in North America, using its 17,500 miles of pipeline to transport gas from where it is produced (in the Gulf of Mexico and Western Canada) to where it is consumed (Florida, the Northeast, the Pacific Northwest, and Ontario, Canada).

A midstream company provides services at every stage of the natural gas business except for the two endpoints. The stages are:

1. Exploration and production (Spectra not involved)
2. Gathering gas from the wellhead and processing it (aka field services) by extracting natural gas liquids (NGLs)
3. Transporting the gas and storing it for later use
4. Distributing the gas locally to end users (e.g., utilities, industry, residential)
5. Consumption by the end user (Spectra not involved)

As the pie chart shows, about $45 \%$ of Spectra's operating income before taxes comes from transport and storage ("U.S. Transmission"), about $35 \%$ from processing (U.S. and Canadian field service operations combined), and about 20\% from utility end user distribution. The processing segment's profits are the most vulnerable to energy prices. The price of NGLs historically moves with oil prices, so for each dollar that oil prices go up, Spectra's pre-tax earnings from its U.S. processing operations increase by $\$ 15$ million. Spectra is the No. 1 NGL producer in the U.S. In Western Canada, its Empress system produces an additional \$25 million in earnings for each $\$ 1$ increase in the spread between the price of propane (a proxy for NGLs) and natural gas.

Half of Spectra's profits are unregulated (e.g., storage and NGL processing), providing the stock with plenty of upside potential. Storage is becoming particularly important given that it is becoming cost-effective to import liquid natural gas (LNG) from foreign countries such as Trinidad and Tobago, Algeria, Egypt, Malaysia, and Nigeria.

In June 2007, the company carved out Spectra Energy Partners (NYSE: SEP), a tax-advantaged master limited partnership (MLP) in which it acts as a general partner and holds an $82 \%$ interest. The MLP is composed of mature income-producing properties that do not require much new investment; and consequently, it pays a higher dividend of $4.7 \%$ compared to Spectra's $3.5 \%$.

## INVESTMENT THESIS

The company is well-positioned for growth, with $\$ 3$ billion of expansion opportunities in the 2007 to 2009 timeframe, as well

Spectra First-Half 2007 Operating Income Before Taxes


Source: Capital IQ
as $\$ 1.4$ billion in new "Greenfield" projects. Even without these projects, demand growth alone puts Spectra in a sweet spot: The company's consumption markets are growing 2.5 times faster than the national average! Its corporate objective is to deliver "solid, steady growth and an attractive dividend to provide a total return of $8 \%$ to $10 \%$ in a relatively low-risk environment." But I think Spectra is low-balling expectations and can, in fact, do much better than this - more along the lines of $15 \%$ annually. Given that the S\&P 500 has historically returned only $6.9 \%$ annually on average, a projected return double this at lower-thanaverage risk sounds mighty fine indeed.

Plus, studies show that spinoffs typically outperform the market during their first three years of independence. Here's why:

- Institutional investors sell them off because they're only interested in the parent company's business, not the spun off business. Many utility mutual funds that own Duke may have been forced to dump Spectra shares since their fund charters only permit them to own stocks in the utility indexes. This indiscriminate selling has caused Spectra shares to be undervalued - they currently trade at nearly $10 \%$ below their opening price at the time of the spinoff in January 2007.
- Managers of the spinoff are now independent and can focus on growing the business without the distraction of competing parent company objectives.
- The company can use its own stock as currency to entice managers to perform well and attract talent to join the firm.
I'm not the only one who views Spectra as significantly undervalued. Substantial insider buying (150,000 shares' worth) has occurred since May, led by Dennis Hendrix, former CEO of PanEnergy, the company that owned and operated Spectra's pipeline assets prior to its acquisition by Duke Power in 1997. If anyone should know the value of Spectra's assets, it's Hendrix. In addition, Bruce Berkowitz, a Warren Buffett protégé investor and portfolio manager of the Fairholme Fund (.pdf file, see p. 5) inherited Spectra shares from his Duke Energy holdings, and, rather than dump Spectra, he decided to hold on to Spectra and dump Duke Energy!

Lastly, and perhaps most importantly, Spectra is run by a management team with more than 20 years' experience in the natural gas industry. Chairman Paul Anderson is a former chairman and CEO of Duke Energy, and CEO Fred Fowler is a former president and COO of Duke Energy. Furthermore, both are former executives of PanEnergy, which, as mentioned above, was a past owner of Spectra's pipelines. These guys know how to run a gas pipeline! It's always a good sign when the management of the parent leaves to join the spinoff. Presumably, people of such power would not leave unless they thought the spinoff presented an even better investment opportunity.

## VALUATION

According to my discounted cash flow valuation model, Spectra is currently worth $\$ 33.60$ per share, $30 \%$ above current levels. I assume $15 \%$ annual growth for the first five years, tailing off to $3 \%$ in year 12 . As a pipeline company largely immune from energy price fluctuations, Spectra is low-risk and deserves a below-average cost of capital of only $8.75 \%$. A multiples analysis yields a similar valuation. Spectra's $\mathrm{P} / \mathrm{E}$ multiple is 18.6 , and enterprise-value-to-EBITDA is 11 , much lower than the industry medians of 24.3 and 13.7 , respectively. If the company's multiples equaled those of the industry average, its stock would be valued at between $\$ 31$ and $\$ 32$.

Since Spectra only went public back in January, we can't do year-over-year comparisons, but the financial performance so far this year has been promising. Return on equity is $10.9 \%$, far above the company's cost of capital, meaning that Spectra is creating value for shareholders. In the past 12 months, cash from operations was a healthy $\$ 1.2$ billion, more than enough to pay the $\$ 424$ million in dividends. As more of Spectra's expansion projects come on line in the next few years, I see the company's cash flow increasing substantially from current levels, which will allow it to increase its annual dividend at double-digit rates. When you combine Spectra's 30\% capital appreciation potential with a $3.5 \%$ dividend that is likely to increase, the conclusion is clear: The company is an exceptional value at $\$ 24.77$ a share.

## CATALYSTS

Now that Spectra has been independent for almost a year, management has had time to iron out most, if not all, of the kinks in running the business, and one-time restructuring charges associated with the spinoff have been booked. A 1993 Penn State study found that spinoff stocks perform best in the second year of independence. Why the second year? Super-investor Joel Greenblatt, author of You Can Be a Stock Market Genius, believes that it takes about a year for the weak holders to sell the stock and for the new management's innovations to start having an effect. True to that idea, Spectra has several expansion projects planned to be operational within the next year. These include new pipeline looping and compression that will deliver an additional 150 million cubic feet per day from Lebanon, Ohio to New Jersey, and a joint venture with CenterPoint Energy (NYSE: CNP) that involves the construction of roughly 270 miles of new pipeline from northern Louisiana to a connection near Mobile, Ala., among many others. With all these exciting new projects starting to generate cash flow, combined with the fact that virtually all of the restructuring charges associated with the spinoff have been taken, Spectra is ready to roll.

## RISKS AND SELLING CRITERIA

Although Spectra's gatekeeper function as a pipeline company is largely fee-based and immune to energy price fluctuations, $30 \%$
of its revenue is exposed to oil and gas prices through its NGL processing business, so any severe reduction in energy prices would have a negative effect on Spectra's bottom line. However, given strong world demand for energy and limited supply, this risk is minimal.

Secondly, a large portion of the company's pipeline is located in the Gulf Coast, which is highly susceptible to hurricane damage. But the company's 2005 experience in the aftermath of Hurricanes Katrina and Rita is encouraging. While some of its facilities were forced to shut down, all of them resumed pre-hurricane levels of capacity utilization within months. Furthermore, Spectra has hurricane insurance that, after a $\$ 5$ million deductible per occurrence, paid off lost revenue and damage claims worth more than $\$ 21$ million. According to the company, insurance rates rose after Hurricane Katrina but "did not have a material adverse effect" on its financial position or cash flows.

A more serious risk is the possibility that Chairman Paul Anderson and CEO Fred Fowler leave the company. I would be far less confident about Spectra's future success (and holding shares) without these veteran gas men at the helm. Fortunately, there is no indication that either is leaving anytime soon.

Finally, the company is subject to extensive regulation by the Federal Energy Regulatory Commission (FERC), the Environmental Protection Agency (EPA), and state and local agencies. Any of them could throw a curveball that would hurt Spectra's business, such as ordering lower transmission rates, mandating increased competition, or imposing fines for environmental cleanup. Shareholders will need to keep an eye out for any serious changes. That said, although regulatory costs are part of doing business, FERC and EPA have tended to be reasonable with their rules. I expect that reasonableness to continue.

## THE FOOLISH BOTTOM LINE

If you are bullish on the growing global demand for natural gas and energy, Spectra is a must-own stock. It is the biggest pure play in the industry, involved in virtually every segment of the natural gas value chain, and it has two of the most experienced management executives at the helm. With significant growth opportunities being developed for the next few years, Spectra is a very safe investment that pays a solid $3.5 \%$ dividend - it is a growth story that offers investors the chance to earn marketbeating returns with below-average risk. Almost 10 months have passed since it was spun off from Duke Energy. Given that spinoffs historically perform best in their second year, now is an opportune time to join company insiders and jump on board the Spectra train before it leaves the station.

At the time of publication, Jim Fink did not own shares of any company mentioned in this write-up. Spectra Energy and Duke Energy are Motley Fool Income Investor recommendations.

# Starbucks: The Next Venti Cap 

BY TOM GARDNER (TOMG@FOOL.COM) AND TIM HANSON (THANSON@FOOL.COM)

## STARBUCKS

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## FINANCIAL SNAPSHOT

Share Price: . . . . . . . . . . . . . . . . . . . . . . . $\$ 22.57$
Shares Outstanding: . . . . . . . . 746.3 million
Market Cap: . . . . . . . . . . . . . . $\$ 16.8$ billion
Cash and Investments
(includes LT investments):. . . $\$ 588.4$ million
Debt: . . . . . . . . . . . . . . . . . . . . $\$ 882.1$ million
Enterprise Value
(includes LT investments):. . . . . \$17.1 billion
(Current as of 11/9/07)

## WHY BUY?

Starbucks (Nasdaq: SBUX) is a Rule Maker.
Remember Rule Maker investing? Way back in 1999, I (Tom) laid out the strategy as follows: "The Rule Maker solution buys stalwart businesses and relies only on simple metrics, common-sense logic, and your patience."

The key back then was to buy superior companies that can be held in 10 -year increments. To think over such a long term, you needed to find stocks with staying power. That's Starbucks. It's an iconic brand with a dominant position and excellent cash flows.

But today's opportunity is even better than that.
The Rule Maker strategy a decade ago lacked one very important variable: valuation. I have come to realize the importance of valuation as it relates to large-cap stocks, where growth from a large base of cash flows becomes increasingly difficult. Because Starbucks has had a few high-profile stumbles recently, the market is giving us the opportunity to buy that same iconic brand, dominant position, and those excellent cash flows for the cheapest relative valuation in the stock's history.

## CORPORATE FACTS

If you don't already know the story of this Seattle-based coffee giant, that means you've probably been cryogenically frozen for the past 10 to 20 years. So, before we get to Starbucks, we should probably first tell you about the even more important things you've missed: the Internet, capitalism in China, and the global craze that is Dancing with the Stars.

But since we don't have the space for that, we'll stick with Starbucks.
Founded in 1971 and purchased by Chairman Howard Schultz in 1987, Starbucks is one of America's great entrepreneurial success stories. The company's nearly ubiquitous (in the U.S.) outposts offer an array of premium coffees, teas, juices, espresso beverages, pastries, and coffee-related merchandise. (What better way to enjoy your Starbucks coffee than in an official Starbucks mug?)

That winning concept has helped the company open more than 14,000 locations in 42 countries, grow revenue by more than $35 \%$ and earnings by nearly $40 \%$ annually for the past 15 years, and reward shareholders with $25 \%$ annual returns since its IPO.

Now, though, the whispers are that Starbucks has lost its mojo. Growth has slowed, same-store sales are down, operating costs are rising, and the dual threats of brand dilution and declining experience spurred Schultz to send an emergency memo to his senior management in February warning that the Starbucks brand - one of the company's most valuable assets - was in danger of becoming commoditized.

Not coincidentally, Starbucks' stock has ceased being a highflier. It's down more than $30 \%$ over the past year - trailing the S\&P 500 by some 45 percentage points.

## INVESTMENT THESIS

Starbucks is not alone among the ranks of great companies that have undergone significant and prolonged declines on the way to earning market-crushing returns. Even the best performers can fall out of favor, as Starbucks has of late.

In a softening economy, the market is skeptical of Starbucks and its premium prices. What's more, there's the belief that the company has almost saturated the U.S. market and that operations abroad, currently stumbling, won't be able to approximate the success that Starbucks enjoyed stateside 10 to 15 years ago.

Schultz disagrees. In his own words, "We're going to increase our international business five times more than it is today. We're going to double the size of the company in four to five years."

That's a bold prediction, but it's achievable. Furthermore, if you believe that Starbucks will eventually get its China concept and then its Mexico concept and eventually even its India concept running on all cylinders, this is a significant opportunity: You can buy a proven operation that we all know can grow like wildfire right before it scores big in some of the world's fastestgrowing economies. This has the potential to cause a bigger rush than a Venti red eye (coffee plus shot ... try it if you haven't).

## VALUATION

While a price-to-earnings ( $\mathrm{P} / \mathrm{E}$ ) ratio of 27 and a price-to-sales (P/S) ratio of 1.9 don't necessarily scream "cheap," both of these numbers are all-time lows for Starbucks' stock. Moreover, for a popular consumer chain restaurant with an elite brand that has consistently grown its top line by $20 \%$ annually, they look downright appealing (see table below).

The companies in the table don't make a perfect peer group, but they should show you what is so special about Starbucks: Though it's a fast-growing large-cap company with above-average margins and returns on equity, it's being valued as though it were a fast-growing mid- or small-cap company with execution risk.

Of course, the international side of Starbucks is a fast-growing mid cap with execution risk. So, when we valued the company, we separated it into two parts: the dominant and predictable U.S. business and the potential blockbuster that is its international side.

The U.S. business is a fantastic operation. Although growth is slowing, it has efficient operating profit margins of $15 \%$, funds its growth from cash flows, can raise prices regularly, and domi-
nates the marketplace. If we believe Schultz that the business can double in five years and will reach saturation in another five or so years after that (2017) with 20,000 stores, we have an operation that's worth approximately $\$ 20$ per share.
That said, the value of the company's international operations, and particularly those in emerging markets, is much harder to pin down. Why? Because although the business has yet to become a consistent cash generator, it has enormous potential.
If you've looked at a public company operating in China or India recently, then you know how fast valuations can get silly when you extrapolate $30 \%$ to $50 \%$ growth rates over a period of years. But that's exactly the potential that Starbucks has if it can perfect its concept within other cultures. We believe this side of the business is worth anywhere from $\$ 2$ to $\$ 20$ per share.
Then there's the brand, the 88th most valuable in the world for 2007, according to Interbrand. It's worth another few dollars per share if only because it would cost a competitor billions of dollars in spending to build a similar name.

Add it all up, and for $\$ 22.57$ per share, you're buying a meaningful chance to double your money or more in five years with almost zero downside risk. That's true even if we put the company on autopilot for five years (meaning that any potential tremendous accretive gains that Asia could offer fail to emerge) as long as the company modestly improves international operating margins and doesn't prove Howard Schultz wrong vis-a-vis its growth potential. (That's based on $\$ 1.80$ to $\$ 2.10$ in EPS with the stock trading at 23 to 30 times earnings.)

## CATALYSTS

If it's not obvious by now, the catalyst we are most relying on to drive Starbucks' stock is the success and expansion of the company's international operations. Its 4,000 international stores currently account for just $17 \%$ of revenue and $8 \%$ of profit - with outposts in Canada and the U.K. being the main contributors to those numbers. Management, however, sees potential for 20,000 stores internationally - a number that we believe will prove to be conservative over the next few decades.

After all, if we can cram 20,000 successful Starbucks stores into the United States (population 300 million and growing by $0.9 \%$ per year), there's no reason why an economically developed China (population 1.4 billion and growing by $0.6 \%$ per year) or India (population 1.1 billion and growing by $1.6 \%$ per year) couldn't accommodate that many ... each.

| Company | Market Cap | P/E | P/S | Three-Year Sales Growth | EBIT Margin | Return on Equity |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Starbucks | \$16,844 | 27 | 1.9 | 22.2\% | 10.1\% | 26.7\% |
| Tim Hortons (NYSE: THI) | \$7,338 | 30.2 | 3.7 | 12.3\% | 20.4\% | 26.4\% |
| Chipotle Mexican Grill (NYSE: CMG) | \$4,001 | 62.9 | 3.9 | 37.7\% | 10.1\% | 12.9\% |
| Panera (Nasdaq: PNRA) | \$1,182 | 20.1 | 1.2 | 30.9\% | 8.9\% | 14.2\% |
| Buffalo Wild Wings (Nasdaq: BWLD) | \$495 | 24.5 | 1.5 | 26.4\% | 8.7\% | 16.7\% |
| Peet's Coffee \& Tea (Nasdaq: PEET) | \$393 | 54.3 | 1.6 | 20.9\% | 4.1\% | 5.4\% |

Source: Capital IQ. Dollar amounts in millions. Data taken from trailing 12-month period

Yes, that's an extremely long-term view. For example, Starbucks doesn't yet have a store in India - though I (Tim) saw several knock-offs of the concept in Hyderabad (the Silicon Valley of India) this year, and they sure looked crowded.

Moreover, Starbucks is still having trouble adapting to Chinese culture - consider the recent closure of its outlet in Beijing's Forbidden City - and needs to perfect its concept there. The model that works in America (fast, coffee-focused) doesn't work in China (sit-down, tea- and food-focused). That said, every Starbucks I (Tim) visited in China, Taiwan, and Macau this year was packed. Yes, they were all in urban centers, but urban centers in China are the next big thing. According to research by Roth Capital, the rural-to-urban migration will average 17 million people annually during the next 20 years. These folks are finding work, earning more disposable income, and being exposed to an increasing number of Western goods.

Starbucks recently announced that it is taking its ready-to-drink coffee beverage distribution partnership with PepsiCo (NYSE: PEP) international - starting in China. This move will have two benefits: First, it should help Starbucks increase sales of its bottled drinks in the fast-growing Chinese market. Second, and perhaps more importantly, it will give the Starbucks brand a bigger presence in the market.

In other words, the candle is being burned at both ends. While Starbucks is (and needs to be) working to get its China product right, the Chinese people are simultaneously becoming more like the profile that so adores Starbucks here in the U.S.

As for domestic operations, one of Starbucks' key means for driving growth as expansion slows will be increasing transaction value per customer - though that means food. Starbucks has a mixed record in this regard, and currently, just $15 \%$ of store revenue comes from food. Egg sandwiches (a staple at McDonald's (NYSE: MCD), which, incidentally, is upgrading its coffee offerings) have proven particularly difficult for the company to get right - and as of our last channel check at the Starbucks adjacent to D.C.'s Verizon Center, while they are still displayed unappetizingly, the products taste better than they used to.

Good coffee gets people in the door, and Starbucks can substantially increase average transaction value if it can nail down its food offerings and replicate them across every store. Look for continued updates from the company on this effort. Warm breakfast items expanded to another 929 locations in the third quarter of 2007.

## RISKS

One of the more bizarre remarks you'll hear during a Starbucks conference call is "Moving on to music and entertainment ..."

Howard Schultz has long sought to make Starbucks more than a coffee purveyor. That desire to be a lifetime brand and media company has led the company to, at times, waste capital and destroy shareholder value. The fact that cash-rich and cash-
generating Starbucks has yet to contemplate a dividend even at a time when growth is slowing demonstrates, for better or for worse, that it will pursue growth at all costs and has no qualms about risking (or destroying) capital. Or, as outgoing CFO Michael Casey said in the third quarter 2007 conference call, "Twenty percent top-line growth ... cannot be achieved if you have a cost-cutting mentality."

The obvious response here is "Why not?" But Starbucks management doesn't want to hear it. Instead, it has opted to repurchase shares on the open market. And while that should reduce the share count going forward, the company wasted some capital by repurchasing shares at high-ish valuations in the past two years. Shareholders, in our opinion, would have been better rewarded with a dividend.

Further, while we tend to agree with Starbucks' management that the company offers an experience beyond mere coffee, the fact remains that stores in "tea-drinking nations" like China have had to tweak their formats and have not yet seen the performance of the concept that spread from Seattle to Miami so rapidly in the past 15 years. American cultural icons can do quite well in other cultures, but they rarely enjoy immediate acceptance. (See Euro Disney.)

Finally, McDonald's and Starbucks, once quite separate entities in the marketplace, are turning into direct competitors. McDonald's has improved the quality of its coffee, and recent rumors have it introducing espresso drinks into its stores by next year. Starbucks has made breakfast and lunch a clear part of its strategy to grow same-store sales. While the companies continue to offer different experiences to the consumer, both are behemoths with wide brand recognition. To compete, Starbucks may have to increase marketing spend or even cut prices - moves that would have a direct negative impact on its bottom line.

## SELLING CRITERIA

Although the current valuation is compelling, like any common stock, Starbucks is not a risk-free proposition. First and foremost, Jim Donald became Starbucks' CEO in 2005, and we have yet to be convinced that he's the right man for the job. His tenure thus far has been racked by operational difficulties such as the blended beverage prep time debacle that ruined the summer of 2006 and the inability to perfect breakfast offerings. If it becomes clear that a change in leadership is needed, Starbucks could get stuck in the mud, and our capital would be put to better use elsewhere.

The other reason to sell the shares would be if our central catalyst - acceptance and growth in emerging markets - fails to materialize. Widespread failure in China, for example, would undermine our thesis.

## THE FOOLISH BOTTOM LINE

The key to buying stocks successfully is recognizing that every investment decision comes with a range of outcomes. The inves-
tors who do best over multiyear timeframes are those who only buy stocks when, to quote Warren Buffett disciple and hedge fund manager Mohnish Pabrai, potential outcomes are limited to "Heads, I win; tails, I don't lose too much."

With Starbucks, we're looking at a company that, even on autopilot, should outpace the broader market from current prices and has a backstop of $\$ 20$ per share. But we also have the variable of international growth that could help the stock do substantially better.

The market believes Starbucks is spending too much to expand into tea-drinking cultures - and that the company won't see the same returns. If that proves to be the case, we won't lose too
much. But if the Starbucks experience translates to China - and we believe it will - we're looking at an investment that will win big for the next five to 10 years or more.

At the time of publication, neither Tom Gardner nor Tim Hanson owned shares of any company mentioned in this writeup. Starbucks is a Motley Fool Stock Advisor recommendation. Tim Hortons is a Motley Fool Global Gains recommendation. Chipotle Mexican Grill is a recommendation in Motley Fool Hidden Gems and Motley Fool Rule Breakers. Buffalo Wild Wings is both a Motley Fool Hidden Gems and Million Dollar Portfolio pick. Panera is a Motley Fool Hidden Gems Pay Dirt selection.

# Thor Industries: Riding the Road to Profits <br> \author{ BY BILL BARKER (BBARKER@FOOL.COM) 

}

## THOR INDUSTRIES

| NYSE: THO www.thorindustries.com |  |
| :---: | :---: |
|  | 419 West Pike Street |
|  | Jackson Center, OH 45334-0629 |
|  | 937-596-6849 |
| FINANCIAL SNAPSHOT |  |
|  | Share Price:. . . . . . . . . . . . . . . . . . . . . $\$ 39.76$ |
|  | Shares Outstanding: ............. 56 million |
|  | Market Cap: . . . . . . . . . . . . . . . \$ 22.2 billion |
|  | Cash (including short-term investments): $\qquad$ \$346.5 million |
|  | Debt:............................. N/A |
|  | Enterprise Value:............... . $\$ 1.9$ billion |

(Current as of 11/9/07)

## WHY BUY?

If you're looking for a great way to fund your next road trip, consider this: Thor Industries (NYSE: THO) is the world's leading manufacturer of recreational vehicles (RVs) and mid-sized buses. It is, by far, the most profitable maker of RVs around, and its weak competition allows it to dominate its sector.

Thor has also demonstrated very investor-friendly behavior and results throughout its publicly traded history, and it's extremely competent in how it uses the substantial cash it produces - carefully timing its acquisitions of smaller operators, share buybacks, and regular and special dividend payments.

Although the dual dragons of higher fuel prices and tougher credit conditions have impinged on sales growth for the last 12 months, the long-term demographics supporting future RV sales are simply outstanding. The baby boom wave of retirees, set to start very soon, means that the segment of the population most likely to buy RVs is increasing dramatically faster than the rest of the population. This will be true for decades. While the last 12 months might indicate to some that the RV sector could be in trouble, the view through the windshield looks a lot better than a glance in the rearview mirror. Shares of Thor have bounced up off their summer lows, but the stock is still trading well off its historic multiples, and now looks to be a ripe time to buy.

## CORPORATE FACTS

Ohio-based Thor is not an homage to the Norse god for whom both a comic-book character and Thursday are named. Rather, the company is named after its founders, Wade Thompson and Peter Orthwein, who combined their two companies in 1980 - along with the first two letters of their last names. The "Th" coming first perhaps reflects that Thompson has a bigger presence, owning 30\% of the company to Orthwein's $4.6 \%$. (Or maybe it's because a company named "Orth" is significantly less sonorous.) Thompson is chairman, CEO, and president, while Orthwein is vice chairman and treasurer.

Thor is the largest builder of RVs in the country, and, therefore, the world, as the RV industry is primarily a North American phenomenon. The roads around the rest of the world just don't accommodate RVs as happily as good ol' American ones do, though there is hope that perhaps in the future, international sales beyond Canada will improve. Thor is also the largest builder of mid-sized buses, with a $38 \%$ share of the industry.

The company's RV operations are divided into two segments: The first and largest comprises towable RVs, which are non-motorized vehicles designed to be towed by autos, SUVs, pickup trucks, or vans. The second segment is motorhomes, which are self-powered vehicles with self-contained living spaces - you might think of them generically as "Winnebagos" (even though Winnebago, like Kleenex or Xerox, is a brand name, not a product category). Thor has a $31 \%$ share of the towable RV industry and a $14 \%$ slice of the motorhome market.

The company produces RVs under many brand names, including Airstream, Breckenridge, CrossRoads, Damon, Dutchmen, Four Winds, General Coach, Keystone, Komfort, Mandalay, and Thor California. The bus segment manufactures under the names Champion Bus, Eldorado National, and Goshen Coach.

Thor's sales are divided as follows:

| Segment | FY 2005 | FY 2006 | FY 2007 |
| :--- | :---: | :---: | :---: |
| Towable RVs | $\$ 1,742(68 \%)$ | $\$ 2,173(71 \%)$ | $\$ 1,890(66 \%)$ |
| Motorhomes | $\$ 566(22 \%)$ | $\$ 577(19 \%)$ | $\$ 566(20 \%)$ |
| Buses | $\$ 250(10 \%)$ | $\$ 316(10 \%)$ | $\$ 401(14 \%)$ |
| Total | $\$ 2,558$ | $\$ 3,066$ | $\$ 2,856$ |

Source: Company filings. Amounts in millions
As you can see, towables are the lion's share of the business, which is fortunate, as they are more profitable than their motorized brethren.
Thor has grown its business steadily for the past 15 years through both organic growth and targeted acquisitions. The RV field is littered with smaller, less efficiently run companies, and when times get even a little tough in the sector, Thor is able to swoop in with its solid balance sheet and acquire operations on the cheap. In recent years, it acquired Damon (2003), CrossRoads (2004), and Goshen Coach (2005). A look at the competition reveals the degree to which Thor dominates the field:

|  | Market Cap | Return on Assets | Operating Cash Flow | Five-Year Shareholder Returns | Net Profit Margin |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Coachmen Industries (NYSE: COA) | \$99.6 | -8.8\% | \$1.4 | -50.3\% | -6.8\% |
| Fleetwood (NYSE: FLE) | \$607 | -3.6\% | -\$14.9 | 68.2\% | -0.46\% |
| Monaco Coach (NYSE: MNC) | \$389 | 1.2\% | \$49.1 | -2.8\% | 1.33\% |
| Thor | \$2,200 | 11.2\% | \$232.8 | 224.5\% | 6.67\% |
| Winnebago (NYSE: WGO) | \$775 | 9.1\% | \$27.8 | 19.8\% | 6.25\% |

Source: Company filings. Dollar amounts in millions

## INVESTMENT THESIS

The long-term demographic trends for RV sales are supported mainly by the aging American population. As Thor noted in a recent investor presentation, baby boomers currently aged 55 to 64 are the industry sweet spot in terms of sales. Twentyseven percent of the U.S. population is older than 55 , and those boomers control $75 \%$ of the financial wealth in the country. The population of 55- to 64 -year-olds is growing about five times faster than the country's total population.
Thor thus has a growing market in which to sell, and it augments that growth by consistently taking market share from its weaker competitors while making targeted acquisitions with its excess cash. The company's sales streak and net income growth was quite impressive leading into the most recently completed fiscal year, which ended July 31:

|  | FY 2003 | FY 2004 | FY 2005 | FY 2006 | FY 2007 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Year-over-Year <br> Sales Growth | $26.2 \%$ | $39.2 \%$ | $16.9 \%$ | $19.9 \%$ | $(6.8 \%)$ |
| Year-over-Year |  |  |  |  |  |
| Yet Income Growth | $53.6 \%$ | $32.9 \%$ | $14.0 \%$ | $37.2 \%$ | $(17.5 \%)$ |
| Source: Company filings |  |  |  |  |  |

The interruption in Thor's growth trajectory gave investors a chance to buy into a very good company at particularly cheap prices for most of the past year. Thor spent $\$ 67$ million on share repurchases in the previous two years, and it paid a $\$ 2$ per share special dividend in October.

It is one thing to grow a company at a sustained clip, but an entirely different matter to grow one in a way that rewards shareholders. After all, if all management does is take the profits of its enterprise and buy other companies, it may succeed in having a larger company (and higher salaries to pay to management), but if that cash isn't being placed into high-returning enterprises, the growth has no value to shareholders.

In this regard, Thor excels, generating returns on assets, equity, and capital that are the envy of the industry, and significantly in excess of what is needed to justify expansion of the company. Just look at how well it has done with these important metrics in the past five years:

|  | FY 2003 | FY 2004 | FY 2005 | FY 2006 | FY 2007 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Return on Assets | $\mathbf{1 4 . 1 \%}$ | $\mathbf{1 4 . 5 \%}$ | $14.1 \%$ | $16.7 \%$ | $11.2 \%$ |
| Return on Equity | $21.0 \%$ | $22.6 \%$ | $21.6 \%$ | $25.3 \%$ | $18.4 \%$ |
| Return on Capital | $20.7 \%$ | $21.5 \%$ | $20.6 \%$ | $24.0 \%$ | $15.7 \%$ |

Source: Company filings
Here's how the competition measures up in the trailing 12 months:

|  | Coachmen <br> Industries | Fleetwood | Monaco <br> Coach | Winnebago |
| :--- | :---: | :---: | :---: | :---: |
| Return on Assets | $(8.8 \%)$ | $(3.6 \%)$ | $1.2 \%$ | $9.1 \%$ |
| Return on Equity | $(12.4 \%)$ | $(6.4 \%)$ | $1.9 \%$ | $16.1 \%$ |
| Return on Capital | $(32.7 \%)$ | $(71.0 \%)$ | $(0.6 \%)$ | $19.5 \%$ |
| Source: Company filings |  |  |  |  |

Thor's comparatively weaker numbers for the just-completed fiscal year came from slower sales: As RV sales ramped up over the past few years in the wake of low interest rates and a strong economy, dealers expanded their inventory. But then gas prices rose and remained high, coupled with mildly increasing interest rates, which notched sales back down dramatically. This was especially true for the heavier and more-expensive-to-use motorhome segment. While companies that were more weighted (pardon the pun) to motorhome sales felt the brunt of the slowdown more, Thor's sales slowed as well.

However, a couple of things are worth noting. Thor maintains a healthy bus division, and as fuel prices rise, bus sales increase, so that acts as a little bit of a hedge against weakness in the RV division. Also, dealer inventory levels have now rationalized and moved back to a more normal point. In fact, for the most recently completed quarter, Thor's backlog (orders it received from customers that it hasn't filled yet) was at a record high. As its backlog is the best indicator of future sales, a return to annual record sales in fiscal 2008 seems likely.

With growth re-established in the near term and very likely for the long term given the compelling demographics, the road ahead looks very promising for Thor. Additionally, you can factor in the weak dollar (a data point that will change many
times in the coming years, to be sure) as a reason to expect that Americans will continue to vacation domestically and follow the allure of the U.S. open road.

## VALUATION

In August 2006, when Thor was trading at $\$ 41$ per share, the company put out a press release announcing, "In the past 60 days we have purchased $1,045,200$ of our shares at a total cost of $\$ 46.4$ million. We believe our shares represent unusually good value at current prices and we will continue our stock repurchase plan."

Fifteen months later, with prices again back around $\$ 40$ a share, the question remains: At today's prices, are Thor's shares still an unusually good value?

There are a lot of ways to value a stock, though ultimately, all reliable methods incorporate some variant of a discounted cash flow calculation. Additionally, a proper valuation methodology will consider various scenarios, from optimistic to pessimistic, giving a probability weighting to each scenario.

For Thor, you can look at the past track record as one possible indication of the potential future growth of the company. From fiscal 2002 to 2007, Thor has grown earnings at a compounded rate of $20.7 \%$ per year. That incorporates the fiscal 2007 results, which were down $16 \%$ from the year before. For the 10 years from 1996 through 2006, the company grew earnings per share (EPS) at a compounded rate of $26 \%$, scoring first out of 28 companies ranked by Fortune in the motor vehicles and parts industry.

Given that the last five years included one off year, I wouldn't discount entirely the possibility that the company could grow earnings over the next five years at $20 \%$ - though doing so off the substantially larger revenue base of today as compared to 2002 would be a mighty challenge. Still, that's hardly a baseline assumption.

The two analysts who have published five-year growth rates for Thor see it growing earnings by $13.5 \%$ annually. That's a substantially better guess, in my opinion, than merely looking at the past. Using that growth rate for five years, and then assuming a perpetual growth rate of $3 \%$ thereafter and using an $11 \%$ discount rate, I calculate a valuation for Thor of approximately $\$ 48$ per share. When you consider that the company's balance sheet has more than $\$ 6$ per share in cash and short-term investments (versus zero debt), I think a fair valuation for the company tops out at around $\$ 54$ per share, adopting this set of semi-optimistic assumptions. I call them semi-optimistic, because although a $13.5 \%$ EPS growth rate is significantly lower than what Thor has achieved in the past, this is still substantially better than the performance of an average company in this sector.

However, given Thor's continued ability to use its cash to buy back shares if the market temporarily discounts the share price again, along with its demonstrated excellence at achieving superb returns on its investment and the attractive demographics of its market, the company should achieve annual growth closer
to $15 \%$. If it does so, it will generously reward shareholders over that time period.

## CATALYSTS

The latest major catalyst for Thor's stock was also in part the cause of the stock's downfall in 2007. Between November 2005 and April 2006, Thor's share price moved up nearly $80 \%$ as FEMA placed a massive order for RVs to serve as temporary housing for victims of Katrina and the other devastating hurricanes of 2005. These orders cleared out RV dealer inventories across the country.

Perhaps investors were looking at the 2005 hurricane season as a harbinger of things to come (certainly, the mass media seemed interested in considering that angle), but fortunately for all of us, 2005 currently appears to be an aberration. The sudden sixmonth spike in the stock price ended in April 2006, and all those RV sales in fiscal 2006 set up a very hard act to follow in 2007. This explains the decline of the stock price during much of 2007, as the company seemed to show no growth.

Similar natural disasters could again give an isolated juice to nationwide RV sales, but we certainly won't hope for that. The simple continued execution of Thor's current strategy will be enough to justify making this stock a buy. A significant drop in gas prices and/or lowered interest rates will improve things for the company as well. The drop in gas makes RVs cheaper to own and use, and the drop in interest rates would make them cheaper to buy.

## RISKS

The major risks for Thor are serious increases in gas prices, a much more serious escalation in interest rates, and the pursuit of a very large acquisition. As for the first two, I really can't give you a better guess than anybody else on where the next stop for gas prices and interest rates will be. Over a longer term (which is much more relevant for any investment thesis), I would expect that gas prices are far more likely to continue increasing than to decrease, given the nature of growth in a global economy.

Still, I don't think that a sustained gradual increase in fuel prices will significantly harm Thor. Its growing bus division is aided by rising fuel prices, its towable segment is not nearly as sensitive to fuel prices as motorhome sales are, and gas, despite all the headlines, is still a cheap commodity in the U.S. today. Driving an RV around the country, while more expensive than it used to be, is still an economical way to travel.

As to the threat of a very large acquisition, I don't see it happening. Certainly, if it did happen, I would reassess holding the stock. However, Thor's management, while obviously interested in a growth strategy, has made acquisitions on an orderly and intelligent basis, not on the grounds of empire building. I expect more of the same, and for the opportunities to gobble up the lesser players in the field to continue - and continue to be beneficial to Thor.

## SELLING CRITERIA

I would sell the stock if the basic investment thesis does not play out. I'm assuming that the company will continue to be the preeminent player in the RV sector, both in terms of sales and profitability. If it loses that top-dog slot and becomes a scrounger among many other RV manufacturers, it would be very unlikely to remain an attractive investment. The profits that the rest of the players in the industry manage to find are essentially negligible. So, we don't want to see Thor participating on an even basis with these companies.
I would not sell simply on the basis of a few missed quarters, or even a solid year of poor performance, if that performance seems to be caused by industry-wide factors. These will inevitably occur, as they did earlier this year, in terms of dealer inventories, gas prices, and interest rates.

If the company makes an outsized acquisition that appears to be nothing more than an attempt to increase the size of its operations, I would quickly sell.

I'd also sell if the stock significantly overshoots its intrinsic value. This came close to happening in the spring of 2006, when the hurricane-related sales pushed the stock up to nearly $\$ 57$ a share. At that time, reasonable long-term growth projections of $15 \%$ or so would not have indicated a value above $\$ 50$ per share, at best. Personally, I would probably be inclined to hold up to a level of $15 \%$ to $20 \%$ above reasonable intrinsic value, but not much beyond that.

## THE FOOLISH BOTTOM LINE

Thor is an outstanding company operating in a fairly stable and growing sector that shows some cyclicality. Its stock was available at compelling prices for most of the year, though this autumn's rise now makes it perhaps only $20 \%$ undervalued. Given that this company still holds the promise to grow sales and revenue significantly, I think that at prices in the mid- $\$ 50 \mathrm{~s}$ or lower, it will comfortably churn out market-beating returns.

At the time of publication, Bill Barker owned shares of Thor.

# Janus Contrarian: Going Against the Grain 

BY AMANDA KISH (FUNDFOOL@YAHOO.COM)

## JANUS CONTRARIAN

JSVAX
www.janus.com
151 Detroit Street
Denver, CO 80206
800-525-0020

## FINANCIAL SNAPSHOT

Net Asset Value:
. $\$ 20.39$
Fund Type:. . . . . . . . . . . . . . . . . . . . . Large Blend
Assets:. . . . . . . . . . . . . . . . . . . . . . . . . . $\$ 8.4$ billion
Inception Date: . . . . . . . . . . . . . . . . . . 2/29/2000
Turnover: . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 39\%
Expense Ratio: . . . . . . . . . . . . . . . . . . . . . . . . 0.95\%
Manager Name:... . . . . . . . . . . David C. Decker
Tenure: . . . . . . . . . . . . . . . . . . . . . . . . . . . 7.7 years

Note: Prospective investors in Janus
Contrarian who would hold their shares in taxable accounts should keep from investing until after the fund makes its 2007 distribution. Currently, the shop estimates a payout of $\$ 1.15$ per share on Dec. 14 to investors of record on Dec. 13, 2007. That amount is subject to change - Janus will release final figures on Dec. 14. For additional details, visit www.janus.com.
(Current as of 11/9/07)

## WHY BUY?

Investing in stocks can be a lot of fun, but also a lot of work. You've got to spend a great deal of time not only finding excellent companies, but also keeping a watchful eye on them to make sure they continue to represent profitable investment opportunities. So, it makes sense to supplement your stock holdings with at least one or two top-notch mutual funds. Hey, if you can find one of those rare fund managers who has consistently beaten the market, why not invest in that stock-picking expertise?

To that end, I highly recommend Janus Contrarian (JSVAX), a mutual fund that even stock lovers can get behind. Contrarian isn't afraid to go against the grain. The fund's longtime manager, David Decker, likes to pick up out-of-favor companies that are generating substantial free cash flow and are poised for a turnaround.

This off-the-beaten-path strategy has worked well for the fund, which has soundly thrashed the market since its inception. In fact, the fund ranks in the very top percentile of all large-blend funds in the Morningstar database for the trailing three-year and fiveyear periods through October 2007. That's no small accomplishment considering how many fund competitors are out there! Janus Contrarian is not for everyone, but dyed-in-the-wool stock investors will find a lot to like.

## LOOKING UNDER THE HOOD

Do I believe that socking away money in mutual funds is one of the safest and most efficient ways to reach your investment goals while sleeping more soundly at night? Absolutely. The problem with mutual fund investing is that there are so many truly lousy funds out there, and if you are unlucky enough to find yourself stuck in one of them, it can sap the life right out of your portfolio.

The trick to profitable mutual fund investing is sticking with those funds that have a proven formula for success. Here are a few things that smart investors should look out for when trekking through the mutual fund jungle:

- How long has the manager or management team been in place at the fund? Studies have shown that funds with long-tenured managers typically perform better than those with newer managers: The longer a manager has been in place at a fund, the more experience he or she has had managing money in that particular style at that specific company with that particular asset base. And, more experience usually translates into better expertise at picking stocks. So, check out how long a fund's management team has been around. If they've only been on board for a year or two, I'd pass on the fund and keep looking. While it takes some work to find them, there are plenty of funds out there with experienced, long-tenured managers at the helm. Contrarian is one of them.
- How has the fund performed in both good and bad market environments? It's easy for fund managers to look like geniuses if they've never had to manage money during a bear market, but it's a completely different matter when the market heads south. How well did the fund hold up during the last extended downturn? To get an answer, you'll need to look back to
the last bear market, during 2000 to 2002 - did your fund keep its head above water in those years? If it hasn't even been in existence since 2000 or 2001, I would keep on walking. While past performance is no guarantee of how the fund will perform in the future, you want to have at least some idea of what to expect from your manager in all types of market environments. Contrarian scores an A in this department, too.
- How much are you paying for the fund manager's expertise? Fees comprise one of the biggest predictors of mutual fund outperformance. It seems obvious, but it bears repeating: Fund expenses eat into returns. Funds that charge excessive fees set a much higher bar for themselves and have to do that much better to get back on equal footing with their cheaper fund counterparts and the broader market. A lot of funds are much too expensive to do investors any good, so be aware of how much you're paying for the pleasure of owning a mutual fund and how that compares to the average fund.

This is not a complete list of all the finer points you need to consider when shopping for mutual funds, but it is a starting point. Keep these things in mind, and you'll become something very dangerous: a well-informed mutual fund investor!

## CRACKING THE FUND-AMENTALS

Even though Contrarian satisfies all of the criteria above, it isn't your typical large-cap blend mutual fund. There's a lot going on under the surface here that differentiates it from its competition. The most obvious is David Decker's practice of picking out-offavor companies whose intrinsic value is not currently reflected in their share prices. He places more emphasis on how a stock is priced in relation to itself and its own fundamentals rather than on how it is priced in comparison to its peers or the market as a whole. As a result, the fund usually holds stocks from both the growth and value camps.

| Janus Contrarian Top 10 Holdings |  |
| :--- | :--- |
| Company | Industry |
| 1. Owens-Illinois (NYSE: OI) | Containers \& Packaging |
| 2. Liberty Global (Nasdaq: LBTYA) | Broadcasting \& Cable TV |
| 3. Coventry Health Care (NYSE: CVH) | Insurance |
| 4. Ceridian (NYSE: CEN) | Business Services |
| 5. Reliance Industries (India) | Energy Materials |
| 6. The St. Joe Company (NYSE: JOE) | Real Estate Operations |
| 7. Tenaga Nasional Berhad (Malaysia) | Utilities |
| 8. J.C. Penney (NYSE: JCP) | Retail |
| 9. NRG Energy (NYSE: NRG) | Electric Utilities |
| 10. Amgen (Nasdaq: AMGN) | Biotechnology |
| Source: Company website |  |

Part of Contrarian's charm is its wide investment mandate. The fund looks across the spectrum of market caps and can invest in stocks of any size, although it tends to focus mostly on the mid-to-large-cap space. Currently, $50 \%$ of the portfolio is in large-cap stocks (companies with market caps of more than $\$ 10$ billion), and $30 \%$ is in mid-cap stocks (between $\$ 5$ billion and $\$ 10$ billion). The remaining $20 \%$ of assets are invested in small-to-mid-cap stocks (less than $\$ 5$ billion).

Contrarian also invests abroad and currently holds more than $40 \%$ of fund assets in foreign companies. As of the end of August, its largest foreign country exposures are to India, which soaks up $11 \%$ of the portfolio, and Japan, which clocks in at $5 \%$ of assets. So, investors in this fund should be aware that they are getting significant foreign exposure, as well as exposure to stocks of all sizes. As a result, the fund does not typically look like the broad market S\&P 500 Index, and more often that not, it doesn't act like it, either.

Contrarian's sector concentrations reflect Decker's offbeat investing style. As of September 2007, the fund is underweight in hardware, software, and consumer goods, but overweight in media, financials, and industrial materials stocks. This allocation has worked to its advantage, as holdings in the financials and materials sectors have been amongst the top contributors to fund performance in recent months. Contrarian is also relatively overweight in utilities and business services compared to the S\&P 500 Index, but overall, these sectors comprise a much smaller part of its assets.

Investors should take added comfort in the fact that manager Decker holds a substantial investment in this fund. According to Morningstar data, nearly all of Decker's liquid net worth is invested in Contrarian. That's really putting your money where your mouth is, and something that doesn't happen nearly enough in the mutual fund world. When a manager is invested right alongside fundholders, especially to as great an extent as Decker is, that manager is much less likely to make overly risky or imprudent investment decisions.

Contrarian's expenses are also quite reasonable, weighing in at $0.95 \%$. This is far below the average domestic equity fund expense ratio of $1.51 \%$, so fundholders needn't worry that they are coughing up an excessive amount for Decker's management expertise. In fact, in December 2006, an independent consultant conducted a management fee evaluation of all of Janus' funds. The findings indicated that the average assetweighted management fee paid by each of the Janus funds for the year ended July 31, 2006 was $13 \%$ below the average management fee of the respective Lipper Expense Universe. In addition, turnover is about half that of the average domestic equity fund ( $39 \%$ compared to $82 \%$ ), so you know there's not a lot of needless trading going on in this portfolio - and the fewer the trading expenses, the more money that ends up in your pocket!

## CRUSHING THE MARKET

Contrarian has posted some pretty impressive performance figures in its seven-and-a-half-year life. The fund has returned an annualized $12.6 \%$ from its inception through the end of October 2007, compared to a mere $3.3 \%$ showing for the S\&P 500 Index. That means that if you had invested $\$ 10,000$ in this fund right at the market peak in early 2000, despite the ensuing bear market, you would have come out with more than $\$ 24,800$ today. If you had instead invested that same $\$ 10,000$ in the $\mathrm{S} \& \mathrm{P}$ 500 Index, your investment would be worth only $\$ 12,868$ !

## Janus Contrarian Annualized Total Returns Through 9/30/2007



Source: Morningstar Principia database
The fund has also ranked well against its peers, topping the recent performance for almost all other Morningstar large-blend mutual funds. Furthermore, Contrarian ranks at the top of the charts when compared to other multi-cap funds. It nabbed the No. 2 spot amongst 493 multi-cap core funds ranked in the Lipper database for the five-year period ending Sept. 30, 2007. And in the threeyear period ending September 2007, Contrarian's performance ranked No. 1 against 662 other multi-cap mutual funds. Clearly, it can hold its own against scores of competitors.

Of course, most of Contrarian's performance advantage has come in the recovery years after 2002. While the fund lost money during the bear market, it did manage to keep ahead of the broader market by about an annualized $5 \%$. Investors should keep in mind that this fund will not likely outperform many of its peers during sustained downturns, so if the market heads into a prolonged correction, Contrarian's bold style of investing may be out of favor. Similarly, if foreign markets stumble, this fund is likely to take a hit as well, since a hefty portion of its assets are invested overseas.

Contrarian also ranks higher on the volatility scale than your typical domestic equity offering. At times, its returns may not
fall in line with those of the broader market. But for those investors with patience and a long-term horizon, these bumps should even out and end up producing a handsome return.

And holding for the long term is important. Besides picking firstrate funds, one of the keys to successful mutual fund investing is not trying to time the market. Find a few good funds, and hold on to them, no matter what the market does. Investing styles go in and out of favor, and even the best managers can have an off year or two. A great fund should be able to get you through all kinds of weather, so try not to focus too much on short-term events. Keep your eyes on the big picture, and you'll sleep much more soundly at night.

## FORGIVE AND FORGET?

Of course, some investors still may not have forgiven Janus for the role some of its employees played in the market timing scandal that swept across so many fund companies back in 2003. Back then, evidence surfaced that some Janus executives allowed a hedge fund to market-time a few of its funds, thus harming those funds' longer-term shareholders. Add to that the dismal performance of most of Janus' growth-oriented mutual funds during the bear market, and investors fled the fund shop in droves.

I admit that, for a long time, I had written Janus off and would not consider any of its mutual funds as potential investments due to concerns about the corporate culture. However, Janus has come a long way since that time, and I have reconsidered my stance on the firm. It has made sweeping personnel and compensation changes in an effort to focus portfolio managers' attention on lon-ger-term results. Gary Black, the firm's CEO since January 2006, has made rebuilding research capabilities a top priority, including expanding the bench of analyst talent. The average analyst at Janus is now considerably more experienced than in the late 1990s, and there is now a heightened awareness of risk throughout the firm. Marketing efforts have been redirected with a focus on educating fundholders, rather than making a sale based on hot recent performance. In addition, Janus has moved toward perfor-mance-based management fees on many of its funds, including Contrarian. This change should further align the financial interests of portfolio managers and shareholders in the future.

While investors shouldn't forget the problems Janus had in the past, the firm has taken steps to rebuild confidence and emerge a stronger and more research-focused entity. Most of the firm's funds, including Contrarian, were not touched by the market timing scandals, and some of them now represent compelling buys that have been overlooked by mutual fund investors with a long memory. But, as any good contrarian investor would tell you, there are some great opportunities to be found in those out-of-favor corners of the market!

## THE FOOLISH BOTTOM LINE

All in all, Janus Contrarian is a first class, if somewhat unconventional, mutual fund. It boasts a wide-ranging investment mandate with plenty of room to seek out unloved stocks from all walks of life, a consistent investment history, impressive longterm performance track record, low expenses, and a long-tenured and highly skilled fund manager who is not afraid to eat his own cooking. There are not many funds out there that have all of these things working in their favor. Of course, if Decker were to ever leave the fund, investors would probably be justified in selling their shares, but right now, his stewardship there makes a compelling case for ownership.

If you like your mutual funds with a bit of a kick to them, this one may fit well into your portfolio. Contrarian would probably not work well as a core large-cap fund holding, so don't try to fit it into that mold. But as a supplement to individual stock holdings or to a more index-centered large-cap fund, it would make an excellent companion. It can be tough to delve into areas of the market that no one else wants to be in, but as Contrarian has shown, sometimes going against the grain can have its own rewards.

At the time of publication, Amanda Kish did not own shares of any company mentioned in this write-up. Coventry Health Care is a Motley Fool Stock Advisor recommendation.

# 9 Ways to Take Control of Your Financial Destiny in 2008 

Whether you're new to the game or a seasoned pro ... looking for value or growth ... interested in large caps or small ... investing at home or abroad ... a recent college graduate or about to retire ... The Motley Fool can help you reach even your loftiest financial goals.



[^0]:    1. Royal Bank of Canada (NYSE: RY) ( $\$ 72.7$ billion)
    2. Toronto-Dominion Bank (NYSE: TD) (\$53.6 billion)
    3. Bank of Nova Scotia (NYSE: BNS) (aka Scotiabank) (\$52.7 billion)
    4. CIBC ( $\$ 34.2$ billion)
    5. Bank of Montreal (NYSE: BMO) (\$33.1 billion)
[^1]:    Source: Capital IQ

