

Lying in Wait

Donald and Stephen Yacktman liken their stock-selection process to buying long-term bonds. Their particular skill: Buying AAA quality at BBB prices.

He's been investing for more than 40 years, but don't expect a "been there, done that" attitude from Don Yacktman: "Will Rogers once said, 'Good judgment comes from experience, and a lot of that comes from bad judgment.' I add to my base of experience every day."

Good calls have obviously outnumbered bad ones for Yacktman, whose Yacktman Fund and Yacktman Focused Fund are the second and third best performing large-cap mutual funds tracked by Morningstar over the past ten years, each earning an annualized 11.7%, vs. -2.7% for the S&P 500.

Convinced that today's market is undervaluing quality, Yacktman is stocking up on brand-name companies in such areas as media, consumer products, healthcare and cable television. [See page 2](#)

Back-Alley Investing

Trafficking in "teeny-weeny" companies is in many ways investing at its most basic level, says Paul Sonkin, one of the art's most accomplished practitioners.

INVESTOR INSIGHT



Paul Sonkin
Hummingbird Value Funds

Investment Focus: Seeks companies so far off the beaten path that their assets or potential earnings power are being dramatically undervalued by the market.

INVESTOR INSIGHT



Yacktman Asset Management
Stephen Yacktman (l), Donald Yacktman (r)

Investment Focus: Seek industry-leading companies that trade with attractive free-cash-flow yields when the market "paints with too broad a brush."

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Investor Insight: Donald Yacktman

Yacktman Funds' Donald Yacktman, Stephen Yacktman and Jason Subotky describe why quality should be (but isn't) king in today's market, why beaten-up media stocks have attracted their attention, how they liken equities to long-term bonds, and what they think the market is missing in PepsiCo, Coca-Cola, News Corp., Viacom and Comcast.

You've described your approach as trying to combine the best features of growth investing and value investing. What do you mean by that?

Donald Yacktman: The growth aspect speaks primarily to our focus on business quality. We're not usually looking for the scruffy cyclical or turnaround story, but for businesses with high market shares in their principal product or service lines, with long product cycles but short customer-repurchase cycles, and with relatively low capital requirements that allow the company to generate high cash returns on tangible assets while growing. We've always considered businesses requiring enormous amounts of capital for fixed assets, especially when they're economically sensitive, to be at a big disadvantage. That's why something like the airline industry has been a growth business for most of the past 100 years but doesn't make any money for shareholders.

Stephen Yacktman: Something we find that isn't often fully recognized by the market is how incredible the returns on the marginal unit sold can be for low-asset-intensity businesses with strong market positions. That's why growing businesses can pay off so well – you get the one-time appreciation from a lower base to a higher base, but on top of that you get the compounding effect of significant operating leverage.

That describes well what you mean by quality. What about the value part?

DY: We don't want to pay much for all of that.

Easier said than done, no?

DY: Of course, but the reality is that in a typical year, the average large-cap stock

fluctuates about 50% from its low to its high. If you've done your homework and you're patient, more than enough opportunities will come along.

Jason Subotky: We like dislocation, which can come from company-specific, sector, or overall market issues. The best times, like last year or 2002, are when you find a combination of those issues just decimating share prices. We loaded up last year on Viacom [VIA-B], for example, when the market was falling, media was way out-of-favor, and then the chairman, Summer Redstone, had personal financial issues that put pressure on the share price. A stock we didn't think was overpriced in the first place dropped 75%. It's well up off the bottom, but we still believe it isn't where it should be relative to the value of the business.

SY: The market often paints with too broad a brush. We've owned AmeriCredit [ACF], a subprime auto lender, since 2003. It has a seasoned management team that has been through significant down cycles, and they've always provided detailed and transparent monthly data on their loan portfolio. The company was obviously going to be impacted by the falloff in the economy, but because it had "subprime" and "lender" in its business description, the market overreacted and pushed the stock below \$5, only 1-2x what we considered to be normal earnings. We thought that made no sense, so we doubled our share position as the stock got around \$5. We've trimmed the position, but still own shares. [Note: ACF shares now trade around \$18.]

Are you much less active when markets are calm?

DY: We're not inactive when markets are relatively calm – there's always something



Stephen and Donald Yacktman

All in the Family

Having grown up with a well-known portfolio manager as a father, Stephen Yacktman felt ready to take over the management of his college fund early in his senior year in high school. "I gave my dad my first buy order, for Sears, on the weekend before October 19, 1987. He called me Monday morning and said he had good news and bad news. The good news was that I'd bought my first stock, at something like \$35. The bad news was that it was then trading at less than \$30."

Undeterred by this initial experience, Stephen ended up joining his father's Yacktman Asset Management in 1993 after earning an M.B.A. from Brigham Young University. In 2002 he became co-Chief Investment Officer of the firm, which now manages \$2.3 billion in assets.

"Unlike me, Steve has always been interested at a micro level in how things work," says Don Yacktman. "That often makes his take on any given investment situation quite complementary to mine." But combining work and family hasn't always been easy, says Steve: "This wasn't a problem for us, but let's just say that if you don't get along really well beforehand, don't even think about going into business together."

creating opportunity somewhere – but we do tend to be a lot less active overall. Our turnover has fallen compared to this time last year.

We also don't let cash burn a hole in our pocket when the number of good opportunities decreases. While we were all in last November, our cash position in the funds today is around 15%.

What constitutes a value price to you?

SY: We evaluate businesses with the expectation we'll own them for a long time, and we consider the selection process to be somewhat like we were buying a long-term bond. We project a forward compound cash rate of return and, in order to buy something, we require that it offer a minimum annual return. That return is higher if the business is of lower quality or if it's more unpredictable. For the best businesses today, we'd want to see a return of at least 10%.

Walk through the mechanics of how you arrive at the return estimates.

SY: The first thing we do is normalize what we think the company's earnings power is. A lot goes into that, but it essentially means looking at what the business has traditionally been able to generate over time and adjusting for various factors that might make it more or less attractive going forward. We then estimate the percentage of those normal earnings that the company will keep after things like capital spending and investments in working capital, resulting in a free cash flow number we can divide by the current market value to get a free-cash-flow yield. On top of that we'll add inflation and the annual growth in free cash flow we expect in order to arrive at our estimated rate of return.

As an example, Coca-Cola [KO], whose free cash flow is a high percentage of net income, trades at a free-cash-flow yield on our normalized numbers of about 5.5%. Inflation adds another 3% and we assume another 2% in organic growth, so that gives us an estimated compound annual return of 10.5%.

Compare that to the S&P 500. We estimate normalized per share earnings for the S&P 500 of about \$60, of which you keep maybe 45% as free cash flow. At 1,100 on the index, the resulting \$27 in free cash flow gives you a 2.5% free-cash yield. Add on 3% inflation and 1.5% for cash-flow growth, and we believe the average investor today on a cash basis is looking at a 7% annual return from the market.

Given our belief that Coca-Cola is a higher-quality business with lower risk than the average S&P 500 company, it should trade at a premium to the market, not a discount. When an excellent compa-

ON BUSINESS QUALITY:

Companies without heavy reinvestment needs have a huge advantage that we don't think people are correctly evaluating.

ny like this trades at a solid annual rate of return and that kind of discount to the market, that's attractive to us.

JS: One general thing I'd add is that by focusing on forward rates of return, it keeps us more centered on the fundamentals of the business and its cash flows. We aren't counting on or trying to figure out what someone else might pay as a P/E or cash-flow multiple down the road.

Your portfolio today is filled with brand-name, large-caps such as Coke, PepsiCo, Procter & Gamble, Pfizer and Johnson & Johnson. Is that typical?

DY: Given the types of businesses that attract us, it's not unusual for us to own these kinds of companies. Brand-name, large-cap companies get that way because they benefit from things like market-leading positions, barriers to entry and high returns on capital. That said, to push further the bond metaphor Stephen spoke about, we do believe the return spreads today between low- and high-quality

companies are much narrower than they should be, making the best companies particularly attractive.

Is there a defensive element as well to your owning these types of companies?

DY: Yes. Most of the consumer businesses we own make disposable products with very little economic sensitivity. The consumer goods I'd still be somewhat concerned about in this economic environment are those that have long lives, like autos and appliances, where the replacement decision can be easily delayed.

SY: This goes back again to what we said earlier about the virtue of companies without heavy reinvestment needs. The average company has to pour more than half its earnings every year back into the business to maintain itself. If you don't have to do that – like most consumer-products companies, for example – you have more to invest in new businesses, to give back to shareholders, or to keep on hand for a rainy day. That's a huge advantage that we don't think people are correctly evaluating.

Give us an example of how the occasional small-cap company makes it into your portfolio.

JS: We're always open to a great opportunity. A few years ago some people we know recommended we keep an eye on a small Philadelphia bank called The Bancorp [TBBK], which was founded by Betsy Cohen. She has a distinguished track record in Philadelphia banking and her idea for this new bank was to skip the branch network and build low-cost deposits by providing services to non-bank businesses. They started by administering health savings accounts and later purchased a pre-paid debit-card business. With the low-cost deposits, she's used her experience in the Philadelphia region to build a loan portfolio.

We followed the stock for some time, but it was always too expensive. But as the share price worked its way down from \$30 to the single-digits last year, we

bought in. The company is small enough that we can sit down with the CEO herself and walk through the business and the loan book and see fairly clearly what the risks are, which we think are much lower than at most banks. But while other banks have rallied significantly, this one still trades at less than book value. [Note: TBBK shares trade around \$5.60.] We're still very excited by the opportunity and would buy more except for the fact we already own such a significant stake in the company.

Management is accessible in this case, but probably less so in most of the companies you own. Does that matter?

DY: The most important aspect of analyzing management is how well they've invested cash in the past, not what they say they are going to do. Because we typically own companies generating a lot of free cash flow, we're in trouble if management doesn't allocate that cash wisely.

You tend to be fairly concentrated for a mutual fund. Why?

SY: We'd love to be widely diversified if everything had the same return characteristics, but they obviously don't. There are some rules on diversification for mutual funds, but we basically rank the stocks that meet our minimum-return requirements and try to have as much of the portfolio as possible in the companies with the highest expected rates of return, adjusted subjectively for risk. Right now that leaves us with around 50 positions in the Yacktman Fund, with close to 60% of the portfolio in the top 10.

In our less-restricted accounts, we have 75% of the portfolio in the top 10 – we'd sleep well at night with that at 100%, but that doesn't work for most clients. As a result, we spread the last 25% in names that are typically smaller and with very high potential, but with more expected variance in the outcome.

Describe the specific investment case for News Corp. [NWSA], one of your largest holdings.

JS: The basic thesis is that the market is mistreating News Corp., as it is most other media companies. Its stock trades at about half of what it was at the beginning of 2007, but its business mix and growth prospects are now much better than they were back then.

News Corp. has eight different operating units, which makes it complicated for people to analyze. The most important business by far is cable network programming, including Fox News, FX, Fox Sports and the National Geographic Channel. Revenues and earnings in this business have more than doubled over the past five years, driven by increasing

subscriber fees from cable and satellite companies, as well as higher rates on the advertising side. Even with that performance, we see plenty of further upside. Fox News, for example, has higher viewership than its top three competitors (CNN, Headline News and MSNBC) combined. These viewership increases give News Corp. significant negotiating power when carriage-fee contracts come up for renewal.

Another big growth engine for the company is its non-U.S. operations, where they currently operate more than 150 cable channels around the world and have a significant presence in satel-

INVESTMENT SNAPSHOT

News Corp.
(Nasdaq: NWSA)

Business: Diversified global media company with primary operations in broadcast and satellite TV, cable networks, books, filmed entertainment and newspapers.

Share Information
(@11/27/09):

Price	11.54
52-Week Range	4.95 – 13.09
Dividend Yield	1.0%
Market Cap	\$30.23 billion

Financials (TTM):

Revenue	\$30.11 billion
Operating Profit Margin	12.2%
Net Profit Margin	(-11.0%)

Valuation Metrics

(@11/27/09):

	NWSA	Nasdaq
Trailing P/E	n/a	44.0
Forward P/E Est.	12.3	19.9

Largest Institutional Owners

(@9/30/09):

Company	% Owned
Dodge & Cox	11.2%
Franklin Resources	7.2%
Capital Research	6.4%
AllianceBernstein	6.4%
Barclays Global Inv	5.1%

Short Interest (as of 11/13/09):

Shares Short/Float	1.0%
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NWSA PRICE HISTORY



THE BOTTOM LINE

Driven by its expanding cable-network and non-U.S. businesses, the company's current free-cash-flow yield plus annual cash flow growth results in an estimated mid-teens percentage return per year, says Stephen Yacktman. Profit improvements in network TV and the movie business provide free options on the upside, he says.

Sources: Company reports, other publicly available information

lite broadcasting through an equity position in BSkyB in the U.K., Sky Italia and some other diverse Asian broadcasting assets. Rupert Murdoch has always emphasized the company's global footprint, which we see as a tremendous opportunity.

Is there much to be enthused about in the TV or movie operations?

JS: The TV side of the business anchored by Fox Network is weak right now because of slow advertising sales, but it has continued to generate strong ratings and we see an eventual advertising upturn as kind of a free option. The network also has some potential upside from carriage fees from cable and satellite operators. It's hard to judge how the ongoing negotiations over this will turn out, but it could provide material upside. The company has tossed around numbers like \$1 per subscriber per month as a goal.

The movie business is difficult to project on a year-to-year basis, and we're not counting on it to do anything particularly spectacular.

Is it difficult to normalize an earnings estimate for a company like this?

SY: Somewhat, given the cyclical nature in certain parts of the business like those that are advertising driven. But we've gone through every major business in great detail and believe the company overall can conservatively generate more than \$1 per share in free cash flow. With the stock currently around \$11.50, that's a free-cash-flow yield of roughly 8.5%.

What amount of growth are you expecting on top of that?

SY: The cable networks, which are now roughly half the overall business, can grow in the low to mid teens. The other half of the business is all over the place from a potential growth perspective, but even if we call the rest flat, we'd expect a total of 6.5% annual growth on top of the current free-cash-flow yield. At today's share price, this has an estimated

return in the mid-teens per year, double what we'd expect from the S&P 500.

Is the fact that Rupert Murdoch is 78 a concern?

SY: News Corp. is obviously closely identified with him, but it's far too substantial and established a company to lose momentum if he weren't there. Could that be an issue a long time down the road, maybe, but not in a time horizon that matters to us here.

JS: It also depends on what you're paying. If we were paying a premium for his

presence, we might have a problem if something happened to him. We don't think that's the case here at all.

Describe another bet on media content you mentioned earlier, Viacom [VIA-B].

SY: This is more of a pure-play content company, which owns various cable networks, including Nickelodeon, MTV and Comedy Central, as well as the Paramount movie studio.

The story here is also centered on the value of the cable networks. Given how incredibly difficult and expensive it is to establish cable-network brands, we have

INVESTMENT SNAPSHOT

Viacom
(NYSE: VIA-B)

Business: Creator of entertainment content primarily through Paramount Pictures and cable networks such as MTV, VH1, Nickelodeon and Comedy Central.

Share Information
(@11/27/09):

Price	30.03
52-Week Range	13.15 - 31.56
Dividend Yield	0.0%
Market Cap	\$18.23 billion

Financials (TTM):

Revenue	\$13.76 billion
Operating Profit Margin	20.1%
Net Profit Margin	7.9%

Valuation Metrics

(@11/27/09):

	<u>VIA-B</u>	<u>S&P 500</u>
Trailing P/E	16.8	71.4
Forward P/E Est.	13.6	17.3

Largest Institutional Owners

(@9/30/09):

<u>Company</u>	<u>% Owned</u>
Van Kampen Asset Mgmt	6.5%
AllianceBernstein	5.7%
NWQ Inv Mgmt	4.7%
Vanguard Group	3.6%
State Street Global	3.4%

Short Interest (as of 11/13/09):

Shares Short/Float	2.3%
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VIA-B PRICE HISTORY



THE BOTTOM LINE

Carriage-fee growth and cyclical advertising upside should result in the cable networks alone generating \$2.50 per share in annual free cash flow, says Stephen Yacktman. Assuming only S&P 500-average growth on top of that and nothing from the movie business, he says, the shares today offer a 12-13% expected annual return.

Sources: Company reports, other publicly available information

a very strong appreciation for premier content players like Viacom. Last year Time Warner Cable battled over fee increases that Viacom was trying to push through. Viacom's response was something to the effect that, "We're only 2.5% of your cable bill, yet we provide 20% of your viewing time." Time Warner backed off, and we believe that there is further upside to the carriage fees over time. Parents don't want to see Nickelodeon pulled off the air over a few pennies a month.

On the advertising side, we actually believe strong cable networks will come out of the cyclical decline in even better shape than before. Recessions can reallocate resources in a lasting way, which we believe will be the case at the margin as advertisers shift spending to cable in search of cost savings and find out that it works just as well for them. That should allow Viacom's advertising to more than bounce back when the economy improves, especially because advertisers love the age and demographic groups the channels reach, which are hard to target elsewhere.

Are you counting on a Paramount turnaround as well?

SY: Given how we look at valuation, Paramount is adding nothing to the investment case today because it doesn't generate any cash. But if it stood on its own, there's clear value in the franchise and the studio library, which is probably worth \$5-7 per Viacom share. Anything on top of that – say, actually generating cash flow from making movies – is just gravy.

The stock has risen significantly since March, to a recent \$30. How attractive do you consider it at that level?

SY: We think the cable networks alone will generate \$2.50 per share in normalized free cash flow. That's an 8% cash yield. Even if Viacom grew no faster than the average S&P 500 company – and we think it should do better – that gives us an expected return of 12-13% per year. That

on its own is plenty attractive to us, without assuming any upside from the movie studio, which is worth more than zero.

The market has been justifiably concerned with how Internet delivery of content might impact media companies like Viacom. How do you look at that?

SY: I actually built my house assuming the Internet would be the way I access TV. My basic sense is that the owners of content that people want should be fine as that content is delivered in different ways. Whether I get it through traditional cable or satellite – which will still be the norm

for many years – by streaming it over the Internet and watching ads, or by downloading shows at \$2 a pop, if the content sellers are smart they should make their profits.

Talk about one of your consumer-goods favorites, PepsiCo [PEP].

SY: Somewhat distinct from Coca-Cola, which we also like, Pepsi's fortunes are much more driven by snack foods, in which they are a powerhouse. Walk down the chip aisle at the grocery store and you'll see it dominated by Frito-Lay products. With their distribution and shelf

INVESTMENT SNAPSHOT

PepsiCo
(NYSE: PEP)

Business: Manufactures, markets and distributes beverages, packaged foods and snacks, under such brands as Pepsi, Frito-Lay, Gatorade, Tropicana and Quaker.

Share Information
(@11/27/09):

Price	62.30
52-Week Range	43.78 – 63.27
Dividend Yield	2.9%
Market Cap	\$97.22 billion

Financials (TTM):

Revenue	\$42.66 billion
Operating Profit Margin	18.2%
Net Profit Margin	12.3%

Valuation Metrics

(@11/27/09):

	PEP	S&P 500
Trailing P/E	18.7	71.4
Forward P/E Est.	14.8	17.3

Largest Institutional Owners

(@9/30/09):

Company	% Owned
Barclays Global Inv	3.8%
Vanguard Group	3.6%
State Street Corp	3.3%
Capital Research	2.9%
Columbia Mgmt Adv	2.1%

Short Interest (as of 11/13/09):

Shares Short/Float	1.5%
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PEP PRICE HISTORY



THE BOTTOM LINE

The market is not adequately recognizing the company's competitive strengths in the attractive snack-food business or the potential overseas growth for its low-price-point branded beverages and foods, says Stephen Yacktman. So much so, he says, that the shares today are priced to offer an estimated annual return of 12-13%.

Sources: Company reports, other publicly available information

space, they benefit from very high barriers to entry. If anyone comes up with something new, Frito-Lay can roll out a comparable product and push the competitor out. After years and years of strong growth, Frito-Lay now accounts for roughly half Pepsi's overall business.

The snack-food business is a good one. Buyers are not too price-sensitive, margins are high, and unit-volume growth is pretty strong as busy lifestyles prompt people to eat things on the run.

JS: The second big driver of the business will be continued global expansion. While I'd rather have Coke internationally, Pepsi has an established and improving international presence, through which they can distribute their low-price-point branded beverages and snack foods. The demand for these products increases as disposable incomes go up.

The company plans to spend some \$8 billion to buy independent bottlers in North America. Does that make sense to you?

SY: We're fairly indifferent. We don't like the commitment to a more capital-intensive business, but we do see some of the benefits they expect from controlling their distribution system more closely.

What return expectations do you have with the shares priced today at \$62.30?

SY: On a forward basis, we're estimating \$3.85 per share in normalized earnings. They should keep roughly 85% of that, so free cash flow would be around \$3.40. That's a 5.5% free-cash yield, on top of which we're expecting 3-4% annual volume growth, primarily from increased snack-food sales and overseas expansion. Add in some pricing, largely to keep up with inflation, and the expected annual return is 12-13%.

What do you think the market is missing?

JS: People often ask us what unique insight we have in buying something like Pepsi. It's almost as if to be considered astute, you need to have some complex

thesis that no one else comprehends. The fact of the matter is that there are times when quality businesses are undervalued and we just have to be smart enough to recognize when that is and own them. It doesn't have to be more complicated than that.

There was an article in the 1930s, describing what a great growth story Coca-Cola was. It went on to say, though, that it was too late to benefit on the stock because the story was so well understood. Sometimes the market understands, and sometimes it doesn't.

ON COMCAST/NBC:

Do we think buying NBC is a great idea? No, but it also doesn't change our view that the stock is undervalued.

SY: If we can earn a 9-10% real return owning one of the best companies in the world, while lying in wait for opportunities that are even more attractive, we've found that that's a pretty sound way to make money for our investors. Even if our entire portfolio consisted of opportunities like Pepsi and over a long period we compounded money at 5% per year in real terms above the S&P, most people would be thrilled.

Are there any significant risks you see with Pepsi?

SY: Probably the biggest risk would be if the government looks for money by raising taxes on the international operations of U.S. companies. That wouldn't be specific just to Pepsi, but it could be a problem.

Comcast [CMCSK] shares have appeared rather value-trappish in recent years. Why do you like them now?

SY: The knock on Comcast historically was that there was never any cash gener-

ated – all the earnings needed to be invested for expansion or equipment upgrades. Recently when that dynamic started to change, media companies went out of favor. Then the whole market fell apart.

What sets Comcast as a company apart today, in our view, is the capability of its cable system – which can offer a full complement of television, Internet, and phone services. They've been quite successful in rolling out these bundled services in their territories and skimming off profit from phone companies like AT&T and Verizon. For example, Comcast now provides phone service to about 30% of its cable subscribers.

What sets Comcast apart as an investment is the fact that a lot of the enormous capital spending necessary to build that network is going away. We believe it now has a platform to meet customer demands well into the future at modest incremental cost. That will have a dramatic impact on free cash flow generation.

Are you concerned the proposed deal for NBC Universal will negate that impact?

SY: Given the company's history and the current deal talks, that's a legitimate concern. The way we look at it, if a deal happens as has been reported in the press, Comcast will contribute content assets and spend \$5-6 billion in cash for a controlling stake in NBC. Let's assume they overpay and spend \$3 billion too much for their stake in the company. That amounts to value destruction of about \$1 per share. Do we think buying NBC is a great idea? No, but it also doesn't change our view that the stock is undervalued.

Does Comcast's appetite for content signal a concern about its core business?

SY: Given our positions in News Corp. and Viacom, we agree that owning top-tier content is valuable. But we believe the distribution model is far from dead. Customers benefit from Comcast's ability to negotiate programming fees paid to media giants like Disney, Viacom and

News Corp. The cable networks themselves have also benefited tremendously from the stability of the fees the cable and satellite companies provide, so we would expect these content creators to work well with the cable and satellite players in order to preserve that revenue stream.

As for competition from distribution of video over the Internet, we see that as a very long and drawn-out transition. It eventually impacts Comcast, but they'll have a lot of time to prepare for that and should benefit from the increased importance and value of the Internet access they provide. As the NBC deal and other

investments in things like expanding their ability to serve business customers show, they're not standing still.

At a recent \$14.15, how inexpensive are the shares?

SY: Free cash flow should exceed net income by \$1-1.5 billion per year as capital expenditures are much lower than depreciation and amortization. On a normal basis, we estimate free cash flow at more than \$1.50 per share, resulting in a 11% cash yield. On top of that we'd add inflation plus 2% or so, as they continue to take phone and Internet share.

That leaves us with an expected mid-teens return for a company that on a fundamental basis continues to perform extremely well. Does it have some risk that a company like Pepsi doesn't have? Yes, but we think we're being compensated for that.

Speaking generally, do views on the broader economy make it into your analytical process at all?

SY: We spend almost no time trying to forecast things like inflation, interest rates and the value of the dollar, but we do try to pay a lot of attention to cycles in how we normalize earnings. If margins are at a peak, for example, we don't necessarily assume they'll stay there forever. That alone kept us out of a lot of the financials that got hurt the most in the meltdown.

Potential inflation, or the lack thereof, seems to be fairly top-of-mind for investors. What's your take on that?

DY: Over time, we're very concerned about the risk of higher inflation, but we expect that the kinds of businesses we own – those that can reprice their products fairly flexibly and that are heavily exposed to currencies other than the U.S. dollar – will navigate an inflationary period fairly well.

Don, you've been around long enough to have been dubbed an investment genius, then a buffoon in the late 1990s, and now back to a genius again. Is that hard to deal with?

DY: My children and grandchildren make fun of all my quips, but I always say that the difference between being stubborn and being determined is that if you at the end of the day were right, you were being determined.

No one likes to be criticized, but I've always been fairly good at staying objective, focusing on the long term, and having an iron stomach when things go badly. That doesn't guarantee you'll always come up smelling like a rose, but it certainly increases your chances. **VII**

INVESTMENT SNAPSHOT

Comcast

(Nasdaq: CMCSK)

Business: Cable-system operator delivering television, Internet and phone services to more than 24 million customers in 39 states and the District of Columbia.

Share Information

(@11/27/09):

Price	14.16
52-Week Range	10.33 – 17.35
Dividend Yield	1.9%
Market Cap	\$42.48 billion

Financials (TTM):

Revenue	\$35.34 billion
Operating Profit Margin	20.2%
Net Profit Margin	8.8%

Valuation Metrics

(@11/27/09):

	CMCSK	Nasdaq
Trailing P/E	13.9	44.0
Forward P/E Est.	12.4	19.9

Largest Institutional Owners

(@9/30/09):

Company	% Owned
Templeton Investment	5.8%
Davis Selected Advisers	4.8%
Fidelity Mgmt & Research	3.8%
Capital Research	3.7%
Lazard Asset Mgmt	3.3%

Short Interest (as of 11/13/09):

Shares Short/Float	2.3%
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CMCSK PRICE HISTORY



THE BOTTOM LINE

Given that the company's existing technological platform should meet customer needs well into the future, Stephen Yacktman expects a dramatic decline in capital spending and a dramatic increase in annual free-cash-flow generation, to an estimated \$1.50 per share. His estimated annual return on the shares from today's price: 15%-plus.

Sources: Company reports, other publicly available information

Investor Insight: Paul Sonkin

Hummingbird Value Funds' Paul Sonkin explains why he's unlikely to ever move up the market-cap food chain, how he's set up his own customized research service, why he doesn't consider himself at all overtaxed in tracking 100 positions at a time, and why he thinks Rand Logistics, Avantair, Keweenaw Land and SouthPeak Interactive are mispriced.

There are small caps and then there are *really* small caps like the ones you buy. How did you arrive at that strategy?

Paul Sonkin: In my second year at Columbia I took Bruce Greenwald's value investing class, and on the first day he showed us a table from Eugene Fama and Kenneth French's famous *Journal of Finance* paper called "The Cross-Section of Expected Stock Returns." The table showed how low-price-to-book stocks and small caps tended over long periods of time to outperform the market as a whole. The whole idea made so much sense to me that I decided that was the basic direction I wanted to go.

In that same class, I was working on a paper that was inspired by an article I'd read in *Barron's* that talked about a pink-sheet company called Park Lexington, which happened to be based in New York between Park and Lexington avenues. They owned three residential buildings in and around the city and I started to put together a research report, but had so many questions that I called one of the investors mentioned in the *Barron's* article, Ed McLaughlin, and he suggested the two of us go together to speak with the company. We had no trouble getting answers to our questions and Ed ended up sending my final report to the company's board, which reviewed it. It may have just been a coincidence, but they ended up going private six months later.

I thought, "Wow, you can pick up the phone and talk to these people and maybe have some influence on what they do." That seemed much more interesting to me than holing up at a desk somewhere and poring through the footnotes in GE's 10-K.

Describe your opportunity set.

PS: There are something like 30,000 securities that trade primarily over-the-count-

er through the pink sheets, an electronic quotation system that displays quotes from broker/dealers. Of that number, maybe 40% are so obscure that they rarely, if ever, have a bid or offer. A much smaller subset are foreign ADRs, for companies like Nestle or Danone that don't want to report financials using U.S. accounting principles.

Where we're active is in the remaining companies, which are either old-school pink-sheet holdovers like Ash Grove Cement or Boston Sand & Gravel, or newcomers to the pink sheets that, because of the expense or hassle of being public have decided to "go dark" and stop filing 10-Ks and 10-Qs with the SEC. They can do that if they have fewer than 300 shareholders. Our contention is that there's no better place to look for inefficiently priced securities than in those of unfollowed, unwanted and unloved companies. We call it combing through the back alleys of Wall Street for garbage people have thrown away. That's how you can find small, obscure companies trading at 2-3 times earnings.

You'd be amazed at the offbeat companies that exist out there. One stock we own is Scope Industries [SCPJ], which has been around for 70 years and basically takes stale bread and turns it into what it calls "dried bakery product" that gets put into animal feed. About five years ago they sold off a business running beauty schools, and they've been quite smart about allocating capital as they've developed the cattle-feed business. They pay dividends. They buy back stock. They make accretive acquisitions.

Until just a couple days ago, the stock traded at around \$120 per share, which translated into an enterprise value (after \$23 million of net debt) of \$87 million. This for a company that earned \$18.5 million of operating income in the fiscal year ending in June, which was down



Paul Sonkin

Getting Serious

Paul Sonkin's first exposure to the investment business came through an uncle who was a successful broker at Smith Barney. "As a teenager, I thought it looked like great fun," Sonkin says. "I remember thinking all he did was talk to people on the phone, tell jokes and play a lot of golf."

Sonkin got serious about investing at Columbia Business School, graduating with an MBA in 1995 and then serving stints at Royce & Associates and First Manhattan before striking out on his own – with seed money from famed Columbia alum Mario Gabelli – in 1999.

Sonkin's ties to Columbia have remained deep. In 2001 he was one of the co-authors, led by Columbia Professor Bruce Greenwald, of the highly regarded *Value Investing: From Graham to Buffett and Beyond*. He still serves as an adjunct professor at the business school, where he teaches courses on security analysis and value investing. Does the good professor have another book in him? "I've thought a lot about the basic criteria for an ideal investment idea, and could see writing a book around that one day," he says. "At the moment, though, I've just got too much else to do."

from more than \$27 million the year before. We thought the stock was quite cheap, given that the profit decline was likely just a cyclical pricing issue and not the result of anything fundamental. While I can't say I know exactly why, the stock rose 33% on the day before Thanksgiving.

I don't want to give the impression that only the oddball companies can be bargain-priced. We just met recently with Edgewater Technology [EDGW], an IT consulting company in which we have a starter position. The CEO is very impressive and we think the company has normalized earnings power of \$5-6 million, post recession. Against that you have a market cap of \$34 million, which net of cash is only \$12 million. Those are the types of valuations you can find in companies like this.

Where do your ideas come from?

PS: I like to have information pushed at me, so I've set up keyword alerts on something like 3,000 companies, which results in 20-25 press releases a day announcing things like management changes, reorganizations or new dividends. Ideas come out of that all the time.

Another thing I've done in my personal account is to buy one share of probably 250 companies, which is kind of my own customized research service. The daily mail delivery is kind of a Christmas grab bag – you never know when an annual or quarterly that arrives is going to catch your eye. Scope Industries' 2009 annual report showing up in the mail, for example, led me to take a closer look at it and I ended up buying the stock.

One last thing I'd mention as an idea generator is tracking new-lows lists. I always say margins of safety are created out of broken dreams, and there's a fresh list of those broken dreams published daily for us to hunt through.

Describe the general composition of your portfolio – we imagine you have to own a lot of these little companies at a time.

PS: Concentration and micro caps don't mix all that well, so we typically own

around 100 names, with a big position being 3-4% of the portfolio. Tiny companies are by definition more vulnerable to catastrophe if something goes wrong, so we try to limit the potential damage from that by owning a lot of them.

I've had people ask if we're spreading ourselves too thin by owning so many positions at a time. What I answer is that there's an enormous difference in the effort required to follow a big company than a small company. I'd argue that a portfolio of 20 large-cap companies, each

ON ILLIQUIDITY:

Illiquidity today is a dirty word, but we believe we're being paid more than handsomely to assume liquidity risk.

of which is in five or six distinct businesses, is more difficult to keep track of than 100 small companies that typically operate in a single niche. An IBM or a Disney can have a single footnote longer than a lot of the entire annual reports I look at.

How important to you is interaction with management?

PS: In our larger holdings we will have done a lot of due diligence and expect to know management and need to be impressed with them. In our smaller positions contact with management is less important – we're buying into the business mostly because it's statistically cheap. The financials and whatever other communication exists can generally give us a good sense of how shareholder friendly those companies are.

I'd add that while it takes a lot less time to cover a micro-cap company, the potential value added by the research is substantially greater. I have a lot less competition. I'm also much more able to speak directly with the CFO or CEO, who may not be as polished in the ways of Wall Street and might be more open and forthcoming about their business. All of that makes it easier to uncover new

and previously unknown facts, which can be an important edge.

Is portfolio volatility a killer for you?

PS: While individual positions can obviously be volatile, over a diversified portfolio we've found that a lot of that volatility goes away.

When I worked for Chuck Royce he had me working on the technology sector, where you really learn that volatility can be your friend. I have a section in my original Hummingbird strategy paper that compares the stock charts of a proverbial "drill-bit" company, which happened to be Federal Signal, and a technology company we've owned over time called Simpletech. Over the period or three or four years we looked at, Simpletech went from \$10 to \$1 to \$10 to \$2 to \$10 again, while Federal Signal oscillated between \$15 and \$25. We're hardly day trading in our stocks, but volatility is what gives us opportunities to buy low and sell high.

How would you characterize the appetite for micro caps today?

PS: There's quite a bit of evidence that investors (and speculators) have pulled way back from smallest micro caps like the ones we buy. Trading volume has dried up and bid-ask spreads can be huge – in many cases the offer is 100% above the bid. Not terribly surprising after the crisis, illiquidity is a dirty word.

We actually believe that's given us the best opportunity to put capital to work since 2002. People today are so obsessed with liquidity that the premiums being paid for it are very high. Since we're long-term investors, we believe we're being paid more than handsomely to purchase illiquid securities and assume the liquidity risk.

Let's talk about some of the best opportunities you're finding, starting with Rand Logistics [RLOG].

PS: Rand owns a fleet of 13 bulk carriers that provide freight shipping services in the Great Lakes. They focus on river-class

vessels, which are somewhat smaller and can navigate a lot of the twists and turns you find on the lakes. The cargo mix is primarily stone, grain and salt, serving a blue-chip customer base – including Anheuser-Busch, Archer Daniels Midland, Georgia-Pacific and Cleveland-Cliffs – with mostly long-term contracts.

This is a case where we're betting on the jockey as well as the horse. The CEO and President, Laurence Levy and Edward Levy (who aren't related), know how to make money and have a history of doing so in companies with hard assets that also generate a lot of cash flow. They're not particularly promotional and

don't always communicate with investors that well, but I'll take substance over style any day.

The business is protected in a couple of structural ways. The first is that both Canada and the U.S. have laws – the Jones Act in the U.S. and the Canadian Marine Act in Canada – that prevent foreign-built ships or foreign crews from operating in this region, and the process for getting approval to operate is onerous and drawn-out. The number of boats on the Great Lakes is actually going down, as older boats get taken out of service faster than new boats are added. That gives Rand more upside on raising prices

without losing business, so they've been getting 5-6% price increases as they roll over contracts.

The company also has a structural cost advantage, which is a function of the types of boats they own and the favorable union contracts they have. They can staff their ships with 20-30% fewer people than competitors typically have to use, while still meeting the U.S. Coast Guard's minimum requirements.

How economically sensitive is the Great Lakes shipping business?

PS: Volume goes up and down, but Rand's cargo tends to be somewhat less economically sensitive. Through July of this year, the company cited numbers showing that overall tonnage of iron ore on the Great Lakes was down 50% over the five-year average, limestone was down 46%, and coal was down 22%. But Rand's overall sales were down less than 10%. One big reason for that is that in tough times they pick up incremental business because their rates per ton are lower than the competition's – not just lower than other shippers, but also compared to shipping by rail or truck.

Longer-term we consider continually strong trade between the U.S. and Canada as a secular tailwind for Rand. It will also be a big beneficiary – because of all the basic materials and aggregates it ships – if there's the big investment in road, bridge and tunnel infrastructure that people are expecting.

How inexpensive do you consider the shares, now trading around \$3.10?

PS: We expect the company to earn around \$7 million in EBITDA for the year ending in March 2010, and we consider normalized earnings as they emerge from the recession to be closer to \$12 million. There are 13 million shares outstanding, so that's over 50 cents per share in current cash flow and over 90 cents per share based on where we think the business will be in a couple years. So on a current basis the shares trade at less than 6x cash flow, and on a normalized basis it's only 3.4x.

INVESTMENT SNAPSHOT

Rand Logistics

(Nasdaq: RLOG)

Business: Provider of bulk freight shipping services primarily for the transport of coal, stone, salt and grain in the Great Lakes region, serving U.S. and Canadian ports.

Share Information

(@11/27/09):

Price	3.10
52-Week Range	2.02 - 4.55
Dividend Yield	0.0%
Market Cap	\$40.5 million

Financials (TTM):

Revenue	\$104.0 million
Operating Profit Margin	5.3%
Net Profit Margin	(-6.6%)

Valuation Metrics

(@11/27/09):

	RLOG	Nasdaq
Trailing P/E	n/a	44.0
Forward P/E Est.	7.7	19.9

Largest Institutional Owners

(@9/30/09):

Company	% Owned
David M. Knott	20.9%
Ramius LLC	14.0%
Rutabaga Capital	9.7%
MHR Fund Mgmt	3.5%
Robeco Inv Mgmt	1.4%

Short Interest (as of 11/13/09):

Shares Short/Float	n/a
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RLOG PRICE HISTORY



THE BOTTOM LINE

The company's structural and cost-related competitive advantages have helped it limit damage from the economic downturn and position it well to benefit as bulk-shipping traffic on the Great Lakes eventually improves, says Paul Sonkin. The shares currently trade at only 3.4x his normalized 90-cent-per-share estimate of annual EBITDA.

Sources: Company reports, Hummingbird Value Funds, other publicly available information

What are the biggest risks?

PS: Given where we are in the cycle, we don't see a lot of downside risk to the business. In terms of asset protection, current shareholders' equity, which we think is real, is just over \$3.50 per share. Just doing a quick calculation, they could probably sell off their fleet for something close to \$130 million, which after paying off debt and preferred-stock holders, would leave them with cash equal to the current share price.

In many cases I might worry about the company making dumb acquisitions, but that's not the case here. Management has made accretive acquisitions of vessels in the past at very low EBITDA multiples. With Rand's physical and operational infrastructure in place, new-vessel revenues are very profitable and the addition of capacity can make the company even more efficient in the scheduling and loading of its ships.

Describe your interest in Avantair [AAIR], which is sort of a mini-NetJets.

PS: Like NetJets, Avantair is in the fractional-aircraft business. They own a homogenous fleet of about 55 Piaggio Avanti planes, which are turboprops manufactured by Piaggio, an Italian company that has been around for more than 70 years. The plane looks like it's flying backwards because the propellers are in the rear instead of the front, which allows for a much larger cabin – you get the cabin of a \$14 million aircraft in a plane that costs only \$6 million. The Avantis operate at considerably less cost than a comparable plane like the Hawker 400 jet, which uses roughly twice as much fuel per mile flown. Avantair has the exclusive right to sell fractional shares of the Avanti in the U.S.

How is Avantair's business model supposed to work?

PS: The company buys the planes for \$5 million each and then sells them off in 16 fractional shares for a total of \$6 million. They also charge a \$10,000-per-month

flat fee for maintenance and service, for which a fractional owner gets 50 hours of flight time per year at no additional cost. On the maintenance and service revenue they earn an operating margin of around 25%, which comes out to \$480,000 in incremental margin per plane per year falling to the bottom line.

One important difference between Avantair and NetJets is that NetJets doesn't have a homogeneous fleet. If a certain size plane isn't available when a customer needs it, NetJets may have to provide the customer with a plane that's more expensive to operate, without getting paid any extra for doing so.

We assume scale economies matter – is Avantair big enough to make it all work?

PS: They're at an inflection point. Once they hit 40-45 planes, they can maintain and operate the fleet more efficiently, which makes the economics of the business model kick in. EBITDA first turned positive in the quarter ending last December and in the most recent quarter, ending September 30th, EBITDA was \$1.7 million.

Because they're so much less expensive, Avantair is actually growing fairly nicely through the recession. Fractional ownership in one of its planes costs

INVESTMENT SNAPSHOT

Avantair
(OTC: AAIR)

Business: Sale and management of fractional ownership interests in and charter usage of professionally piloted aircraft for private and business use in North America.

Share Information

(@11/27/09):

Price	1.59
52-Week Range	0.41 - 2.30
Dividend Yield	0.0%
Market Cap	\$45.5 million

Financials (TTM):

Revenue	\$136.8 million
Operating Profit Margin	0.1%
Net Profit Margin	(-3.3%)

Valuation Metrics

(@11/27/09):

	AAIR	Nasdaq
Trailing P/E	n/a	44.0
Forward P/E Est.	n/a	19.9

Largest Institutional Owners

(@9/30/09):

Company	% Owned
AWM Inv	22.1%
Jonathan Auerbach	10.9%
Potomac Capital Mgmt	6.5%
Paul D. Sonkin	6.4%
Gilder Gagnon Howe	5.8%

Short Interest (as of 11/13/09):

Shares Short/Float	n/a
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AAIR PRICE HISTORY



THE BOTTOM LINE

With the economics of its business model "kicking in" as it grows, Paul Sonkin believes the company can earn at least \$20 million in annual EBITDA once the economy starts to fully mend. Against today's market cap of only \$45 million, he says, "You're paying a tiny multiple of earnings power for what is kind of a sexy growth business."

Sources: Company reports, Capital IQ, Hummingbird Value Funds, other publicly available information

roughly half what a comparable plane would cost with NetJets. It's recession chic – if you're going to buy into a private plane, this is a great way to do it.

Even if people are hesitant to commit to buying a full share, Avantair has been successful selling flight time by the hour through what they call their Axis Club. The revenue per hour on those sales is quite attractive, and what should happen over time is that the Axis Club members eventually buy full plane shares.

With the shares now around \$1.60, how are you looking at valuation?

PS: Once the economy improves, we believe they can reach their goal of selling an additional 12 planes per year. That generates \$12 million in additional free cash flow. On top of that would be the \$480,000 in cash flow per plane from the maintenance and service fees, which adds another nearly \$6 million per year. So within the next couple of years we think the company can be earning at least \$20 million in EBITDA per year, against a current market value of only \$45 million. Based on the earnings power of the business, you're paying only a tiny multiple of EBITDA for what is kind of a sexy growth business.

Is the company well financed?

PS: They shored up their balance sheet and reduced annual interest costs substantially through a recent PIPE [Private Investment in Public Equity] offering. One of the lead investors in the PIPE was Special Situations Funds, run by David Greenhouse and Austin Marxe, who we consider very smart micro-cap investors. Other shareholders whom we respect include Jonathan Auerbach of Hound Partners (one of my former students at Columbia) and David Knott. We also think the company's board – which includes people like Clint Allen, one of the founders of Blockbuster, and Bob Lepofsky, the current CEO of Brooks Automation – is first-rate.

We're looking for companies like Avantair that can execute even in a tepid economic environment. That it's holding

up well through such a lousy economy gives us that much more confidence in its prospects when things finally turn up.

What's the investment thesis for Keweenaw Land [KEWL], a veritable mega-cap stock for you?

PS: This is one of those pink-sheet companies that has been around forever. It's basically a timber company with over 151,500 acres of productive timberland in Michigan. In addition, it owns mineral rights to over 400,000 acres of land and has the potential to realize value from wind-power generation, conservation

easements, carbon credits and recreational-use development.

The company is controlled by a wealthy family that has owned it for generations and hasn't been particularly shareholder friendly over that time. To their credit, they provide detailed financials on a quarterly basis and also have a full independent valuation of the company's assets done every three years or so. As is typical of a pink-sheet company with large family ownership and no apparent catalyst, it trades at a huge discount to our estimate of its net asset value.

We got interested when one of our market makers who turned activist

INVESTMENT SNAPSHOT

Keweenaw Land
(Pink Sheets: KEWL)

Business: Ownership and management of timberlands, mineral rights and other commercial and recreational real estate assets located in Michigan's upper peninsula.

Share Information
(@11/27/09):

Price	165.00
52-Week Range	120.00 – 210.00
Dividend Yield	0.0%
Market Cap	\$106.3 million

Financials (TTM):

Revenue	\$9.5 million
Operating Profit Margin	n/a
Net Profit Margin	7.7%

Valuation Metrics

(@11/27/09):

	KEWL	Nasdaq
Trailing P/E	144.7	44.0
Forward P/E Est.	n/a	19.9

Largest Institutional Owners

(@9/30/09):

Company	% Owned
Everett Harris & Co	4.4%
Boston Private Asset Mgmt	1.1%
Boston Family Office, LLC	1.0%
Butler Wick & Co	0.3%
Grace & White	0.2%

Short Interest (as of 11/13/09):

Shares Short/Float	n/a
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KEWL PRICE HISTORY



THE BOTTOM LINE

The company doesn't have a history of shareholder friendliness, says Paul Sonkin, but he believes an activist investor will make headway in unlocking what Sonkin believes is a total asset value of more than twice the current market value. While he waits, he expects the main underlying asset, timber, to continue to appreciate in value.

Sources: Company reports, Capital IQ, other publicly available information

investor, Ronald Gutstein, bought into Keweenaw and started pushing for change. He's had modest success so far, including getting the company to buy back a little bit of stock and sign a contract to explore how to capitalize on the mineral rights. We don't expect the value here to be realized overnight, but the potential upside is big enough that it will pay to be patient.

Walk through how you're valuing the assets, at a time when the shares trade around \$165.

PS: We've tried to layer conservative assumption on top of conservative assumption, using comparable market sale prices and by haircutting estimates from the company and from Ron Gutstein, the activist investor. On a per share basis, we estimate the standing timber value at just over \$200, with the bare land adding another \$105. Commercial, recreational and other development could be worth another \$27 per share, while we're valuing mineral rights at about \$18-19 per share. Assuming nothing for wind power or carbon credits, we put the net asset value at a minimum of \$350 per share.

The biggest risk with this particular investment is that it's dead money for too long. If we realize our estimated value in two years, it's a homerun. If it takes five years, we'll realize a nice 15% compounded return. If it takes 10 years, we've got a not-so-spectacular 7% return. What gives us comfort in being patient is that our assumptions are very conservative and that the main asset, timber, should only become more valuable as time goes on. In fact, timber would do quite well in an inflationary environment, if that comes to pass.

In any activist situation we usually count on what's called the Hawthorne Effect to play a role. The Hawthorne Effect basically says that subjects improve an aspect of their behavior being experimentally measured simply because of the fact that they're being studied. Last year when the activist in Keweenaw waged a proxy fight, he didn't get enough votes to

change the board slate, but he did get enough to send a strong message to the company that they couldn't just sit there and do nothing. We don't believe the activist is going away, and we think the company – which has already responded somewhat – will continue to take steps in response to his watching them so closely.

From timberland to videogames, explain why you see upside in SouthPeak Interactive [SOPK].

PS: The company went public in early 2008 through a reverse merger with a publicly traded SPAC [special-purpose

acquisition company] called Global Services Partners. They are basically value investors in the videogame business, buying rights to games from companies that have little expertise in marketing and distribution, or games that are half-done when the company that owns them runs out of money.

Say a foreign government wants to promote technology and gives a company \$5 million to produce a videogame. SouthPeak might invest along side the government and get the rights to sell the game. It's a publisher and a distributor – without its own studios and the heavy investment that requires – trying to hit

INVESTMENT SNAPSHOT

SouthPeak Interactive
(OTC: SOPK)

Business: Global developer and marketer of interactive entertainment software covering all major game genres and for use on all current videogame platforms.

Share Information
(@11/27/09):

Price	0.29
52-Week Range	0.27 - 2.25
Dividend Yield	0.0%
Market Cap	\$13.1 million

Financials (TTM):

Revenue	\$55.6 million
Operating Profit Margin	(-13.1%)
Net Profit Margin	(-17.9%)

Valuation Metrics

(@11/27/09):

	SOPK	Nasdaq
Trailing P/E	n/a	44.0
Forward P/E Est.	n/a	19.9

Largest Owners

(@9/30/09):

Company	% Owned
Terry M. Phillips	38.1%
Gregory R. Phillips	23.3%
Melanie Mroz	7.1%
Kathleen L. Morgan	6.8%
Hummingbird Mgmt	6.1%

Short Interest (as of 11/13/09):

Shares Short/Float	n/a
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SOPK PRICE HISTORY



THE BOTTOM LINE

Having spent heavily to develop its product pipeline and build out its marketing and distribution capabilities, the company is poised to benefit from an increased number of videogame launches and generate \$8 million in EBITDA within a year or two, says Paul Sonkin. If he's right, he says, today's \$13 million market value looks like a steal.

Sources: Company reports, Capital IQ, other publicly available information

singles and doubles rather than swinging for the fences. It has consistently demonstrated that it can break even on game unit sales of 30,000 to 40,000, which is very little in this business.

There are no insurmountable barriers to entry protecting this company from competitors, but it takes time and effort to develop the strong relationships SouthPeak has with independent producers, with console manufacturers, and with retailers, who are eager to stock a large number of titles in order to drive store traffic. Terry Phillips, who bought the company out of SAS Institute in 2000, has been a successful and well-known player in the industry for a long time.

The company's financial results don't appear stellar and the stock is down 70% so far this year, to around 30 cents. Why?

PS: On the profit front, they've been spending money in developing their pipeline and in building out their marketing and distribution capabilities in advance of increased game launches. Many of those new games are just starting to hit the market, which resulted in revenue growth in the just-finished quarter of 100%. They also wrote off a decent amount of goodwill in the fourth quarter of last year, which made the profits look particularly bad.

One big problem for the stock has been that one early executive of the company left and has been dumping her shares in the open market. That can have a big effect in such thinly traded stocks, but in our view it's not an effect tied to the fundamental health of the business.

We believe the company as early as next year can generate \$100 million in annual revenue, on which they should be able to earn an EBITDA margin of at least 8%. With today's market cap of \$13 million, that means the shares trade at less than 2x normalized EBITDA. For a company with a unique niche in an industry with substantial long-term growth ahead of it, we think that's an extremely good deal.

One thing to point out with tiny companies is that you have to primarily count

on the earnings produced to drive the share price. It's great if the market takes note and decides to pay more for those earnings, but you can't count on that.

Speaking generally again, does selling tend to be a challenge for you?

PS: It's typically not that difficult – we're just very patient until we get our price. When we're right about something, we

ON MISTAKES:

They've been in companies where a bunch of little things went wrong. One lesson: Don't ignore minor setbacks.

can usually find a fairly ready buyer in the company itself. These companies are often not that interested in being public anyway, so they're often open to buying back stock.

More generally, a frequent catalyst in realizing value in these investments is when someone – often the management – recognizes the same opportunity we do and pays a premium to take the whole company private.

Any insights from your mistakes you'd like to share?

PS: There's an interesting section in *Outliers*, by Malcolm Gladwell, in which he describes how disasters like plane crashes or the Three Mile Island nuclear accident are rarely because of one big mistake. They're more likely to result from a series of small mistakes, any one of which, if avoided, would have kept the disaster from happening. Many investing mistakes we've made have been in companies where a bunch of little things went wrong, which when added together made a big problem. Those types of situations can creep up on you, so I'd say one lesson is to not ignore minor setbacks and to be very aware if they start to pile up.

Can you imagine ever moving up the market-cap food chain?

PS: No, which may keep me from ever becoming fabulously wealthy, because I'm never going to run \$1 billion while sticking with these teeny-weeny companies. That suits me, because I much prefer managing a portfolio to managing the staff I'd need with a lot more assets. Most important, though, is that I just love the thrill of the hunt involved with these types of companies. Why give that up? **VII**

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Board Decision

Investors have had plenty of experience in the past year trying to figure out what to do with carefully selected stock holdings as they plunged in value. Here's how Brian Bares has handled one such challenged position.

Had one fallen asleep after reading Brian Bares' *Value Investor Insight* interview last year (September 30, 2008) and just woken up, he or she might imagine the intervening period in equity markets to have been quite dull. The Russell 3000 over that period is down 1.9%, while an equally weighted portfolio of Bares' primary picks – Corporate Executive Board, Greenlight Capital Re, International Assets Holding and Winmark – has performed nearly the same, down 1.6%.

We all know the past 14 months have been anything but boring for investors, who, like Bares, have faced wrenching decisions about portfolio favorites as their values fell off a cliff. The decisions made – sell, hold or buy more – would have resulted in dramatic differences in overall performance over the period.

Bares, who runs Austin-based Bares Capital, says he's added to each of the positions he highlighted in the interview, for one basic reason: "The macro outlook obviously required changes to our DCF models, resulting in lower estimated intrinsic values. Fortunately – or unfortunately – the share prices were falling faster than the intrinsic-value estimates, so it made no sense to sell when the discounts to intrinsic value were actually widening."

That resolve has yet to be rewarded with Corporate Executive Board. The company provides subscription-based best-practices research to large corporations, including 80% of the Fortune 500. Clients subscribe to one of dozens of subject-area programs – at an average cost of around \$31,000 per program per year – agreeing to share their own experiences in return for access to collective data from other subscriber companies. The more companies in the network, the more valuable the end product, creating a natural competitive barrier to entry and providing CEB with historical operating margins well above 20% and returns on capital in excess of 30%.

This recession, however, has been unkind to even the best businesses. CEB revenues are down 25% this year, as renewal rates and cross sales of new programs to existing clients have fallen. The operating leverage that serves the company well when revenues grow has turned against it as revenues fall, sending the latest quarter's earnings down nearly 30%, despite aggressive cost cutting.

Bares remains undaunted. The earnings decline is not symptomatic of deterioration in the company's competitive position, he says, so its earnings power is essentially unchanged. The company has

excellent growth prospects from expanding its middle-market and international client bases, he says, and a recent sales-force reorganization to provide customers with a single point of contact should help improve renewal and cross-sale rates.

With its shares at \$21.25, CEB's enterprise value is 12x the \$1.60 in free cash flow per share Bares expects the company to earn next year. "That's quite low for one of the best small-cap compounders out there," he says. Assuming strong cash-flow gains as revenue starts growing again in 2011 at some 10% annually, he puts the stock's current fair value at \$33. **VII**

INVESTMENT SNAPSHOT

Corporate Executive Board

(Nasdaq: EXBD)

EXBD PRICE HISTORY



▼ VII, September 30, 2008

Share Information (@11/27/09):

Price	\$21.25
52-Week Range	\$12.35 - \$27.18

Valuation Metrics (@11/27/09):

	EXBD	Nasdaq
Trailing P/E	27.6	44.0
Forward P/E Est.	16.5	19.9

ORIGINAL BOTTOM LINE – SEPTEMBER 30, 2008

Having "indiscriminately dumped" the company's shares, the market is undervaluing the strength of its business model and its still-healthy growth prospects, says Brian Bares. At what he considers a reasonable 20x the \$3 per share in free cash flow he expects the company to earn next year, the shares would trade at closer to \$60.

NEW BOTTOM LINE

The company's exemplary competitive position and earnings power have not been eroded by the recession, says Brian Bares. Assuming revenue starts growing again in 2011 at roughly 10% annually, he estimates the stock's current fair value at \$33 per share.

Sources: Company reports, other publicly available information

Survivor: Office Supplies

If they keep their eyes firmly on the road, market leaders heading into a recessionary tunnel should be even more dominant coming out the other side. Potential case in point: office-supply retailer Staples.

As the market has rebounded since March, stock prices of industry laggards have generally outpaced those of leaders as fears of calamitous economic meltdown have abated. The experience in retail office-supply is typical: Since March 9th, shares of long-time #1 Staples are up 60%, while those of struggling Office Depot and OfficeMax have risen a stunning 965% and 413%, respectively.

The result of this enthusiasm for back-from-the-brink stories, says W.P. Stewart's James Tierney, is short shrift given to firms like Staples with the most to gain from the "competitive destruction" wrought by the recession. "Past retail downturns meant capacity growth slowed," he says. "This time capacity is actually shrinking, which should result in significant share gains for the leaders."

Staples already has a large lead on its competitors. It has 1,900 stores in the U.S., vs. 1,100 for #2 Office Depot. Bolstered by its acquisition last year of Corporate Express, it dominates the direct-sale delivery of office supplies – a higher-margin and faster-growing business. Its stores tend to be better-maintained and its staff more knowledgeable, resulting in there being "no comparison in the quality of the customer experience versus the competition," says Tierney. All this translates to the bottom line – Staples operating margins are in the high single digits, versus low-single-digit margins at OfficeMax and losses at Office Depot.

The company is pressing its advantage. While competitors shrink, Staples expects to open 50-60 new stores this year and return to an annual level of 100 openings per year as the economy recovers. It's investing in marketing initiatives to drive store traffic and expand its direct sales effort targeting mid-market companies. Maybe most importantly, it's keeping prices low. W.P. Stewart in-house research found Staples' prices to be 4% cheaper on a broad basket of products than direct

competitors, and 8% cheaper than mass merchandisers like Wal-Mart, Target and Amazon.com. "That's a sign of both strength and latent upside," says Tierney.

With 5-6% growth from new stores, 2-3% gains in retail comp sales, and low-teen percentage growth in the delivery business, Tierney believes Staples revenue can grow 10% per year through 2015. He expects 14% annual EPS growth, as margins expand from better-than-expected cost savings from the Corporate Express deal, as higher-margin Staples-branded

merchandise accounts for more of total sales, and as the company uses free cash flow to buy shares and pay down debt.

Discounting back his 2015 estimated share value of \$51 (\$2.70 in EPS at a 17.5x multiple, plus \$4 in accumulated dividends), Tierney values Staples shares at \$32, a 37% premium to today's price. "It's hard for us to see how both Office Depot and OfficeMax survive in their current form," Tierney says. "Nobody wants this, but the longer the economy is soft, the better long term it will be for Staples." VII

INVESTMENT SNAPSHOT

Staples

(Nasdaq: SPLS)

Business: World's largest retailer of office products, including supplies, office machines, computers and furniture.

Share Information

(@11/27/09):

Price	23.32
52-Week Range	14.35 – 23.65
Dividend Yield	1.4%
Market Cap	\$16.8 billion

Financials (TTM):

Revenue	\$24.48 billion
Operating Profit Margin	6.2%
Net Profit Margin	2.8%

Valuation Metrics

(@11/27/09):

	SPLS	Nasdaq
Trailing P/E	24.6	44.0
Forward P/E Est.	17.1	19.9

Largest Institutional Owners

(@9/30/09):

Company	% Owned
Fidelity Mgmt & Research	12.1%
Wellington Mgmt	11.7%
Capital Research	4.6%

Short Interest (As of 11/13/09):

Shares Short/Float	3.5%
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SPLS PRICE HISTORY



THE BOTTOM LINE

The company is pressing its advantage over weak competitors, says James Tierney, through aggressive pricing, store growth and an expanded delivery business. Assuming 14% annual EPS growth through 2015, he puts the shares' fair value today at \$32.

Sources: Company reports, other publicly available information

Practice, Practice, Practice

For all the similarities in how value investors ply their trade, we're always fascinated by how differently common principles can be applied in trying to find an edge. Our two feature interviews in this issue, the father and son team running Yacktman Asset Management and Paul Sonkin of Hummingbird Funds, illustrate this perfectly. Both are focused on identifying out-of-favor companies with strong competitive positions, but their portfolios could not look more different. While the Yacktmans see great value in brand name behemoths like Coca-Cola, Procter & Gamble and News Corp., Sonkin is buying companies that process stale bread into animal feed (Scope Industries) or that market second- or third-tier videogames like the upcoming *Dementium II* (SouthPeak Interactive).

Beyond uniform principles, top performers in any field also share another common trait, writes Malcolm Gladwell in *Outliers*, a fascinating book on why some people succeed far more than others: They work much harder than anyone else. "The problem with the view [that achievement is talent plus preparation] is that the closer psychologists look at the

careers of the gifted, the smaller the role innate talent seems to play and the bigger the role preparation seems to play," Gladwell writes.

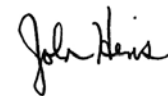
He cites a representative study in the early 1990s of violinists at Berlin's elite Academy of Music. The students were all talented – they wouldn't have been accepted into the academy otherwise – but professors were able to divide them into three distinct groups: stars that could become world-class soloists; good players who had the potential to make a living as professional musicians; and the rest, who mostly intended to be music teachers in the public school system.

In studying the backgrounds of the Berlin violinists, researchers found a clear distinction in the hours of practice put in by players in each group. Everyone in the three groups started playing at around age five, and in the first few years practiced roughly the same amount, two to three hours per week. By age eight, however, the best players started practicing more than everyone else, and by age 20 they were practicing well over 30 hours per week. By that age, the elite performers had put in an average of 10,000 total

hours, versus 8,000 hours for the second group, and just over 4,000 hours for the future music teachers. In fact, researchers in many disciplines have settled on 10,000 hours of practice as the magic number for attaining true expertise.

Contrary to what you might expect, the researchers didn't discover any "naturals," who floated effortlessly to the top while practicing less than their peers. Nor did they find any "grinds," who worked harder than everyone else but didn't have what it took to be among the star performers. Above a threshold talent level, all that really matters is the level of effort, writes Gladwell, with one important addendum: Practice can't just be putting in hours, but rather working "purposefully and single-mindedly" with intent to learn and continuously improve.

He doesn't mention it specifically, but we're sure he'd mean for investors things like poring over every word of *Value Investor Insight*. Just a thought . . . VII



John Heins
Co-Editor-in-Chief



Whitney Tilson
Co-Editor-in-Chief

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