Capital Account

Special Situation and Value Based Investing Opportunities

March 2013

CSX Corporation

The opportunity to acquire an interest in a long-lived asset, operating as a duopoly with its nearest competitor, at a price 50% below its intrinsic value

Such is the tenor of stocks markets in our present generation , with the focus on monthly and quarterly performance by institutional(ised) investors, that even large, high quality well run businesses with excellent track records, are sometimes overlooked. But if one is less concerned with the need to outperform his or her peers and the arbitrary benchmarks over the coming ninety days, and instead might be interested in owning shares in a business they conceivably may never have to sell, then a position in CSX Corp looks most prospective.

There are 5 things we like about the idea:

1) the business is simple to understand;
2) management's track record is excellent;
3) the equity is undervalued on any reasonable measure;
4) they operate with enormous barriers to entry; and
5) they operate with a fundamentally better cost structure than competitive alternatives, namely trucking

Conveniently for us, the market's preoccupation with coal over the past 3 years has provided an opportunity to acquire CSX shares at a significant discount to its peers and to our determination of intrinsic value. Coal is far from the unmitigated disaster that appears embedded in CSX's shares. Since 2004 CSX's revenues have compounded at 5%, but ex-Coal have grown more slowly at 4.2%. In spite of coal loadings having peaked in the third quarter of 2006, the company has continued to extract better pricing per car and provide an offset to the weaker volumes. Behind Chemicals, coal today is amongst the most profitable loading at CSX and has grown strongly over the past half dozen years, as shown in Figure 1 below.

CSX Corp

Situation: Share trading cheap relative to cyclical valuation

Market Cap: $22.5bn

HQ: Jacksonville, Florida

TTM Sales: $11.7bn

TTM EBITDA: $4.5b

Dividend Yield: 2.7%

PE Ratio: 10.2x ('14E)

EV/Sales: 2.65x

Net Debt to Ebitda: 2.0x

Recent Price: $21.9

Intrinsic Value: $34

Figure 1:

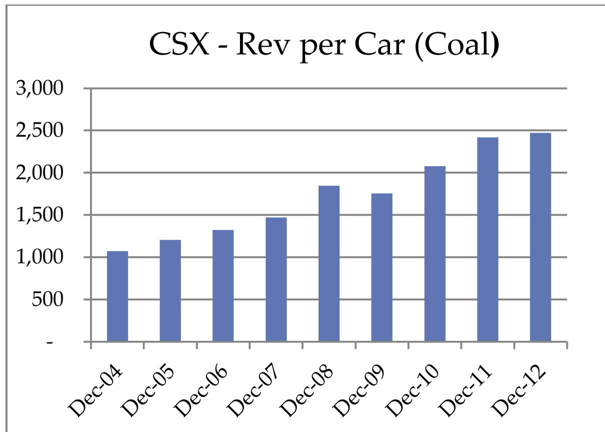
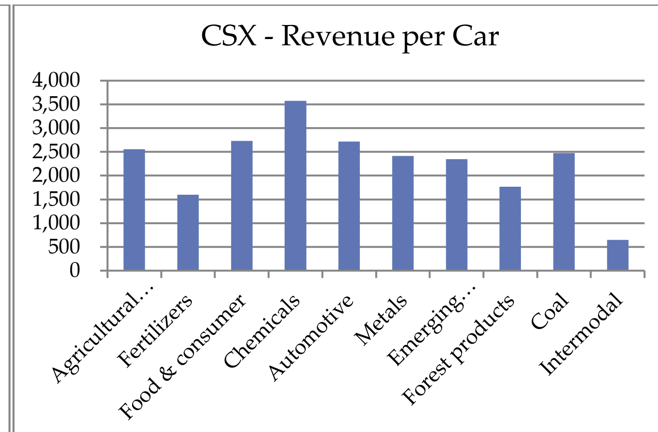


Figure 2:



In 2004 new management were installed at CSX and their undertakings since have resulted in wonderful improvements in all levels of the business. The following chart (Figure 3) bears witness to this claim with returns on invested capital now a multiple of the levels achieved early in the decade. The main driver here has been operating ratios (margins), which have improved consistently over the same time frame (Figure 4).

Figure 3:

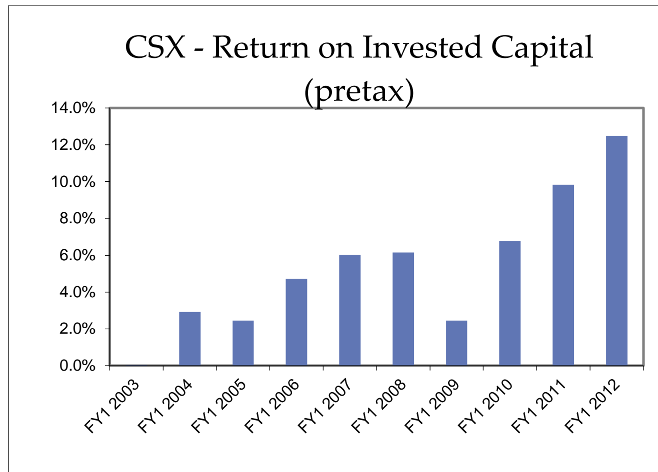
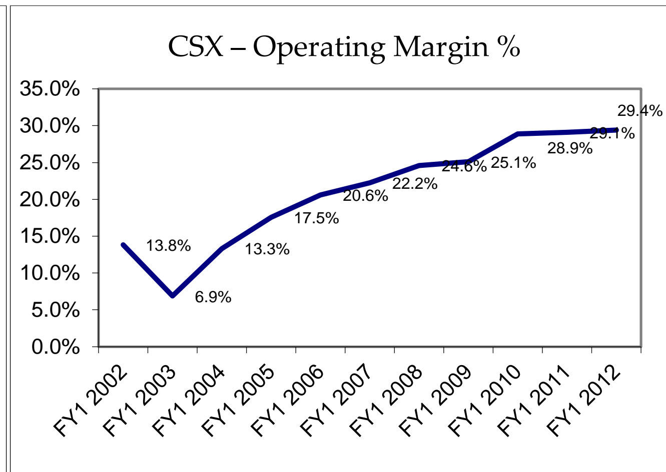


Figure 4:



So what is all the fuss about? Yes coal does matter, but the numbers above suggest the market is overly concerned with its ultimate impact on CSX's business. Off course returns and earnings would be higher than if coal volumes had not declined as much as they have, but with utility demand likely to bottom in the middle of 2013, and the prospect for more normalized weather conditions (hot summer, cold winters), coal fired generation demand is unlikely to take another significant leg down. As it is, Utilities are running their <u>gas-fired</u> generation capacity at maximum levels (taking advantage of lower feedstock costs), and would be required to make a significant round of additional capex in order to further transition away from coal, at ultimately less attractive economics. In all likelihood the big drawdown in coal by the Utilities is now mostly complete in our view. Around 25% of CSX's coal contracts are up for renewal in 2013, and the company believe they can extract still better pricing on volumes going forward, in order to provide for more flexible delivery arrangements now required by the Utilities.

Outside of coal, the market appears also to be ignoring the long term potential for intermodal. Today it represents some 38% of loadings, but carries the lowest yield within the network ($rev/car of $650 versus portfolio average of $1,850). As they establish themselves (via partnerships with the Truckers) in this category they will have more scope to improve pricing and yields, with potentially dramatic effect on the bottom line. With intermodal volumes so significant, pricing leverage here remains the blue-sky scenario for CSX's business over the coming 5-10 years.

Today it will cost you $22 for each of dollar of Kansas City Southern's earnings, $18 for a dollar a Genesee and Wyoming's, and $14.10 for a dollar of Union Pacific's. A dollar of CSX's earnings can be had for a full 20% lower than the least of these and half that of KSU's. For further context, Canadian National today generates annual revenues in the order of $9.5bn, compared with our CSX at $11bn, but carries fully twice the market cap of CSX – go figure. Our own fair value work determines a fair multiple on CSX's earnings is around 14x. Further, we see earnings continuing to grow steadily over the next three years with a 2015 EPS figure of $3.03/share. Apply 14x and discount back at 9.2% yields a present value of $33.50, around 48% higher than current trading levels. If CSX becomes as overvalued in 3 years as it is undervalued today, trading up to say 18x, you have a stock that could more than double. Set against what we consider to be minimal downside at today's prices, the risk-reward profile of nicely skewed in our favour. We like CSX.

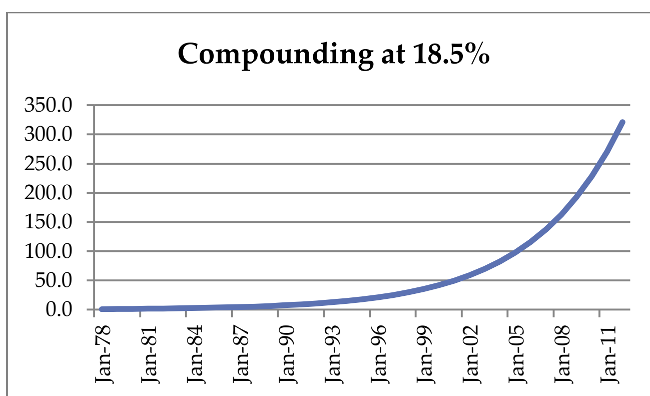
Situations of Interest

Management changes are sometimes a wonderful catalyst for unlocking value, and owning shares just ahead of a management change, more profitable still. Think HPQ in the months prior to Carly Fiorina's departure in 2005. The stock rallied 50% in the 9 months after the CEO's announced resignation. It helped that Mark Hurd was appointed, but her departure cleared the way. Recall too that it was shortly after the disastrous EDS acquisition that the Board finally lost confidence in Carly. Today we see Microsoft similarly poised with Steve Ballmer at the helm. Our internal work suggest Microsoft's shares potentially worth as much as $38/share (including a 1/3 discount on their net cash position), under a potential breakup. Breakup! Well yes why not, but probably not under Steve Ballmer. You have a world class Server and Tools business (the fastest growing segment in their portfolio that we think is worth $8/share, Microsoft Business (Office, Exchange and SharePoint) worth $16/share, Windows and Windows Live at $8.20/share + net cash of $5.2/share (discounted by 1/3). The recently launched Surface Tablet has the (P)otential to become the business tool that the iPad isn't, that is to say a seamless tablet-form extension of your Microsoft desktop environment. Unlike mobile phones, Microsoft are not starting from a position of weakness here, as they own the desktop. Pitched and priced correctly they have a good shot at carving out a decent slice of the tablet market. At 17% (possibly a stretch) share (=34mln units), the Surface could add 15% to current consensus EBIT in FY15.

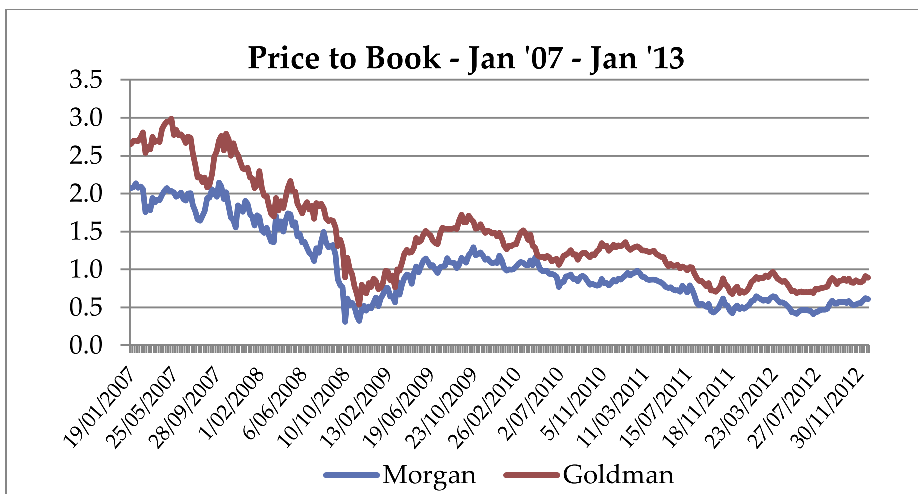
We've long been of the view that the guys who ran the larger tech companies as growth businesses in the 90's are the not the right people to run them as mature harvesting machines (Chambers take note). Paul Ottelini at Intel recently announced he was taking early retirement. Intel have few options other than cranking out faster, cheaper chips. At 56 Ballmer is still young, but if the Board (and more importantly

Bill Gates) is tired of Microsoft being a 20's something stock they may agitate for change. Unlike Intel, Microsoft do have options, some of which carry very favorable implications for shareholders. We may write more extensively on this opportunity in months to come.

Speaking of transactions, the announced spin-off of **Crimson Wines** by Leukedia sparked our interest. Crimson is we think worth about $1/share to LUK, however it is being undertaken in order to clear the way for said parent to issue some 71% of their existing float to buy in the majority of Jefferies (72%) that they don't presently own. Dwelling on this event and the parties involved is more revealing. Here is a company (an investment holding company), with an outstanding record of capital allocation over a long period of time. Beginning in 1978 with a book-value per share of -$0.04c, Ian Cummings and Joseph Steinberg have compounded that book at 18.5% since. In case you're wondering, this is what that achievement actually looks like.



On March 31st LUK will issue 71% (61% net of the announced buyback) of their existing float to acquire control of an investment bank. When you pride yourself on per share compound annual returns, one does not take lightly the thought of issuing 71% more shares than currently on issue. We wonder what this says regarding the investment banking cycle… if we can extrapolate the retiring Chairman of LUK's track record to one final capital allocation decision - probably quite a lot. Morgan Stanley and Goldman Sachs shares can be had today for 0.61x and 0.89x book value respectively. Who knows if we're at the bottom, but we're surely a long way from the top.



Alent Plc

Recently demerged from its parent Cookson, Alent is interesting with prospects for a dividend initiation, upside to margins and a re-rating of their earnings… enough for our consideration!

In mid-December 2012 Cookson Plc was coaxed into breaking themselves into two demerged entities. Spun was Alent Plc, with the Parent remainder being renamed Vesuvius (VSVS). Always looking to avoid blow-up's our attention has turned to the lesser known, smaller, but higher returning Alent. Alent is a specialty materials business with a manufacturing footprint spanning some 23 countries, extensive relationships with their core customers and strong levels of system level engineering expertise. The company supply advance surface treatment plating chemicals and electronic assembly materials. In layman's terms this is an around-about way of saying "high tech glue". Whilst theirs is a business that might be prone to commoditization (from low cost Asian suppliers), Alent have sought and successfully differentiated themselves through a strong focus on new products, superior manufacturing footprint and time to market. We figure that management long ago realized that trying to sell glue that was fancier than the next guy would not cut it. The materials science is important… their stuff can't, not work, but taken that as a given you need to differentiate yourself in other ways (service culture, responsive manufacturing, forefront of innovation etc).

Alent Plc

Situation: Spin-off

Market Cap: £928mln

HQ: Surrey, UK

TTM Sales: £759mln

TTM EBITDA: £113mln

Dividend Yield: 3.5% (prospectively)

PE Ratio: 9.5x ('13E)

EV/Net Sales: 2.0x

Net Debt/Ebitda: 1.3x

Recent Price: 3.35

Intrinsic Value: 420p

Upside ~30%

Combining their materials science expertise, service culture and deep engineering experience allowed the company to operate with returns on invested capital typically associated with a high end consulting business. In the year ended Dec 2011 the company generated a pretax ROIC of 23%, up from 18% in the prior year. Their return on incremental capital in 2011 was an impressive 200%, that is each dollar of new capital generated $2 of pretax income. Alent's reported margins understate the true economics of the business. As much as 50% of their annual sales are a pass-through of raw materials which are sold and delivered on a contracted basis. If we instead focus on net sales (net of pass-through), the operating margin for the most recently reported year was 23.8%, up over 500bp's from the previous year. Our analysis suggests they can improve this further with a strong new product pipeline over the coming 2-3 years focused on LED lighting, automotive, solar modules, and semiconductors for mobile applications. The demerger clearly paves the way for management to begin running this business much more efficiently than was the case when part of a larger conglomerate.

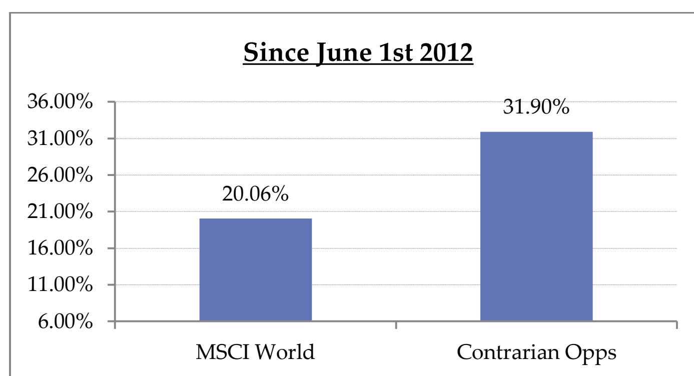
Alent's business model is also capital light with capex running at 10-15% of ebitda over the past 3 years. This has yielded more than adequate free cashflows, which over the next 3 years we expect to represent around 18c of each dollar of net sales. Alent's upcoming dividend should also get investor attention. Our

work on earnings and other capital commitments suggest the business can support a dividend of around 14p/share by 2014, offering a yield on today's shares of circa 4%.

The peer group is disparate, but amongst them you might include Umicore in Belgium trading on 13x 2014, AZ Electronics trading on 15x 2013. At our price target of 420p, Alent would be trading on 11x our estimate of 2014 EPS, seemingly not a stretch if they can deliver on our targets. Interesting, don't you think?

Model Portfolio Update

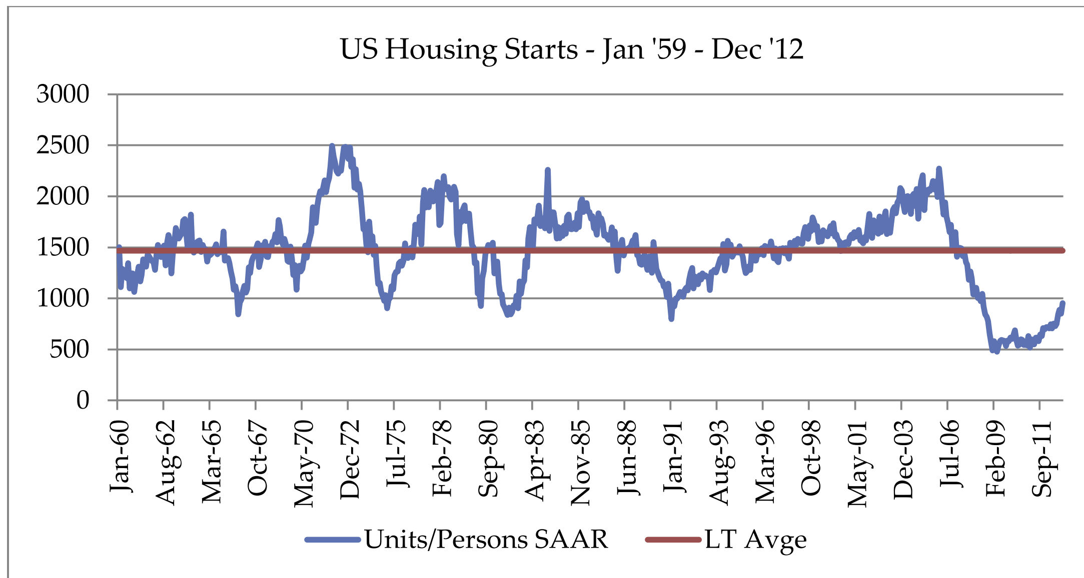
Running since June 2012 the model portfolio is a way of capturing ideas in a portfolio setting and benchmarking these against the broader market. It is actively managed with returns in local currency.



Name	Country	Sector	Weight	Return
GANNETT CO	US	Consumer Discretionary	4.3%	54.5%
GENERAL MOTORS C	US	Consumer Discretionary	3.7%	33.7%
SAFEWAY INC	US	Consumer Staples	2.9%	23.0%
SUSSER HOLDINGS	US	Consumer Staples	3.5%	23.5%
ENI SPA	IT	Energy	3.1%	12.1%
OLD REPUB INTL	US	Financials	4.0%	32.0%
ROUSE PROPER	US	Financials	3.9%	39.9%
WR BERKLEY CORP	US	Financials	3.0%	8.5%
BARCLAYS PLC	GB	Financials	4.8%	79.9%
GSW IMMOBILIEN A	DE	Financials	3.6%	-3.1%
FOREST LABS INC	US	Health Care	2.9%	2.1%
TNT EXPRESS	NL	Industrials	4.4%	15.3%
MFC INDUSTRIAL L	CA	Industrials	9.0%	8.9%
OC OERLIKON CORP	CH	Industrials	3.2%	11.1%
ESTERLINE TECH	US	Industrials	4.8%	16.3%
HYSTER-YALE	US	Industrials	4.2%	20.1%
FIAT INDUSTRIAL	IT	Industrials	3.3%	17.2%
ADT CORP/THE	US	Industrials	4.4%	24.0%
CSX CORP	US	Industrials	2.7%	0.5%
CAP GEMINI	FR	Information Technology	4.4%	6.3%
NETAPP INC	US	Information Technology	3.3%	19.0%
COMPUTER SCIENCE	US	Information Technology	3.9%	23.8%
ALENT PLC	GB	Materials	4.3%	10.2%
LEUCADIA NATL	US	Financials	8.2%	5.6%

A final thought…

This chart caught our attention during the month.



All things housing are now a multiple of their levels two years ago as US housing starts climb from their exaggerated lows to today levels (which b-t-w only correspond with the low point of historic cycles). Since the beginning of 2011, equity return have followed; LEN +118%, PHM +168%, DHI +96% etc etc. Can we overlay this template to other forgotten sectors of the market that were decimated in the post credit-bubble aftermath? Without presuming an imminent recovery, possibly yes. Shipping appears to be where housing was 2-3 year ago. Apathy and disinterest seems to be the predominant attitude towards the sector at present, which is often a forerunner for better things to come. Container, tanker, double hull, handymax, there is lots of jargon to cut through, but for context we present Pacific Basin, a Hong Kong listed entity and operator of Handysize, and Handymax dry bulk. Maybe the bubble years are just that, and will never return… low prices though have a way of correcting overcapacity, given enough time, US housing being our most recent working example. Beginning to get your arms around shipping may in time prove worth the effort.