Capital Account

Special Situations and Value-Based Investing Opportunities

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Spanish Evolution

Recently I attended to an excellent presentation on economic developments in Spain. It was grist for the mill for a contrarian. The following summarizes as well as fleshes out the key points and potential opportunities that may be presently availing themselves

Introduction

This brief report note aims to highlight some of the positive developments that have been occurring in Spain since the onset of the crises in 2008. The Spanish stock market today is valued at only 38% of GDP (versus an average of 85%) and is down some 50% from its peak levels of 2007. Overall earnings are still depressed in most industries, but the foundations for eventual recovery appear very sound.

Country	GDP $usd	Market Cap	Mkt Cap to GDP%
Germany	3,600	1570	43.6%
France	2,773	1780	64.2%
Italy	2,193	498	22.7%
UK	2,445	3140	128.4%
Japan	5,867	4360	74.3%
USA	14,990	20220	134.9%
Canada	1,736	1780	102.5%
Australia	1,379	1530	110.9%
Netherlands	836	778	93.1%
Sweden	539	612	113.5%
Mexico	1,153	633	54.9%
Average			85.7%
Spain	**1,476**	**573**	**38.8%**

The Kingdom of Spain

Situation: A country emerging from bankruptcy under new management

Key Data:

GDP: $2.1trn

HQ: Southern Europe

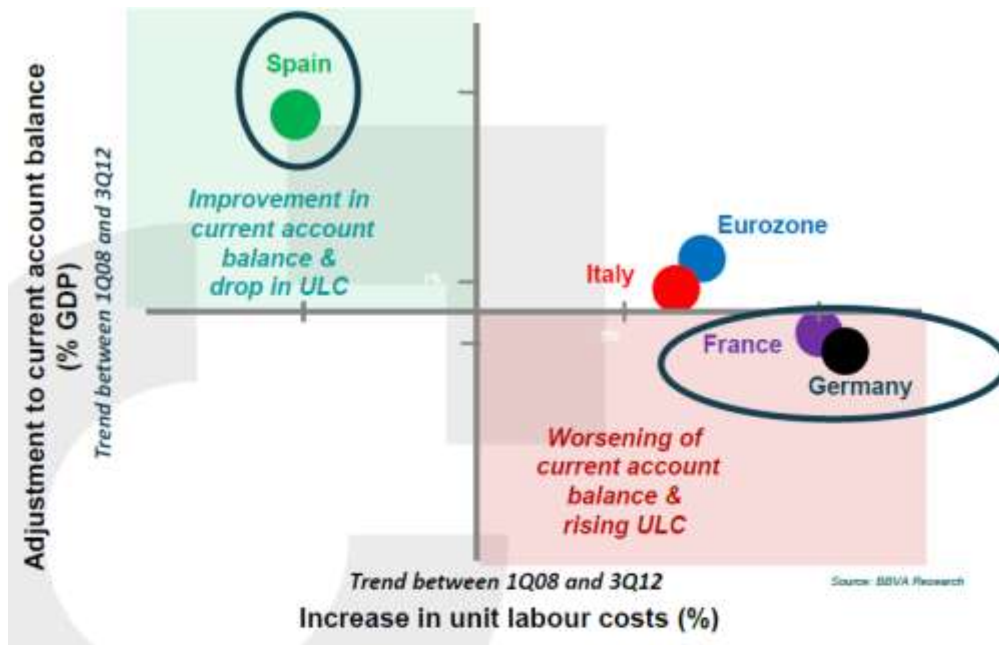
Population: 47mln

10Yr Yield: 2.45%

Market Cap/GDP: 38%

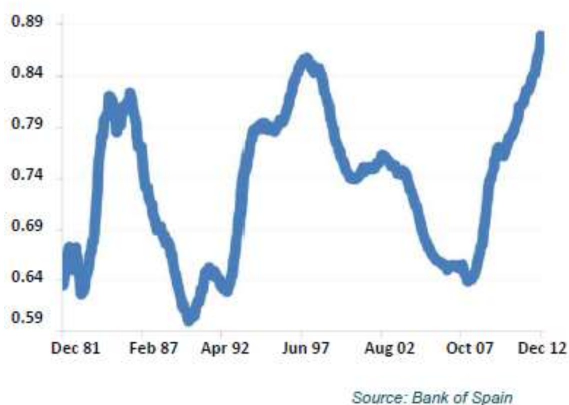
The Labour Market and Competitiveness

Spain has achieved a significant decrease in unit labour costs compared with the rest of the Eurozone while productivity has improved markedly. Research from BBVA shows that Spain has achieved the single largest improvement in unit labour costs amongst the major EU countries (horizontal axis below), while correspondingly has delivered a major improvement in their current account position (vertical axis below). In other words, primarily through a process of internal devaluation and investment in productivity , Spain has fundamentally improved its market position vis-a-vis its EU competitors, which has now become evident in their growing share of EU exports.

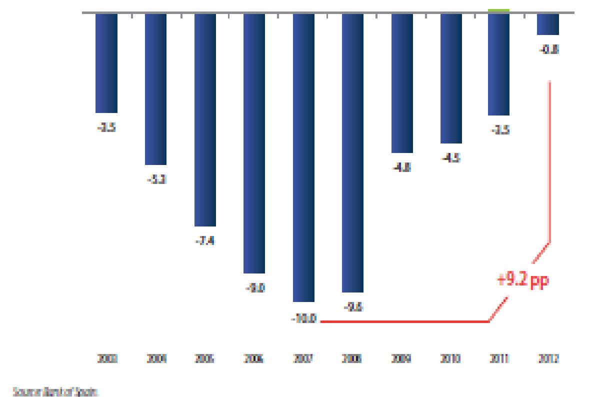


The magnitude of improvement in Spain's export position as well can further be highlighted in the following two charts. This improvement in Spain's external position it should be noted is partly attributed to weaker imports, per the downturn, but Spanish exports today are running 25% higher than the levels of 2006-7. There would be few countries in the world that have achieved this feet over the past 6 years. Consequently Spain's ratio of exports versus imports is running at record high levels, while the country has delivered an almost 10% improvement in their current account deficit as a percentage of GDP.

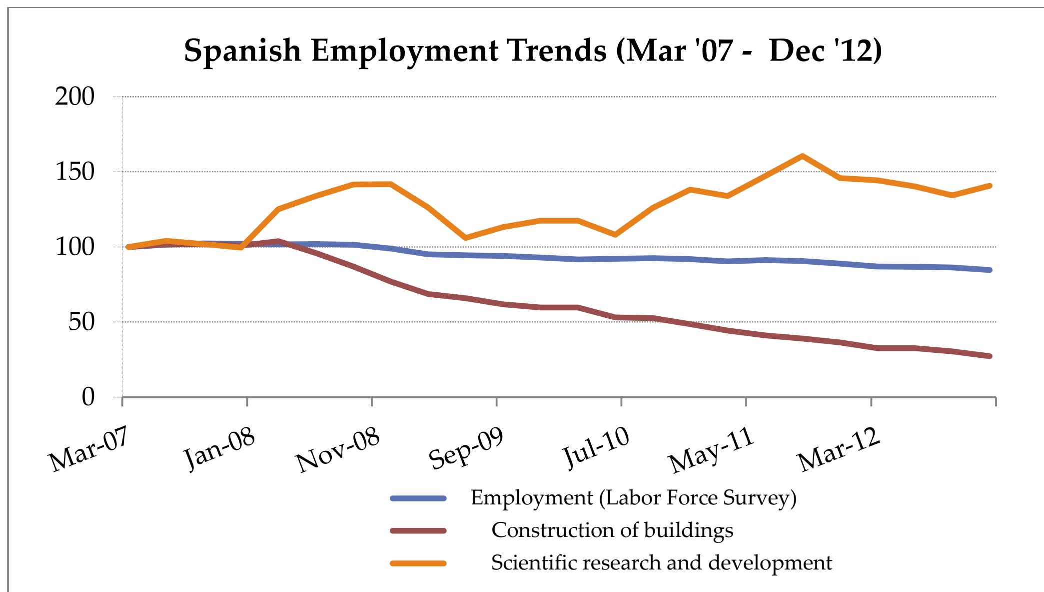
Ratio of Exports to Import – All Time High



Current Account Balance Adjustment – 5 Yrs



Looking at labour trends in Spain since the peak in 2007 we see an economy that firstly, is going through a great deal of pain with total employment down by some 16% from its peak levels, but secondly, a labour market that is transitioning away from low value-added jobs (construction) to high value-added scientific research and development roles. The aggregate data hide an otherwise very positive shift underway in the country.



Developments on Foreign Investment

Spain remains an attractive destination for foreign investment. In 2011 around 300 new FDI projects kicked off in Spain, 60% more than in the previous year according to research from Ernst & Young (European Attractiveness Survey). In the 4 years to the end of 2012, around Eur25bn of FDI per annum flowed into Spain, only slightly below the E27bn that was flowing in, in the 5 years prior to the bust. As a country Spain has over 8,620 foreign subsidiaries in operation (23% more than before the crisis) turning over some Eur401bn (1/3 of GDP) and employing 1.2mln people or 7.7% of the Spanish workforce. Based on all this data it appears as though Spain continues to remain attractive for foreign investment.

Underwriting this continued attraction as a destination for foreign investment is the dynamism and internal competitiveness of the Spanish economy. To this point there are number of things worth mentioning:-

- 32% of the population has some type of higher education qualification, above France (30%), Germany (27%) and Italy (15%), and 8% above the EU average.
- Spain ranks 10th in the world by scientific output and accounts for 12% of all European scientific output (see employment chart above)
- A relatively inexpensive workforce compared with other European countries: with costs 29% below France, 13% lower than Italy and 9% lower than Germany. The EC also estimate that the wage costs over the next 2 years will rise at only 25% of the rate of increase in in Germany, 33% that of the UK, and 50% that of France and Italy.
- The average gross monthly salary of a University graduate in Spain is 40% lower than in Germany and 25% below the UK, France, Holland and Italy.
- Spain is the only EU country where the corporate margin per employee measured as the difference between production costs and cost per employee has increased between the 1990's and 2012, with the margin per employee rising from Eur14k in the 90's to Eur24k by 2012.

- Of note also is the fact that employment levels in absolute terms are back to 2002 levels, however GDP is 40% higher than 2002's levels.

35% of Spain's GDP is comprised of 6 strategic sectors, automotive, biotechnology, ICT, food & agriculture, aerospace, and machinery & tooling. These six sectors also account for 42% of Spain's exports and employ more than 2mln people or (12% of the workforce). During the downturn these sectors combined, have increased output by an average rate of 3% per annum and in terms of productivity, have generated output per employee which is 76% higher than the economy as a whole. These sectors are innovation oriented with annual R&D running at around 2.5% of sales, a multiple of the broader economy. Together these six sectors are the bedrock for the future growth and success of Spain as a nation. For all the hype, we need only reflect on where Australia is by comparison to judge the foundation of the so-called Aussie economic miracle.

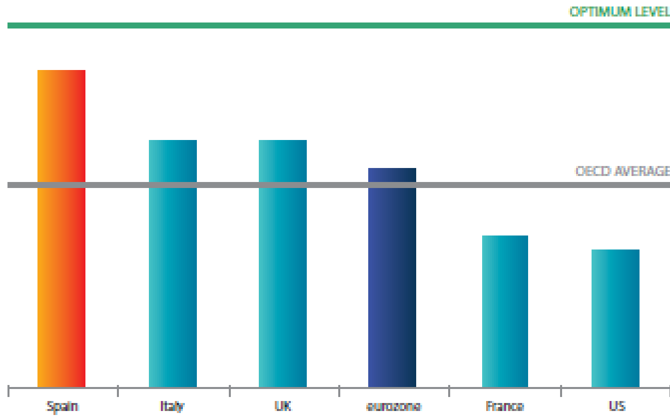
Fiscal and Economic Reform

Spain has also made great progress on necessary fiscal adjustment that is taking place across the Eurozone. In 2012 the fiscal deficit as a % of GDP had declined to 6.7%, well below the levels seen in places such as Italy, the UK and US for that matter. Looking at the funding requirements of Spain over the coming two years, that is, fiscal deficit + long term maturities, as a percentage of GDP Spain is relatively well placed versus other countries.

Public deficit and long-term maturities (as a % of GDP)	2013	2014	TOTAL
Spain	8.9	9.2	18.1
Italy	11.1	12.8	23.9
France	7.7	8.5	16.2
Belgium	10.4	8.7	19.1
United Kingdom	10.5	10.4	20.9
United States	15.7	13.5	29.2

Source: Bloomberg, IMF Fiscal Outlook October 2012.

According to research published by the OECD, Spain has also been much more proactive in moving forward on reforms. The following chart highlights the country's relative progress, in the opinion of the OECD.



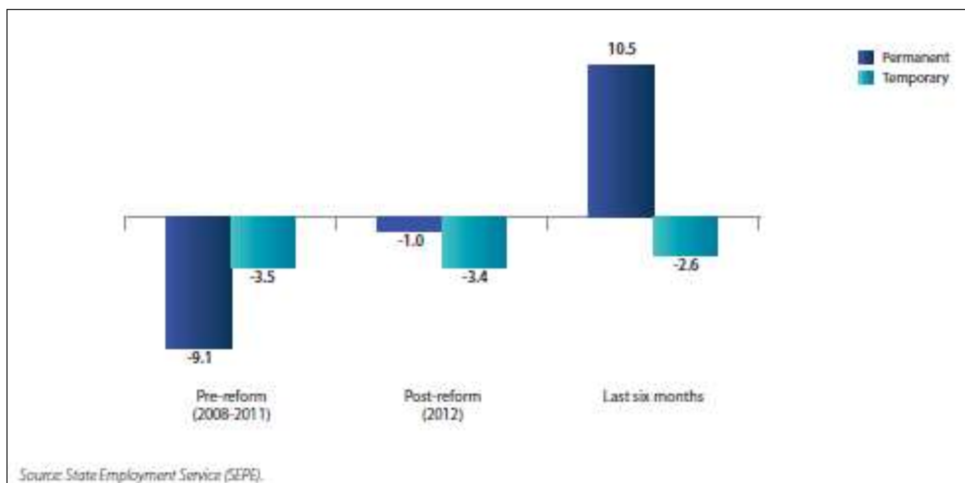
Key reforms have included the following:

- raising of retirement age
- increase in min years required to qualify for 100% state pensions
- establishment of more robust and transparent deficit targets,
- introducing co-payment for medicines
- increases on levies for university education
- measures to reduce the cost of doing business in Spain
- measures to make it easier and cheaper to hire and (importantly) fire
- increasing the number of remedies that can be used in collective bargaining agreements , thereby reducing the centralisation of the bargaining process
- various measures to weaken the hold of unions in several important Spanish industries

Spain remains both competitive and innovative:

It obviously very early days to measure the impact of labour market reforms however the data in the chart below indicate potential progress with the number of permanent versus temporary contract awarded showing positive signs over the last six months of 2012.

<u>Recent Trends in Hiring</u>:



Spanish Banking

It's fair to say that this sector of the economy remains opaque. We know the crisis in Spanish banking was driven by a giant misallocation of capital into the real estate and construction sectors after their entry into the Eurozone. But is remains difficult to truly assess the underlying the health of the Spanish banking sector. A few points though are worth mentioning:

- total provisions covering assets have risen by E67bn over the course of 2012 to E192bn
- loan loss provisions cover approximately 50% of all toxic assets which is over and above the provision of other European countries
- min capital requirements have now been covered by either the banks themselves (issuing equity or assets sales or exchange of hybrid instruments) or through Eur39bn of pubic capital injected through the credit line of the ESM
- we have seen a decrease the number of active bank branches from 45k at the peak to 39k at present, while the number of banks have decreased from around 50 in 2009 to just 16 today
- solvent banks today, manage some 70% of all of Spain's banking assets, suggesting that credit can be extended on reasonable terms in Spain.
- actions of the ECB are clearly helping to manage down the cost of rolling existing debt within the system, as is the case for much of the Eurozone today.

The healing of any banking sector after a major real asset bust such as that experienced in 2008-10, is necessarily a slow process. Arguably Spanish banks are through the worst, while an ability and willingness to lend remain intact given supportive interest rates, sector consolidation and tentative signs of growth beginning to appear (driven mainly by exports).

Summing Up

Spanish GDP will likely again be negative in 2013, but much improved from the levels of the 3 years prior. Consensus expectations (for what they're worth) though show that GDP should finally turn positive on a year on year basis the December quarter. Exports are the key driver here when one looks at the numbers, but the underpinning of a more sustained period of growth and prosperity in Spain look to be in place. Further, the driver of this economic performance is a diverse balance, including automotive, food and biotechnology to name a few. The government has also made great strides in dealing with the banking collapse as well a stabilizing their fiscal position. And finally Spain remains a favoured destination for attracting foreign investment with its inexpensive but highly educated workforce. I venture to say that with the release valve of a freely floating currency Spain today would already be well into its recovery but equally it seems inevitable that over the next 2-3 years this will come.

We plan an up-coming visit to Madrid, and hope to feed ideas into later reports… stay tuned.

Barrick Gold Corporation

Nestled within the most hated sector in the market is Canadian gold producer Barrick whose share price has fallen by some 65% over the past 18 months, now offering prospective buyers a 4.1% yield and less than 6x projected 2014 earnings.

One can't help but be drawn to the train wreck that are today's Gold equities. Under the weight of en-masse switching into alternative (pure play) ETF's, and poor returns on capital, Gold equities today feature as the most prominent sector on 52 week low lists. And rightly so… the economics of mining for grams amongst tones has been terrible over the past decade, and with the arrival of liquid ETF's, investors no longer needed to pay premiums to NAV in order to gain exposure to the sector. Other natural resource stocks, pick your commodity, trade at discounts to the present value of the stuff in the ground. So why shouldn't gold… and I agree. And indeed that is now a reality.

In his letter to shareholders in the 2012 Annual Report, Founder and Chairman Peter Munk acknowledges this reality…

Barrick Gold Corporation

Situation: Market Dislocation

Key Data:

Market Cap: $19.5bn

HQ: Toronto, CA

PBR: 0.86x

PE: 5.8x (CY14)

Yield: 4.1%

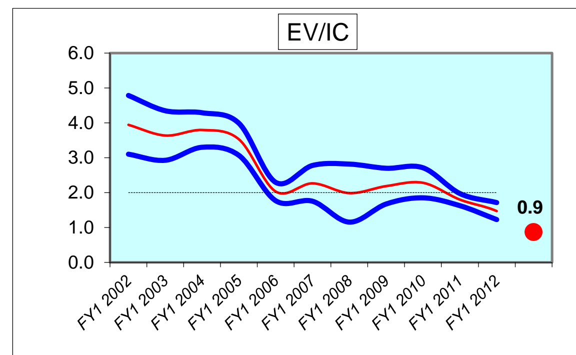
Net Debt/Ebitda 2.0x

Our dismal share performance last year clearly reflected these setbacks, yet there are other new realities in our industry that also played a significant role. In the years leading up to the global financial crisis, rising gold prices and booming equity markets created a mood of euphoria among investors, rewarding gold producers that delivered aggressive production growth, no matter what the cost. The industry as a whole, and Barrick in particular, delivered. In fact, between 1986 and 2006, as Barrick expanded its operations around the world, our shares increased in value by approximately 4,000 percent, or about 20 percent compounded annually. In order to sustain that kind of growth, gold mining companies and others began to make ever-larger, unprecedented capital investments in new projects to deliver more ounces. Many came from lower-grade ore bodies, erroneously justified by expectations of higher gold prices, and yielded ever more expensive ounces, at ever-growing capital costs. These growing capital commitments virtually eliminated free cash flow generation. Yet that was what investors expected to be available to them — in direct proportion to increased gold prices. It didn't happen — and the disappointment of investors was severe.

As a result, investor confidence was roiled and wealth managers began to shun gold shares. At the same time, most investors looking for full participation in the rise of gold prices moved vast sums of money from gold equities, where they perceived risks but little return, to gold ETFs. These — of course — offered full participation in gold price movements, without any operational risks. The numbers tell the story: since the creation of the gold ETFs some eight years ago, their value has reached an incredible $140 billion! Meanwhile, gold mining company multiples have suffered an unprecedented contraction, particularly when measured against the performance of their sole product, gold itself.

Rarely have I witnessed such honest introspection on the failings of a business by a CEO. An indeed the market has dealt them a severe blow as the following EV to Invested Capital Chart shows.

When one considers the move in the gold price between 2002 and the end of Q1, '13, versus the value now accorded the equity of Barrick, it has indeed been a lost decade. The message from Barrick though in our view provides some hope that a new more mature approach to capital management may be upon us, ultimately for the benefit of shareholders. Munk goes on to say…

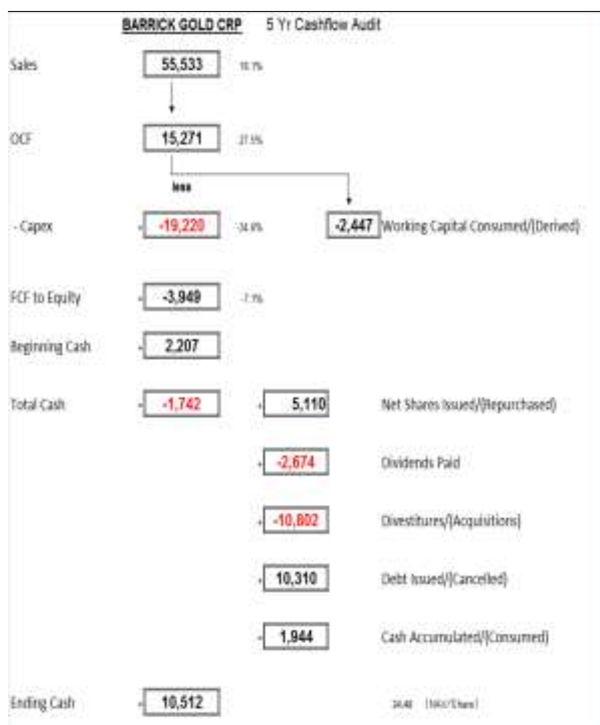


Recognizing the above facts, it is clear that a new approach — indeed a whole paradigm shift — is required so that an investment in Barrick becomes desirable, rewarding and viable — a demonstrably superior alternative to investing in gold itself. This major shift requires a continuation of asset rationalization, the exploring and realizing of available operational and administrative synergies, a rigorous application of capital discipline, and other measures enhancing our ability to increase payouts to our shareholders. These are all clearly options available to Barrick — with its size and scale — and will make our shares a realistic alternative to ETFs.

Accordingly, Barrick is leading the change from a focus on growth, in favor of maximizing free cash flow and growing rates of return: a significant paradigm shift for our industry. In June of last year, following Jamie Sokalsky's appointment as CEO, I was proud that his first message to shareholders was a commitment that has become nearly universally accepted throughout the industry: "Returns will drive production, production will not drive returns." Each and every CEO has phrased it differently, but the end result is the same.

We believe this is the right approach for us and the only one that will deliver results and rekindle shareholder interest in Barrick and the industry at large. Yet we must also realize that repositioning Barrick — a company of considerable size and operational diversity — to deliver against this paradigm cannot happen overnight. Large ships take longer to turn around. I can assure our shareholders that at all levels within Barrick — be it at our Board or at the executive management level — we are united in our commitment to effect the significant change needed and which our investors clearly demand.

Looking over the past five year and one recognizes that this spoken of paradigm shift begins from a low base. The following chart, our cashflow audit, looks at the accumulated performance of the company from 2007 to 2012. It's not pretty.



With aggregate revenues of $55bn, resulting in operating cashflows of $15.2bn, Barrick have gone on to spend $19bn in capex and $10.8bn on acquisitions, in the process adding $10.3bn of additional debt to the balance sheet. Under the weight of this excess, it is no wonder that the EV/IC chart looks as it does.

A reorientation from growing, to harvesting the assets, could be a most favourable development. Surely too, the relaxation of strains in the mining supply chain will aid in driving efficiencies and lower costs through their business. As the market-clearing price for miners, diggers and their ancillary services resets to a more normalized level, (and likely overshoots), it should allow a business of this scale to generate significant savings.

"When sentiment changes the last shall be first, just as the first have been last." – James Grant

In 2012 the company deferred some $4bn of capex on new and existing projects, which in a single stroke reverses the free cashflow consumption of the past 5 years. It speaks to the cash generation potential of the model when a more measured view of the business by management is taken. While earnings estimates at Barrick need to further reset to account for the correction in gold prices, the great unwind in valuation, in our view is complete. And whilst it has become popular to call the end of the bull market in gold, as signs of improved economies enliven equity markets, the reality of the never-before-seen co-ordinated intervention of central banks, with the BoJ taking their cue from the so-far benign outcomes of Federal Reserve, is yet to be determined. Failing to purchase inexpensive protection on these group-think based organizations utterly misreading the outcome of their actions, would simply be imprudent. Barrick Gold is a buy.

Other Thoughts

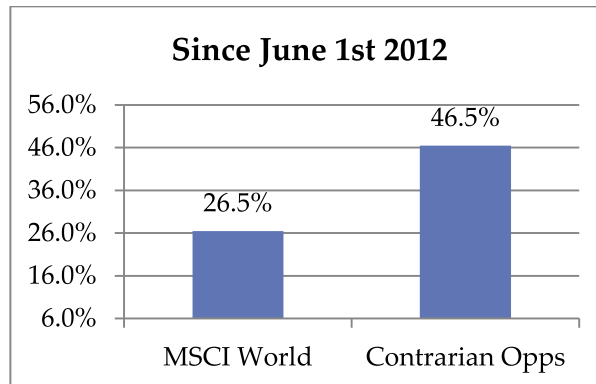
We got an interim management statement from Alent Corporation which featured in an earlier report. Net net, business at Alent is fine. A significant profit warning from competitor AZ Electronics has reset sentiment, but this in our view is an opportunity to build positions. We also had a glimmer of positive news on European auto sales, with the first positive month of registrations in nearly 2 years. This would provide an unexpected boost to the story. This is fundamentally a high-return cash generator that will route excess capital back to shareholders. It also provides inexpensive optionality on improvements in the PC and mobile phone electronics supply chain and exposure to structural changes in micro-chip packaging.

Watching the somewhat under-reported launch of Xbox One this month was something of a revelation. I felt for the first time in more than a decade that this sleepy, slow-moving behemoth in

Seattle had slightly stolen the "coolness" limelight from their southern neighbors. It's been a long time since I purchased a games console, but I may well be tempted this Christmas.

Model Portfolio:

A number of changes have taken place in the model. We exited a postion in Zenkoku a Japanese mortgage finance business as well as a couple of smaller positions. In their place we have added Barrick Gold, Alcatel-Lucent, France Telecom and Deutsche Telekom, and the all recently IPO'd INGA USA, now names Voya.



Name	Country	Sector	Weight	Return
BARRICK GOLD CRP	CA	Materials	4.9%	0.8%
GSW IMMOBILIEN A	DE	Financials	3.2%	-5.0%
DEUTSCHE TELEKOM	DE	Telecoms	4.5%	-3.8%
CAP GEMINI	FR	Information Technology	4.3%	14.2%
ALCATEL-LUCENT	FR	Information Technology	3.9%	10.4%
FRANCE TELECOM	FR	Telecoms	3.9%	4.5%
ALENT PLC	GB	Materials	4.2%	18.6%
ENI SPA	IT	Energy	3.0%	19.0%
FIAT INDUSTRIAL	IT	Industrials	2.8%	11.2%
JAPAN TOBACCO	JP	Consumer Staples	3.1%	15.3%
CENTRAL JAPAN RL	JP	Industrials	4.8%	17.4%
GANNETT CO	US	Consumer Discretionary	4.2%	67.7%
GENERAL MOTORS C	US	Consumer Discretionary	4.0%	59.5%
DIRECTV	US	Consumer Discretionary	3.9%	2.5%
SAFEWAY INC	US	Consumer Staples	3.1%	41.9%
ING US INC	US	Financials	5.4%	33.3%
WR BERKLEY CORP	US	Financials	2.7%	6.5%
LEUCADIA NATL	US	Financials	8.0%	21.7%
ESTERLINE TECH	US	Industrials	4.7%	26.5%
HYSTER-YALE	US	Industrials	4.6%	45.8%
CSX CORP	US	Industrials	2.7%	11.9%
MICROSOFT CORP	US	Information Technology	7.8%	13.1%
NETAPP INC	US	Information Technology	3.2%	26.7%
COMPUTER SCIENCE	US	Information Technology	3.3%	15.9%
Market Cap (avge)	--			**$22.3bn**
PE Ratio (fwd)	--			**10.7**
Dividend Yield	--			**2.1%**

… and finally, discovering the voice of John Fullbright ("from the ground up") has stolen a moment from us in our otherwise daily fixation with financial markets. Enjoyed with a glass of whisky it makes a fine combination

Capital Account,
Sydney, May 2013