Capital Account

Special Situations and Value-Based Investing Opportunities

Oct 2013

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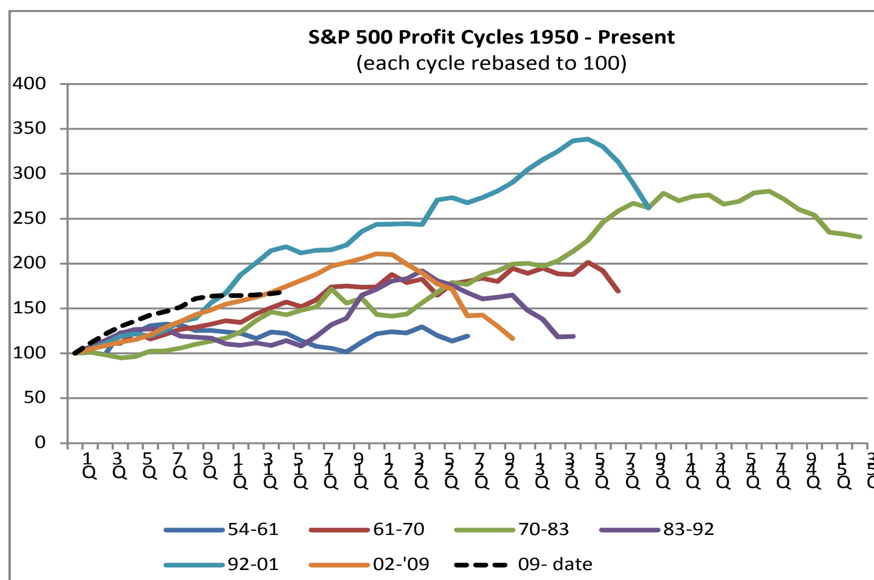
Time to Take Stock

The levitating US equity market, where seemingly all bears have now capitulated, and where buy-siders chase performance into year end, is worth reconsideration. We have looked at the current earnings cycle in the context of the past 60 years and are asking some questions of the marginal buyer.

Introduction

Periodically we revisit the top down picture on the world's most important equity market. Why? With average holding periods of the S&P100 under 6 months, we believe most market participants are probably don't. There are many ways of cutting the top down data, all fraught with potential for statistical error, erroneous extrapolation and mistaken correlation… but we do it anyway. Our perspective is on earnings, and true to the process, the cycle of earnings. The chart below maps from 1950 to June 2013, the quarterly progression of earnings of the S&P 500, rebased to the beginning of each business cycle. It is a way of putting into perspective the current cycle, which we think began in the June quarter of 2009.



US Equity Market

Situation: A country emerging from crisis under the direction of experimental central bank policy and the biggest debt the world has ever known

Key Data:

GDP: $14.1trn

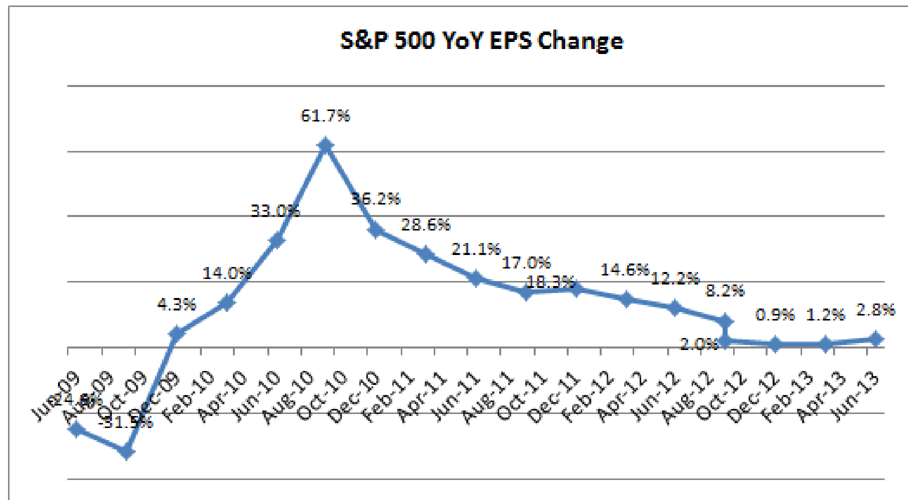
HQ: Wall Street

Population: 325mln

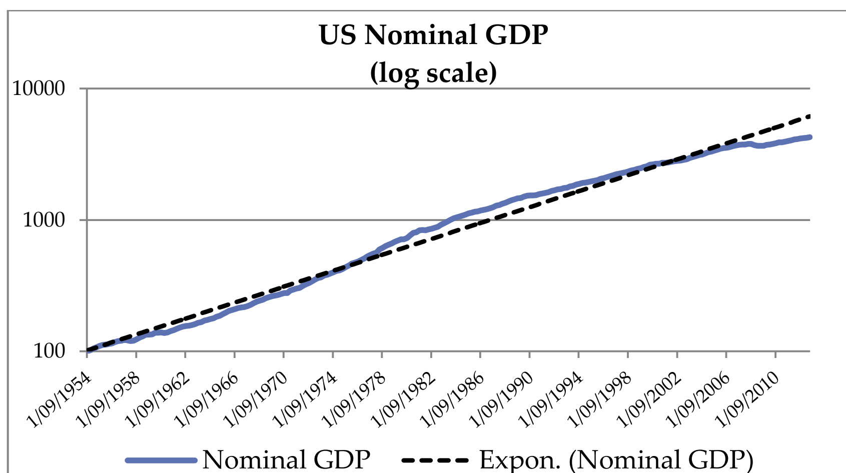
10Yr Yield: 2.68%

Market Cap/GDP: 136%

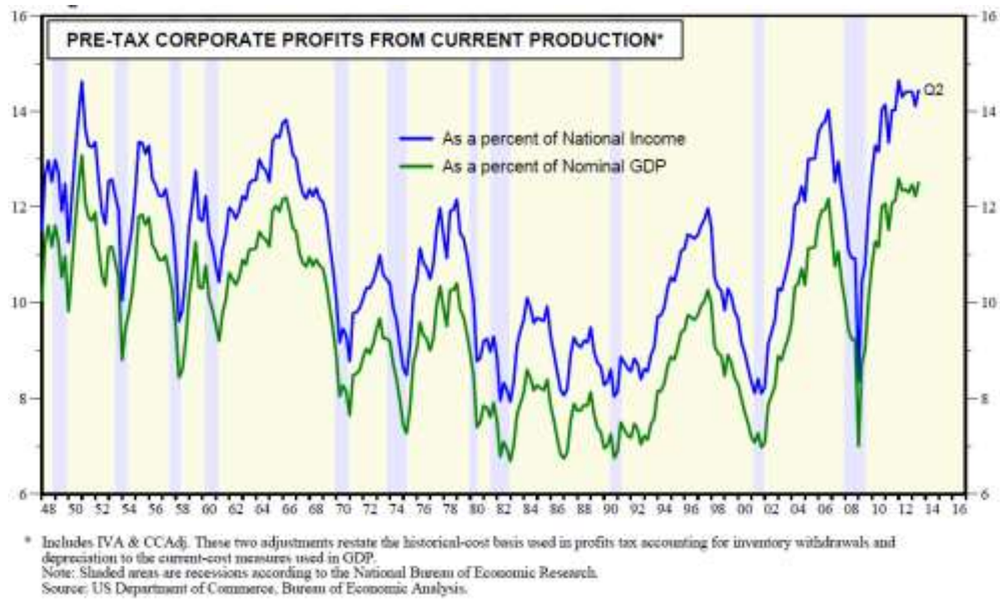
If averages are relevant here (and they're probably not) the current cycle at 14 quarters, is now half over, and has thus far been more than robust based on historical comparison. Only the '92-'01 (also predated by a banking crisis) cycle was steeper in terms of its initial recovery. Another point to note is that mid-cycle corrections or slowdowns are very normal over the life of a cycle. The chart below traces y/y changes in S&P500 EPS since the beginning of the cycle, with the mid cycle phenomenon adjustment phase very evident here.



If you were to strip out the effects of share repurchases from these EPS figures, the year over year progression would be less flattering still. Part of the problem for the marginal buyer today is that the economy is not providing the sponsorship it should be at this juncture. US GDP, has remained below trend since the implosion in 2008/9. The chart below demonstrates this, with a noticeable departure from trend in the very late 2000's. We acknowledge that US GDP and S&P 500 earnings are not as closely linked as they may been historically, with around 20% of earnings coming from offshore, but the domestic economy remains the single largest driver.



In the absence of this economic sponsorship though is the remarkable performance of corporate America, who has extracted its highest share of GDP since WWII, evidenced from the chart below. With profits as a share of GDP significantly above trend, and GDP performance below trend, and presently little to no EPS growth, one wonders of the sustainability of share prices.



Looking at a cyclically adjusted measure of valuation, price to trailing 7 year average EPS, the market is far from a peak. Then again at ratios above 20, one has to be more considered with purchases. Looking at all of the evidence, we have come to view the current market as stretched. While near term momentum appears almost unstoppable, risks are also rising. We continue to find interesting stock ideas in our valuation range, however have instigated a partial hedge in the model this month in recognition of the heighted risk to general equity prices. In effect we remain 95% long but have a 5% (2.5% nominal) position in the S&P ProShares Ultrashort, providing 2x inverse return on the S&P 500.

Other Thoughts

What to do with Microsoft….? Just when the tide appeared to be turning for long suffering investors, with arrival of an activist investor and the surprise announcement of Steve Balmer's retirement, there was once again a sting in the tail. The decision to acquire Nokia's device business for around $7bn wasn't the news we were looking for, and with the prospect of Stephen Elop, who oversaw the latter years of Nokia's handset decline, now firmly in the frame for the CEO role, one could be forgiven for hitting the sell button on the day of the announcement. Tangentially, our position in Alcatel was marked up 10% on that day (on prospects of a tie-up with the slimmed down Nokia) but that is for another discussion.

After a period of reflection we now wonder if Balmer, in his boots 'n all foray into handsets, hasn't inadvertently made the case for a break-up of Microsoft that much more compelling. That case is simply this… Microsoft, post closure of the Nokia deal, will have developed into a sprawling technology conglomerate spanning the spectrum of consumer (game consoles, handsets, tablets, search and display advertising, PC's) and enterprise offerings (server & tools, office productivity, operating systems, email, instant messaging, cloud infrastructure and associated services). In describing Microsoft's portfolio we are in-fact reminded of the failed Japanese technology conglomerates whose businesses spanned many things, few of which were done well. Not only did they fail to establish strong positions in their end markets, when those were relevant, their organizational structure and resource allocation meant the Japanese failed to anticipate and/or respond to fundamental shifts in the technology landscape. Sony should have the invented the iPod, not Apple, giventheir legacy in portable music. Steve Balmer, when asked of any regrets over his reign did confess to wishing that they had been earlier into handsets and mobility, when in the early 2000's they were instead preoccupied with the Vista operating system. The Japanese case in point.

Surely the case can now be made that if Microsoft is to be successful as both a consumer and enterprise facing company, these entities need to be run with separate management teams, organizational goals, cultures and probably brands. Would you today put Apple and IBM together, Oracle and Amazon, or Netflix and SAP? These make as little sense as retaining Microsoft Consumer and Enterprise into the future. A separation of course wouldn't guarantee success, but the prospect of failure appears much higher if the group remains as one. Microsoft's enterprise business today is conceivably worth the current share price. Consider the following data which breaks out their Enterprise business, server & tools and the business division (Office, Sharepoint and Exchange). A business with $50bn in sales generating operating margins in excess of 50%, growing organically at 2-3x GDP over the past 5 years… What multiple might you pay? On 12.5x, you reach $31/share. Only Check

Point Software has comparable margins (yet lower growth), yet trades at 15x forward EPS, which if applied would get you to $37/share.

MSFT Enterprise	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15	CAGR
Sales	33,020	33,826	39,054	42,643	46,054	50,199	54,372	8.7%
y/y growth		2.4%	15.5%	9.2%	8.0%	9.0%	8.3%	
Operating Income	17,477	17,204	20,335	23,119	24,883	27,264	29,423	
opm %	52.9%	50.9%	52.1%	54.2%	54.0%	54.3%	54.1%	
Corporate Expenses	-2,959	-1,134	-1,912	-2,507	-2,000	-2,000	-2,000	
Interest Income	546	445	477	546	546	546	546	
Interest Expense	0	76	148	190	190	190	190	
PreTax Income	15,064	16,440	18,753	20,968	23,239	25,620	27,779	10.7%
Taxes @25%	3,766	4,110	4,688	5,242	5,810	6,405	6,945	
Net Income	11,298	12,330	14,065	15,726	17,430	19,215	20,834	
Shares	8,945	8,813	8,490	8,490	8,490	8,490	8,490	
EPS	$ 1.26	$ 1.40	$ 1.66	$ 1.85	$ 2.05	$ 2.26	$ 2.45	11.7%
				Target PE	12.5	$ 30.67		

One has to be careful to avoid what David Einhorn describes as the evolving thesis dilemma, but with a new CEO in the wings (Mullaly or Hurd would do fine) and a returns-focused activist looming at this critical time, the opportunity for decisive value-creating action has never been greater.

The other notable OTHER in recent weeks has been the formal separation of News Corp's US Cable assets (renamed 21st Century Fox) from their newspaper and Australian digital assets (News Corp). In this newly created News Corp, trading as (NWSA) here is what you get for $7.6bn of enterprise value:

The Wall Street Journal, Barrons, Dow Jones Newswires, Factiva, The New York Post (US), The Times of London (UK), The Sunday Times (UK), The Sun (UK), The Australian, The Daily Telegraph (Oz), The Adelaide Advertiser, The Brisbane Courier Mail, 63% of realestate.com.au, 50% of Foxtel, Fox Sports Australia, Harper Collins + The largest free standing insert business in the United States

By comparison, to buy say

The New York Times, Daily Mail, Valassis Communications, Fairfax Australia, The Washington Post, Gannett + John Wiley

….would cost you $24bn or 7.9x trailing 12 month ebitda.

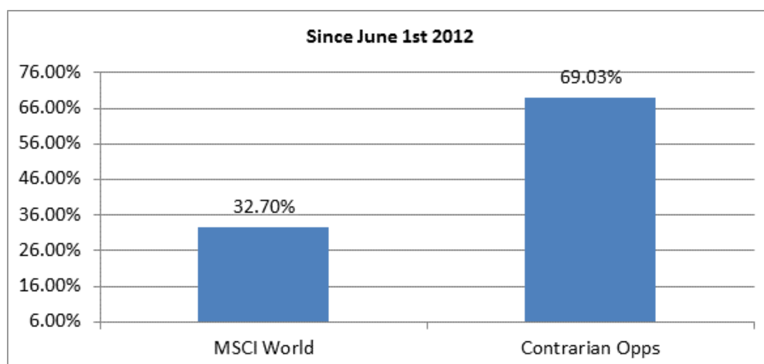
News however trades at only 4.7x their trailing (proportionate) ebitda, which seems a little mean even given the presence of RM and family on the board. By our reckoning the newspaper assets at NWSA can essentially be had for free at this price, which appears to be a bet worth taking given the quality of the brands involved, as well as margin potential that comes with a new CEO and newly defined corporate structure.

Model Portfolio:

It has been some months since the last update, and several changes have taken place. We realized a very handsome return in Alcatel (purchased in May) which was sold in September, our position in Fiat Industrial is now CNH Industrial following the completion

of the FI/CNH merger. We added a position in US Airways immediately following the announced law suite by the DoJ in September, as well as a position Ciments Francais which yields >6% with the likelihood of minorities being consolidated by Italceminti and an ever-so-slightly more positive tone on European macro. In addition we took a position in Deutsche Telekom, which out 18 months was yielding 10%, with the prospects of more benign regulatory conditions, industry consolidation and less-bad macro suggesting little downside to the equity. As referenced above we also took a position in the S&P ProShare Ultrashort, leaving us effectively 95% invested and 5% short the market.

Name	Country	Sector	Weight
VALASSIS COMM	US	Consumer Discretionary	4.2%
NEWS CORP-CL B	US	Consumer Discretionary	4.7%
GENERAL MOTORS C	US	Consumer Discretionary	3.6%
DIRECTV	US	Consumer Discretionary	3.2%
JAPAN TOBACCO	JP	Consumer Staples	2.7%
SAFEWAY INC	US	Consumer Staples	3.7%
MURPHY OIL CORP	US	Energy	3.1%
ING US INC	US	Financials	5.0%
WR BERKLEY CORP	US	Financials	2.5%
LEUCADIA NATL	US	Financials	6.6%
SIEMENS AG-REG	DE	Industrials	4.6%
US AIRWAYS GROUP	US	Industrials	3.2%
CNH INDUSTRIAL N	NL	Industrials	2.5%
CENTRAL JAPAN RL	JP	Industrials	4.8%
ESTERLINE TECH	US	Industrials	4.2%
HYSTER-YALE	US	Industrials	2.9%
CAP GEMINI	FR	Information Technology	4.2%
MICROSOFT CORP	US	Information Technology	6.7%
NETAPP INC	US	Information Technology	3.1%
PRO ULTSHRT S&P	US	Market	2.7%
CIMENTS FRANCAIS	FR	Materials	3.2%
ALENT PLC	GB	Materials	3.4%
DEUTSCHE TELEKOM	DE	Telecommunication Services	4.9%
CASH	0	0	4.2%
Market Cap (avge)			$22.3bn
PE Ratio (fwd)			13.33
Dividend Yield			2.7%



(local currency returns)

Capital Account,
Sydney, October 2013