Capital Account

Special Situations and Value-Based Investing Opportunities

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A Kodak Moment?

It may well be. Having emerged from a an 18 month bankruptcy and significantly reset their business model, Kodak today offers that magic elixir of limited downside versus a potential return which is a multiple of the current share price.

Introduction

It was ugly to watch the slow motion train wreck that was Kodak, but we have at last emerged on the other side of oblivion. This past month Kodak, trading as KODK, IPO'd from chapter 11 with a new organizational structure, vastly improved balance sheet and a plan to return to steady state free cashflow generation. The equity is currently capitalized at around $1bn, with net cash of some $150mln on the balance sheet at the end of the September quarter. The majority of the equity today is owned by creditors who are on a 6 month lock-up following the Oct 29th IPO and have various windows of exit thereafter. The following is a list of key developments through the bankruptcy:

- 23% workforce reduction, cutting 4,000 heads
- exit or divested all loss making businesses
- sale of digital imaging patents for $530mln
- eliminated ~$110mln/year of annual opex
- spun-off personal imaging and document imaging business for proceeds of $325mln in cash to the UK pension plan
- settled claims with US retirees to permanently eliminate $1.2bn liability

> **Eastman Kodak**
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> Situation: A storied American institution in 2013 emerging from bankruptcy
>
> Key Data:
>
> Market Cap: $1,000mln
>
> Net Cash: +150mln
>
> EV/Sales: 0.4x (trailing)
>
> Return Potential: 100%

This process has taken Kodak from a company with annual revenues of $5.1bn and negative and ebitda in 2011, to a revenue run rate today of $2.5bn with expected 2013 ebitda of $170mln. Corporate overhead had gone from $390mln to $170mln over the same period. Shrink to grow strategies always interesting.

What remains today are two divisions, a low-to-no-growth cash generator called Graphics Entertainment and Film (2013 rev $1.6bn, ebitda $325mln) and the higher growth Digital Print & Enterprise business (2013 rev $838mln, ebitda $71mln), which should underwrite overall GDP+ top line growth starting in 2014. We make no claim to expertise in these two end markets, but in their favour the company retain strong positioning with a significant

level of recurring revenues from plates, ink and other consumables across the two divisions. In fact "consumable" revenues within the various segments range from 60 to as much as 90% of revenues. The strategy largely remains that of a traditional printing technology company, grow and upsell the installed base then sit back and collect the high margin consumables. Again with not great claim to expertise, the traditional commercial printing industry is both highly inflexible and has a large environmental footprint. We found this short video quite instructional as to the considerations facing commercial print operations today. Needless to say the trend towards digital and chemical-free printing address these two industry concerns and appears to pave the way for steady growth in replacement demand in what is an otherwise mature industry.

Taken from their lender presentation[1], the following two charts provide a window on management's ambitions for the new Kodak over the coming 4 years.

Kodak's present CFO was appointed by creditors, however we expect a permanent CFO will be named within the next 6 months, and will be able to take what are still bloated working capital requirements, and slim these down now that they are out of bankruptcy. In the 9 months to September '13 Kodak generated around $145mln in operational ebitda versus a loss of $165mln in the year ago period, on 12% lower revenues. Within these figures the more prospective of the two businesses barely contributed to the ebitda suggesting ample fire power to the ebitda progression as this business clicks into gear.

Kodak today trades at 0.4x ev/sales and prospectively at just 2.0x steady state ebitda levels of 2017. That is some way out we concede, but a lot of heavy lifting has already been done. We reckon the business could trade at 1x sales as they provide proof that the mid-term targets at within reach, set against limited loss potential having now dealt will the major issues of the past decade. Management should now be able to focus on the task of executing to their operational plans, shoring up the brand and installed base. Their customers appear to be on a steady path to modernization which should drive unit growth and pull through high margin consumables in future years. Ahead of the broad recognition of these facts in the market, the stock looks interesting.

[1] http://files.shareholder.com/downloads/EK/2811611124x0x687962/59e07752-107e-436b-ac25-eda8e76205ab/Excepts_from__Lender_Presentation2013.pdf

We've been ruminating over the prospects for JC Penney in recent weeks. Bill Ackman came with a plan, but seemingly the wrong man. The magic of Apple, probably not surpisingly, didn'y carry over to the structurally challenged JCP. We wonder though if Ackam and crew in their efforts didn't at least leave behind a template for stabilisation and turn-around which could be embarked upon by a new (old) management team. Last month the CEO purchased $1mln of stock personally, ahead of them announcing a 10% November comp. Pretty exciting, but then again in CEO circles $1mln is actually not that much of a statement, and the company continue to hemorage cash. One might have thought the stock could be had for absolute bargain basement prices given turmoil of the last several years. At 0.65x ev/sales you could say it was somewhat cheap, but we were able to purchases shares in GM last year at 0.19x sales, and Alcatel this year at 0.15x sales. Further we can purchase UK retailer Tesco for 0.56x sales, they too own most of their real estate and offer a 4.5% yield. Shares in Abercrombi & Fitch at 0.65x ev/sales, with the likely impending departure of their 69 year old CEO upon contract expiry on Feb 1st look better value. Yes they're challenged, but not in the same way as a mismanaged department store. Were does this lead… we're not sure either, but it doesn't seem as though there is enough pain reflected in JCP's valuation to make it the free option we'd be looking for.

Time to raise a glass!

Owens Illinois is the world leader in glass packaging for the beer, wine, spirits and food industry. Having fought the bloody battle of industry consolidation at a time of market decline, the stock can be had for levels that it traded at in 1997, a lost decade and then some.

We first met with the company in 2010 in Sydney, again in 2011, and more recently via an arranged conference call. Shares in O-I today can be had for the same they price they changed hands for in 1997. The market though is not stupid, for this fact reflects what has been a quite terrible state of affairs for all participants in the glass packaging industry over the past 15 years. A fragmented market had to absorb the loss of share in important food categories (mayonnaise and ketchup) to plastic and the rising growth of metal containers in the all-important beer market. The capital cycle though destroyed high cost producers and has brought the industry to the point where the key markets are highly consolidated, volumes are once again growing and pricing leverage awaits.

Owens-Illinois

Situation: Industry consolidation survivor, set for structurally higher returns

Key Data:

Market Cap: $5,500mln

Net Debt: +3,600mln

Plus asbestos liabilities and pension obligations

EV/Sales: 1.3x (trailing)

Return Potential: 50%

The glass packaging industry is expected to grow at 3% compound to almost 60mln tonnes by 2019. Growth in alcohol consumption in the developing world as well as recovery in "on-premise" alcohol consumption in North America will be the key factors underwriting demand. French materials company Saint-Gobain are presently seeking to divest their North American glass packaging assets to Ardagh which would result in the top 2 players, O-I and Ardargh, controlling some 92% of the market. This proposed deal is being met with FTC resistance, and will likely see divestitures, but with beer pricing contracts up for renewal in 2014, the packaging companies are well positioned to extract price increases compared with the last round of negotiations in 2009. Saint-Gobain may also seek to divest their glass packaging business in Europe further consolidating this region. O-I's European margins are the lowest in the group, however with their restructuring actions, improved industry volumes and potential for further consolidation, prospects for higher margins here look strong.

O-I's historic financial profile is not a pretty picture. The business has oscillated between profit and loss, has failed to consistently earn its cost of capital and has grown indebted. The company today have $3.2bn in net debt, set against expected 2013 cash operating income of $1.3bn. All that said, the economics of their business is much improved, rapid deleveraging should follow, as will a high-20's ROE, and reported operating margins should be north of 14% by 2015. The deleveraging will allow more of this operating performance to flow through to equity holders, and result in compound EPS growth of almost 50% over our forecast period. The last time O-I generated an operating margin of 14%, the shares traded at approximately twice the current price. Our expectations are more modest, but we think they're entitled to a multiple of 13x normalised earnings. Our belief is the market will come to see the business in a different light as more concrete evidence of pricing leverage, margin stability and free cash flow generation materialize… after which the stock should rise 50%.

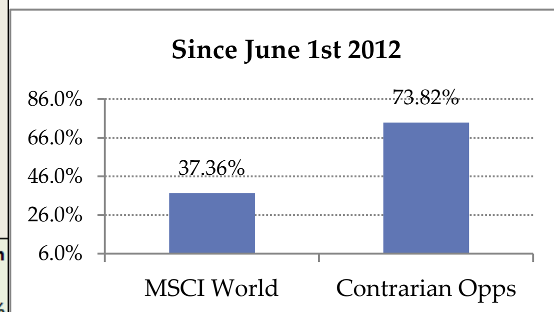
Other Thoughts

We've re-evaluated the prospects for General Motors, an original position in the model from $21.35 in August 2012. With the US and Canadian government having exited their stakes, the company having repurchased the first tranche of their high cost preferred securities, and making great strides in getting to their target operating model, we still find the equity exceedingly cheap. At $40/share the business is capitalized at $55bn. The company have net cash of $15bn, and should generate around $8bn in free cash flow in 2014. GM's enterprise value is just 30% of their trailing 12 month sales. By comparison, Toyota and BMW trade at around 1.4x enterprise value to sales. With the remainder of GM's preference shares callable at the end of 2014, no government influence, and enormous latent balance sheet capacity, we see no reason why the business could not carry a multiple closer to 1x sales over time. Yes Europe remains problematic, but the company have made great progress in lowering break-even production volume, and are in the sweet spot of their product launch cycle in the rapidly improving US market. GM's management are a new breed of financially focused

value extractors. We applaud their actions to date and barring a change in market environment, see no reason why the company will not put this excess balance capacity to work in a fiscally judicious manner. Our blue-sky scenario for GM would see the stock at $100 possibly as early Dec '14, 4x our purchase price.

Our cautious, neh bearish, stance back in September has proven unfounded. The market continues to march higher, and ownership of the position in SDS (Inverse S&P 500 ETF) has offset gains elsewhere in the model. The result has been market-only returns for the past few months. The one saving grace about this short is that it grows smaller the more you are wrong, unlike an actual short position in a stock… we wonder how that works for the good folk at Pro-Shares. I'm sure they have it sorted.

Name	Country	Sector	Weight
VALASSIS COMM	US	Consumer Discretionary	3.8%
NEWS CORP-CL B	US	Consumer Discretionary	4.6%
GENERAL MOTORS C	US	Consumer Discretionary	4.1%
DIRECTV	US	Consumer Discretionary	3.5%
JAPAN TOBACCO	JP	Consumer Staples	2.6%
SAFEWAY INC	US	Consumer Staples	3.6%
MURPHY OIL CORP	US	Energy	3.2%
ING US INC	US	Financials	5.7%
WR BERKLEY CORP	US	Financials	2.4%
LEUCADIA NATL	US	Financials	6.4%
SIEMENS AG-REG	DE	Industrials	4.7%
US AIRWAYS GROUP	US	Industrials	3.4%
CNH INDUSTRIAL N	NL	Industrials	2.0%
CENTRAL JAPAN RL	JP	Industrials	4.3%
ESTERLINE TECH	US	Industrials	4.8%
HYSTER-YALE	US	Industrials	2.4%
CSX CORP	US	Industrials	2.5%
CAP GEMINI	FR	Information Technology	4.4%
MICROSOFT CORP	US	Information Technology	7.3%
NETAPP INC	US	Information Technology	3.0%
COMPUTER SCIENCE	US	Information Technology	3.4%
PRO ULTSHRT S&P	US	Market	2.3%
CIMENTS FRANCAIS	FR	Materials	3.1%
ALENT PLC	GB	Materials	3.5%
DEUTSCHE TELEKOM	DE	Telecommunication Servi	4.9%
CASH			4.1%
Market Cap (avge)			**$22.3bn**
PE Ratio (fwd)			**13.7**
Dividend Yield			**2.5%**



(local currency returns)

Capital Account,
Sydney, December 2013