August 31, 2012

Value Investor INSIGHT

The Leading Authority on Value Investing

INVESTOR INSIGHT

G. Staley Cates
Southeastern Asset Management

"If macro factors are too big a determinant in your appraisal of intrinsic value, you should just sit that out."

Your latest quarterly letter describes a "safety bubble" that began inflating in 2008. Describe what you mean by that.

Staley Cates: We're seeing an almost desperate attempt on the part of investors to avoid volatility. U.S. or German bonds yielding 2% are seen as preferable to average corporate earnings yields on stocks of 6-9%. Stocks with high dividend yields and stable earnings have been pushed to or through fair values, while those of competitively entrenched businesses with high returns on capital but more cyclical earnings and/or some debt have been abandoned. The last time we've felt this out of sync as value investors was in the late 1990s.

Given all the things to worry about today, couldn't waiting it out to a certain extent be a legitimate response?

SG: We've rejected that for a couple reasons. One is that we're basically taking the posture of granting all the negatives. That Europe is going to be a mess for a long time. That the bears are right about China slowing down, which has huge implications for commodities and a variety of China-themed ideas. We're discounting all this in, but we're still finding companies that can thrive and control their destinies regardless, run by skilled managers and with stocks priced with a significant margin of safety.

You could still argue to wait, because you may not get paid on these ideas in the near term. To that we would argue that it's just impossible to know the timing, and to suggest that you can know it strikes us as misguided ego. Something like 90% of your payoff in stocks comes from only 10% of the days you own them, so how can anyone expect to consistently get right when to be in and out on a short-term basis?

I would add that if macro factors are too big a determinant in your appraisal of a company's intrinsic value, you should just sit that out. Given all the issues in Europe, for example, we don't have to bet on European consumer companies whose fortunes are closely tied to how the debt crisis there plays out. In the U.S., we don't have to bet on healthcare stocks whose futures depend on macro healthcare legislation or the financial strength of government entities that pay a lot of the bills. We should just move on to where the micro is driving value.

Immediately post-crisis, you were big buyers of high-quality stocks. Has that theme run its course?

SC: The definition of quality that rules the day is high returns on capital, organic growth and stability. If you buy into that definition of quality, you're going to pay up. Where we're finding opportunity is in companies with high returns on capital and organic growth, yes, but not necessarily the stability that everyone is tripping over themselves to own.

If you do a Porter model on the aggregates businesses like Vulcan Materials [VMC], Martin Marietta Materials [MLM], Texas Industries [TXI], Cemex [CX] and Lafarge [LG:FP] – we own all of them – it's hard to find a better long-term business with pricing power. But in this macro-dominates-everything world, the fear that government finances are so screwed up that road building and other civil works will be impacted forever makes these high-operating-leverage businesses look vulnerable. Our basic view is that this spending is like fixing your roof, it has to happen, and if governments can't pay, a number of privatized options will be pursued. So there's macro fear but a micro response that we believe will end up making these stocks look like a steal at today's prices.

Another area in which we're finding bargains is European-domiciled companies where you're not having to bet on the European consumer. Ferrovial [FER:SM] is based in Spain, but more than 80% of its assets – which include stakes in two of the most-attractive infrastructure properties in the world in London's Heathrow Airport and the ETR-407 toll road in Toronto – are based outside the eurozone. It looks highly-leveraged at first glance, but its debt is 100% non-recourse, held against the concession assets, and they have net cash at the holding company level. We can buy this set of high-quality assets today at a significant discount to our appraisal value and those asset values should continue to grow with increasing transportation demand and built-in pricing allowances.

Describe the thesis for another of your large European holdings, Philips Electronics [PHIA:NA].

SC: Almost any man on the street would tell you that Phillips is a European consumer company, but it's just not. The drivers of value for it today are medical diagnostic and treatment devices, where Philips is one of the three leading companies in the world, and lighting, where it provides everything from consumer lightbulbs to sophisticated commercial and municipal lighting systems. Some 40% of revenues come from emerging markets and, in general, its global brand and distribution footprint is well-established and first-class. How the European debt situation develops and affects European consumer demand is just not a big swing factor in its future.

The returns on capital in both the medical and lighting businesses are high and the growth prospects are excellent. In medical, the drivers are demographics and the fact that Philips is one of the few truly global providers of extremely high-end systems and services, with a trusted and entrenched brand. That's particularly important in such a highly regulated business and one where there aren't a lot of incentives to go with an upstart competitive brand.

The growth in lighting is more driven by new technology, such as corporate or municipal LED installations that offer two- to three-year paybacks and an upgrade in lighting quality. The money-saving and environmentally friendly aspects of the new technology means there's plenty of room for growth even in strapped economic times. This is also a world where established and respected brands like Philips have an advantage – the college redoing its campus-wide lighting systems is likely only going to talk to a Philips, Siemens or GE.

Has Philips' new management, installed just over a year ago, had much of an impact yet?

SC: They've been focused on addressing bloated costs, selling off the television division and setting achievable 2013 targets for each business. They've also instituted a €2 billion stock repurchase program, which is well underway and is expected to run through the second quarter of next year. Given Philips' history of profit misses, the market is skeptical that new management will deliver on its 2013 estimates, but we think they're doing a great job and the market is likely to be surprised.

With Philips Electronics' shares currently trading around €18, how are you looking at valuation?

SC: If we back out the two main businesses, medical currently trades at a high-single-digit multiple of EBITDA and a low-double-digit multiple of operating income, both of which are lower than comps. Comparable stand-alone medical companies currently sell for low-double-digit EBITDA multiples and mid-teens multiples of operating income.

It's more complicated with lighting, which is coming off what we believe are a variety of temporary and one-time factors that have severely impacted margins in recent years. The bottom line is that we think that business is worth 1x revenues when it hits the company's low-double-digit targets for operating margin. That's not three years out, but should happen within a year.

If we use those kinds of multiples on medical and lighting, add in a conservative value for the consumer business that makes things like electric shavers and electric toothbrushes, and adjust for a small amount of net debt, we come to a fair value in the high-€20s per share. On top of that you're getting a more than 4% dividend yield. We just think that's a very attractive margin of safety.

INVESTMENT SNAPSHOT

Philips Electronics
(Netherlands: PHIA:NA)

Business: Diversified conglomerate with product lines focused primarily on lighting, healthcare-equipment and consumer-electronics markets worldwide.

Share Information
(@8/30/12, Exchange Rate: $1 = €0.794):

Price	**€18.08**
52-Week Range	€12.00 – €19.01
Dividend Yield	4.1%
Market Cap	€18.80 billion

Financials (2011):

Revenue	€22.58 billion
EBIT Margin	(-1.2%)
Net Profit Margin	(-3.4%)

Valuation Metrics
(Current Price vs. TTM):

	PHIA	S&P 500
P/E	24.8	16.2

PHIA PRICE HISTORY

THE BOTTOM LINE

The market isn't adequately recognizing either the earnings power or growth prospects of the company's two value-driving businesses, medical equipment and lighting, says Staley Cates. Using peer multiples on each business, after adjusting for temporary or one-time factors, his sum-of-the-parts fair value estimate for the stock is in the high-€20s.

Sources: Company reports, other publicly available information

You've talked in the past about the importance of management having skin in the game. Is that even more important today?

SC: Yes. If the stocks we own are as beaten down as we think they are, we better see management and the board acting on the same premise. At Chesapeake Energy [CHK], where the whole board has been redone, the insider buying has been gigantic. At Dell [DELL], another large position of ours, Michael Dell has been buying a huge number of shares at prices higher than today's.

We're ringing the bell with our clients as well. Yes, the current situation feels bad and yes, our numbers haven't been good, but that's exactly why this is such a good time to invest. We're right there with them adding to our Longleaf ownership. VII

This excerpt, reprinted with permission, is from a feature interview with G. Staley Cates that appeared in the August 31, 2012 issue of *Value Investor Insight*.

Important Disclosure Information

Average annual total returns for each of the Longleaf Partners Funds and their respective benchmarks for the one, five, ten year, and since inception periods ended June 30, 2012 are as follows: Longleaf Partners Fund, -5.65%, -3.47%, 4.62%, 10.66%; S&P 500 Index, 5.45%, 0.22%, 5.33%, 8.74%; Longleaf Partners Small-Cap Fund, 1.28%, 1.83%, 9.42%, 10.54%; Russell 2000 Index, -2.08%, 0.54%, 7.00%, 8.79%; Longleaf Partners International Fund, -22.31%, -7.33%, 3.27%, 7.09%; EAFE Index, -13.83%, -6.10%, 5.14%, 3.11%. Fund returns and those of these unmanaged indices include reinvested dividends and distributions, but do not reflect the deduction of taxes. Past performance information includes periods during which the Funds used currency hedging as an investment strategy. Current performance may be lower or higher than the performance quoted herein. Past performance does not guarantee future results, fund prices fluctuate, and the value of an investment at redemption may be worth more or less than the purchase price. ***Please call 800-445-9469 or visit www.southeasternasset.com for more current performance information or www.southeasternasset.com/mutual_fund_documents/prospectus for a current copy of the Funds' Prospectus and Summary Prospectus, both of which should be read carefully before investing to learn about the investment objectives, risks, charges and expenses of the Longleaf Partners Funds.***

The annualized expense ratio for the Longleaf Partners, Small-Cap, and International Funds are 0.91%, 0.91%, and 1.27% respectively. The risks associated with an investment in the Longleaf Partners Funds are detailed on pages 15 to 17 of the Prospectus. These risks include stock market risk, investment selection risk, corporate ownership risk, non-diversification risk, non-US investment risk, small cap risk (particularly with respect to the Small-Cap Fund), focused geographic risk, and derivatives risk. Funds Distributed by: Rafferty Capital Markets, LLC

Discussion of particular investments is not a recommendation to buy or sell any security. Securities mentioned in this article accounted for the following percentage of net assets of the Longleaf Partners Fund at June 30, 2012: Chesapeake Energy 6.2%, Philips Electronics 5.0%, Vulcan Materials 4.9%, Dell 6.7%, Cemex 5.8%.

Securities mentioned in this article accounted for the following percentage of net assets of the Longleaf Partners International Fund at June 30, 2012: Lafarge 7.3, ACS 7.7%, Ferrovial 6.6%, Philips Electronics 5.9%, Cemex 7.9%.

Securities mentioned in this article accounted for the following percentage of net assets of the Longleaf Partners Small-Cap Fund at June 30, 2012: Texas Industries 8.8%, Martin Marietta Materials 4.7%.