ValueInvestor INSIGHT

The Leading Authority on Value Investing

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In Due Time

Buyers of just about anything want high quality at a discount. C.T. Fitzpatrick has particularly excelled in applying that ethic to buying common stocks.

He has only good things to say about his 17 years working for Mason Hawkins at Southeastern Asset Management, but C.T. Fitzpatrick was ready to go out on his own in 2007. "My real passion is research," he says. "I found myself more distracted from that as Southeastern grew more complex."

Fitzpatrick's ability to focus has served his investors well. Since March 2007 his Vulcan Value Partners small-cap strategy has earned a net annualized 7.2%, vs. 1.3% for the Russell 2000. His large-cap portfolio has beaten the S&P 500 by 530 basis points per year over the same period.

Among the diverse areas in which he's finding overlooked value today: entertainment, grocery stores, consumer goods, software and specialty chemicals. See page 9

INVESTOR INSIGHT

C.T. Fitzpatrick
Vulcan Value Partners

Investment Focus: Seeks companies that compound value despite the macro environment, on those rare occasions when their stocks become bargain-priced.

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PERFORMANCE THROUGH DISCIPLINE

Inside this Issue

FEATURES

Investor Insight: Mario Gabelli
Finding unrecognized value and ways to unlock it in companies such as Legg Mason, Pep Boys, National Fuel Gas and TDS. PAGE 2 »

Investor Insight: C.T. Fitzpatrick
Identifying value "compounders" trading at bargain prices, including Time Warner, Jarden, CME, Tesco and KMG Chemicals. PAGE 9 »

Strategy: GaveKal
How a premier macroeconomic researcher is translating its expertise into investing insight. PAGE 17»

A Fresh Look: Gardner Denver
Deciphering the complications that arise after a highly regarded CEO's unexpected departure. PAGE 21 »

Editors' Letter
On unintended consequences; Defending drunken sailors. PAGE 22 »

INVESTMENT HIGHLIGHTS

INVESTMENT SNAPSHOTS	PAGE
Gardner Denver	21
Jarden	14
KMG Chemicals	15
Legg Mason	5
National Fuel Gas	8
Pep Boys	7
Telephone & Data Systems	6
Tesco	13
Time Warner	12
Williams Partners	18

Other companies in this issue:
Beam, Bolt Technology, Cincinnati Bell, Cheung Kong, CME Group, Diageo, Endurance, General Mills, Hewlett Packard, HSBC, Kellogg, Lamar, MasterCard, Myers, Oracle, Parmalat, Post, Smart Balance, Standard Chartered, Swire, Tupperware, U.S.Cellular

Investor Insight: C.T. Fitzpatrick

Vulcan Value Partners' C.T. Fitzpatrick, Allen Cox, Bruce Donnellan, Mac Dunbar and Hampton McFadden explain why they shun turnarounds, where they're finding a concentrated number of small-cap bargains, why they gave up on an industry that value investors often favor, and why they see upside in Time Warner, Jarden, Tesco and KMG Chemicals.

One might characterize your strategy as quality first, value second. Is that fair?

C.T. Fitzpatrick: We consider ourselves first and foremost value investors, but we don't start by looking for cheap stocks. We spend our time following outstanding businesses that we would want to own should they ever become cheap. They're rarely inexpensive when we start trying to understand them, but we follow them closely so that on the rare occasion they become discounted, we can act right away. Coming at it this way also means we're not wasting our time chasing statistically cheap companies that we will have no interest in owning. Time is precious in this business.

There are certainly quantitative metrics, mostly return-based, that signify business quality. We want to see high marginal returns on invested capital – stripping out the impacts of things like leverage, taxes and intangible assets – and we want those marginal returns to be stable or increasing. We want high operating margins that can expand. We like consistently high levels of free cash flow production and will not invest in a company that doesn't produce free cash flow, period.

But while we can run spreadsheets with the best of them, we really emphasize understanding the qualitative factors that drive the numbers. Market shares. Competitive advantages. The secular and cyclical impacts on the industry. Management's skill in allocating capital. The goal is to identify companies in which we have a great deal of confidence that their values are going to continue to compound as we own them. Companies come on and come off, but there are usually around 500 that we're tracking on a regular basis.

In the 2008 crisis, for example, there was no shortage of financial companies whose share prices were rapidly declining. For most of them we couldn't have cared less because they had very high leverage, no free cash flow, opaque balance sheets – basically, we didn't at all think the value inherent in the business was stable. Contrast that with MasterCard [MA], which we had followed since it went public but the stock had never been close to cheap. It had net cash on the balance sheet and produced a high and recurring free-cash-flow coupon that we expected to continue to grow nicely over time. It didn't have to build plants or finance inventory to grow. That's so much better than a business that can grow nicely but has to reinvest capital to do so; or than one that produces free cash flow but doesn't have any growth. With a company like MasterCard, you can have your cake and eat it too. That's why it's almost never cheap. The crisis made it cheap, but the compounding nature of the business allows us to still own it, even though the stock has more than tripled from the bottom.

Does it usually take a big market correction to unearth values that interest you?

CF: Not necessarily. We recently purchased CME Group [CME], which operates the Chicago Mercantile Exchange, the Chicago Board of Trade, NYMEX, and the COMEX futures exchange. It's the market leader in its key product categories, including futures and options based on interest rates, equity indexes, foreign exchange, energy, and agricultural commodities. Because its market shares are so high, CME provides by far the most liquidity for those trading its products, which gives it in some cases almost impenetrable barriers to entry. As a result, the company earns high and stable margins and generates considerable free cash flow.

With interest rates at record low levels, demand for derivatives to hedge interest-rate exposure is very low and that will lead to CME this year posting its first

C.T. Fitzpatrick

Forging Ahead

In using Vulcan for the name of the money-management firm he founded in 2007, C.T. Fitzpatrick wasn't playing off the home planet of *Star Trek*'s Mr. Spock. The reference is instead to the Roman god of fire, who is often depicted with a blacksmith's hammer and came to symbolize the steel-making heritage of the firm's Birmingham, Alabama home. "Vulcan takes something that has little value and through the sweat of his brow turns it into something of productive value," says Fitzpatrick. "We like that image."

Fitzpatrick learned the nuts and bolts of the investment business over 17 years at Southeastern Asset Management, which he joined out of business school in 1990. Southeastern was reorganizing its research effort at the time and chief investment officer Mason Hawkins was hiring high-potential analysts to train in its value strategy, which emphasizes deep fundamental research, strict valuation discipline and a much longer time horizon than most investors contemplate – all traits Fitzpatrick tries to emulate today at Vulcan. "You have to make the most out of your career opportunities," he says, "but I'm the first to admit this was one of those better-lucky-than-smart cases of being in the right place at the right time."

down earnings year ever. That makes people nervous, which gets reflected in the stock price, but even in a tough environment they're generating substantial free cash flow and launching new products. We don't spend a lot of time worrying about the macro world, but with every central bank pumping liquidity into the system, interest rates will eventually move higher. When that happens, CME is going to do extremely well. In the meantime, we're being paid to wait because the value keeps building through the production of free cash flow.

Hampton McFadden: Tupperware [TUP] would be another recent example where more company-specific issues created an opportunity for us. Its in-home marketing and distribution methods have become fairly outmoded in the U.S., but it now earns 90% of revenues internationally and is growing rapidly in emerging markets. Returns on invested capital are high and it generates considerable free cash flow. The market lately has gotten worried about a potential slowdown in emerging markets and that Tupperware's short-term earnings might be hurt due to foreign-currency exposure. We don't believe either of those over our investment horizon will limit the company's ability to increase value by taking advantage of the roughly tripling in size of the global middle class that should occur in the next decade or so.

What would cause something to fall off your love-to-own list?

CF: A key element of quality is obviously the sustainability of the business and its ability to generate free cash flow into the future. After a lot of internal debate last summer, we concluded that the content-distribution companies that we had owned for a long time – such as DirecTV, Time Warner Cable and Comcast – could be losing their competitive advantages in the digital age. From strictly a valuation point of view we could have justified owning them, but the nature of their advantage had changed enough that we now consider the risk too high.

Do you tend for ideas to gravitate to one end or the other of the cap-size spectrum?

CF: The dynamics we look for in companies to own at the right price tend more often to be in large-caps than small-caps. We agree with all the arguments that small-caps may benefit from persistent market imperfections that can lead to them being mispriced – which is one reason we like them – but the fact is that large-caps meeting our criteria get mispriced from time to time as well. Maybe the inefficiency has a different trigger, but whatever the reason, we're glad it exists.

ON TURNAROUNDS:

We're better off investing in a good business that constantly compounds value from the beginning of our ownership.

Do turnarounds ever interest you?

CF: We actually don't do turnarounds. What attracts us to the whole concept of value investing is the idea of having a margin of safety, in terms of value over price. That margin of safety only exists if values are stable and it only improves if value increases. With turnarounds, you're making a bet – maybe a very intelligent one, but still a bet – that something broken can be fixed. Even in the best case, you may be looking at years when value declines or stagnates. Our experience is that we're better off investing in a good business that is constantly compounding value from the beginning of our ownership, without what to us is the unacceptable risk that the turnaround doesn't work. We just don't think we need to take that kind of risk to earn strong returns.

Are there industries you avoid?

CF: There's not an airline in the world we would own. We don't like utilities, whose returns are in the hands of regulators. We don't like commodity-oriented companies that don't control their own destiny. That includes energy companies – we'd be interested in maybe 5% of the companies in the sector.

Such as?

Bruce Donnellan: We don't own it at the moment, but we've had success with and follow very closely a company called Bolt Technology [BOLT]. It makes products used in deepwater exploration, primarily seismic guns that can help map undersea formations to identify the best places to drill. Bolt has a commanding global market share of that business and while they provide a very tiny piece of the E&P process, if their guns break you've got a ship sitting out in deep water that can't operate, so nobody's going to buy somebody else's gun to save $100. When energy or energy services gets out of favor – as during the Deepwater Horizon spill – something like this can become very interesting.

CF: To your earlier question about small-caps, Bolt is a company with only one analyst following it. That can work to our advantage.

Your small-cap portfolio has significant exposure to insurance. Is that a quality business?

CF: We have found a lot of opportunity in the specialty-insurance area in companies that offer things like crop insurance, medical-malpractice insurance and marine insurance. Speaking generically, insurance is among the lowest-quality industries we'd consider owning. If you're chasing short-term earnings growth at the expense of building long-term value, like a majority of insurers, it generally ends badly. But if you have a management that does the opposite, insurance can be a fabulous compounder. Our companies talk about the business the same way we talk about stocks, writing business only when there's a margin of safety. That won't necessarily produce consistent earnings growth, but it can produce consistent value growth.

The specialty companies we own are also very underfollowed. To a certain extent investors appear to have given up on the industry, as if there will never be another hard pricing market. We don't think that's the case.

How about an example?

Mac Dunbar: A good example we own is Endurance Specialty Holdings [ENH]. Half of the book is reinsurance and the other half is anchored by a large crop insurer called ARMtech, which has been consistently profitable and benefits from the way government is involved in reinsuring that business. Over time the company has reserved conservatively and has operated at an excellent combined ratio in the low-90s overall, as management has proven smart in stepping away from certain lines as they become less profitable and directing capital to others as they become more profitable. As C.T. said, that dynamic can generate a lot of value.

Like C.T.'s former firm, Southeastern Asset Management, you try in managing your portfolios to drive the overall price-to-value ratio as low as possible. Describe how you do that in practice, and how attractive the opportunity set today is.

CF: As you say, we want to drive the weighted average price-to-value ratio as low as we possibly can, holding quality constant. If we own two companies of equivalent quality and one trades at a larger discount, we'll reallocate from the more fully valued name to the lesser-valued name. So we may hold MasterCard for a long time, but its weight in our portfolio will likely be all over the map as its price-to-value changes.

What tends to happen is that as the market gets more expensive we take on more, less-discounted names, and when the market is less expensive, we'll have fewer names trading at bigger discounts. At the market peak in 2007, for example, we held about 40 names in our large-cap portfolio and the overall price-to-value got to 82%. The other extreme was March 2009, when our weighted-average price-to-value ratio got down to 40% and we concentrated the portfolio in 18 names. Today we're somewhere in the middle in both large-cap and small-cap, with price-to-values surprisingly consistent in the upper-60s.

Will you go to cash if the discounts aren't adequate?

CF: People we greatly respect think about this differently, but if even in 2007 we could buy a company like Wrigley at 80 cents on the dollar, we think that's a lot more attractive than holding cash. We were getting a substantial free-cash-flow coupon, a strong balance sheet with net cash, and bottom-line earnings growing at double-digit rates. The way we look at things, even at 80 cents on the dollar, we'd expect a rate of return on something like that in the mid-teens annually. And that was available in, across the board, the priciest market I've ever seen.

ON SELLING:

If we think a business is becoming less competitively entrenched, as with content distributors, we sell.

Describe your selling discipline.

CF: We naturally sell down positions as the price-to-value ratio approaches 100%. We recently sold spirits company Diageo [DEO], purely because we thought the margin of safety was gone. As hurtful as it was to sell such an excellent company, we were able to reinvest the proceeds in the same kind of quality but with far higher upside potential. One name we bought, for example, was Oracle [ORCL], which we consider one of the most competitively entrenched technology companies we've ever analyzed. Customer retention rates exceed 90%. The majority of revenue is recurring. Pricing power and margins in software are high. If Oracle never landed a new customer, we estimate that it could grow its value at a mid-single-digit rate just from its existing customer base. Even with all that, we were able to purchase the stock in the second quarter at a much steeper discount than the businesses we sold to pay for it.

We will also sell if we believe a business will be less competitively entrenched going forward than it has been in the past. That was the case with the content distributors we spoke about earlier. They might still be statistically cheap and the financials might still look great, but we'll sell if the competitive position is eroding.

Another thing that causes us to sell is when our estimate of value declines. If we're basing our value on a certain set of assumptions and the company doesn't deliver on those – it doesn't grow as we expect, margins decline unexpectedly, or management makes bad capital-allocation decisions that destroy value – we stop everything and reevaluate the business. If the problem is exogenous to the company, we'll probably hang in there. If it's self-inflicted, we have to be humble enough to admit our mistake and move on.

Would Hewlett-Packard be a good example of the latter?

CF: Management transitions are always tough to analyze and they introduce a lot of risk. We were caught off guard when Mark Hurd was replaced as H-P's CEO, but as best we could determine we thought his replacement, Leo Apotheker, would probably be OK. The stock was down after Hurd left and we decided it was really cheap, so we kept our position. Then came the disastrous conference call, where they announced they were going to quit making PCs, or maybe not. They were going to give up on tablets, or maybe not. Then they announced paying $10 billion for software company Autonomy, which we concluded was really worth about $2 billion. And to pay for that, they were going to quit buying their stock, which was trading for 5x earnings at the time. After we picked ourselves up off the floor and

reassessed fair value, we decided this was just a mistake. We got out in the low-$20s last summer, which turned out to be a really good decision. [*Note*: H-P stock currently trades at around $17.]

Is it still on your potential-buy list?

CF: It is, but with a pretty fat asterisk. We'd have to see a lot of positive changes, which haven't occurred, for us to get interested again.

You mentioned losing confidence in content distributors like DirecTV. What interests you in a content creator like Time Warner [TWX]?

CF: This is another company I feel like I've followed forever, with strong assets in good businesses, but for much of the time just really poor management. Things got so bad in the aftermath of the AOL merger that some better managers started to emerge, the most prominent of which was Jeffrey Bewkes, who had strongly opposed the merger and became CEO at the beginning of 2008. We were still far from investing in the company, but we started to pay more careful attention.

Actions speak louder than words and he was doing the right things. He spun off Time Warner Cable, a very shareholder-friendly thing to do. He got rid of AOL. He reconfigured the board, with people we thought very highly of taking the place of people we didn't think highly of. He started buying back a lot of stock when it was cheap. He spoke intelligently about the movement to digital distribution of content and how Time Warner would benefit. With confidence in management, when the bout of market volatility hit in the summer a year ago we had the opportunity to buy.

Through its cable networks like HBO and CNN, its Warner Brothers film and TV studio, and its magazines like *People* and *Sports Illustrated*, the company is now essentially a pure play on the creation and ownership of entertainment and media content. We think that a very good place to be going forward.

Elaborate on that.

CF: We don't claim to have unique knowledge on how content distribution is going to shake out, but we do believe the leading sources of content will control their own destiny as there are more bidders for their wares and more windows through which to sell. The fact that companies like Netflix are hungry for content is great news for monetizing Warner Brothers' film library. It helps drive up the value of the new series' created by HBO. If the supply of top-quality content is limited and more and more people want to get their hands on it, we like that position. You do have to embrace the new world and tailor your business models to capture it, but we think Time Warner under Jeff Bewkes is doing that.

Is there even a sliver of hope for the magazine business?

CF: We expect it to continue to shrink and honestly aren't attributing a lot of value to it. That said, it's possible that new devices like the iPad and Kindle Fire could create a new, more-profitable delivery mechanism that would breathe some life into the

INVESTMENT SNAPSHOT

Time Warner
(NYSE: TWX)

Business: Global provider of media and entertainment, with three operating divisions focused on cable-TV networks, publishing, and movie and television production.

Share Information
(@9/27/12):

Price	**45.38**
52-Week Range	28.43 - 46.56
Dividend Yield	2.3%
Market Cap	$43.06 billion

Financials (TTM):

Revenue	$28.98 billion
Operating Profit Margin	20.8%
Net Profit Margin	9.0%

Valuation Metrics
(@9/27/12):

	TWX	S&P 500
Trailing P/E	17.6	16.9
Forward P/E Est.	12.4	14.1

Largest Institutional Owners
(@6/30/12):

Company	% Owned
Dodge & Cox	5.5%
JPMorgan Chase	5.3%
Vanguard Group	4.2%
Capital Research Global	4.0%
Capital World Inv	3.5%

Short Interest (as of 9/14/12):

Shares Short/Float	3.2%

THE BOTTOM LINE
As the distribution of entertainment and media content continues to evolve, the company should benefit as the value of its high-quality content appreciates, says. C.T. Fitzpatrick. From today's price, his expected annual return on the stock – a combination of the 9.5% free-cash-flow yield and 10% estimated annual earnings growth – is pushing 20%.

Sources: Company reports, other publicly available information

business. That could surprise us, but we're not counting on it.

At a recent $45.40, how inexpensive do you consider the shares?

HM: The stock trades at less than 12x our $3.85 estimate of next year's EPS. Estimated free cash flow per share is higher, at $4.30, putting the free-cash-flow yield at 9.5%.

Driven in large part by increasing affiliate fees for networks like HBO, CNN and TBS and from increasing rights fees for content, we believe earnings per share can grow by 10% per year over our five-year time horizon. Add that to the free cash flow yield and that gives us an expected annual return from today's share price pushing 20%.

CF: We just don't think the market is correctly differentiating between companies that own their content and those that don't. Not to pick on anybody, but a company like AMC Networks [AMCX] has a much weaker hand than Time Warner's, but a much higher valuation. That doesn't make sense.

What do you think the market is missing in U.K. grocery giant Tesco [TSCO:LN]?

CF: Even Wal-Mart does not have the same kind of market power in general merchandise in the U.S. that Tesco has in groceries in the U.K., where it controls roughly 30% of the market. The company was for a long time run by a legendary CEO, Sir Terry Leahy, who did a fabulous job over his career but probably stayed a year or two longer than he should have. Wanting to go out on a high note, he squeezed costs so hard near the end of his tenure that stores weren't adequately stocked or maintained and overall service levels fell off. For the first time ever, same store sales started to weaken. When you combine that with the U.K. economy going south in the crisis and only slowly recovering, you have a problem. The company last January issued its first profit warning in 20 years.

So the biggest part of the story is the effort underway to right the ship in the U.K. under new CEO Philip Clarke. It's really all about blocking and tackling. They're hiring 20,000 new employees to address service issues, improve distribution, improve inventory management and better maintain the stores. They're investing in remodeling and refurbishing dated stores. It's early days, but the initial results are encouraging.

For all its U.K. troubles, Tesco's market share there has been slow to erode. What's behind that?

CF: One enduring strength of the company's franchise – and its most important competitive advantage – is real estate. Due to regulatory barriers and the density of the trade area around most of Tesco's stores, it's very difficult for a competitor to build nearby. That's a tremendous advantage for a company that has a long history of paying up for great locations.

The brand also means a lot in the U.K. Some 30% of the population shops regularly at Tesco and the name is well-regarded and trusted. The company can't rely on that forever, but it does make people slow to switch loyalties.

How important is international growth to your thesis?

Allen Cox: Tesco generates about one-third of its sales and profits outside the U.K., roughly half of which comes from

INVESTMENT SNAPSHOT

Tesco
(London: TSCO:LN)

Business: U.K.-based grocery retailer operating more than 6,000 stores in 14 countries located in Western Europe, Eastern Europe, Asia and the United States.

Share Information
(@9/27/12, Exchange Rate: $1 = £0.616):

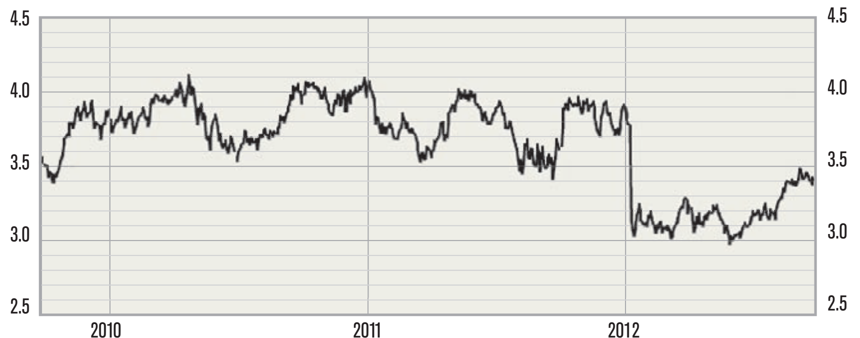
Price	**£3.36**
52-Week Range	£2.94 – £4.13
Dividend Yield	4.9%
Market Cap	£26.98 billion

Financials (FY ending 2/12):

Revenue	£64.54 billion
Operating Profit Margin	6.2%
Net Profit Margin	4.6%

Valuation Metrics
(Current Price vs. TTM):

	TSCO	S&P 500
P/E	9.1	16.9



THE BOTTOM LINE

As the company's heavy investments to reestablish its market dominance in the U.K. and to expand already-strong footholds in emerging markets in eastern Europe and Asia bear fruit, says Allen Cox, he's looking for a 20% annual return on the stock from today's price – a combination of high-single-digit EPS growth and a 12% free-cash-flow yield.

Sources: Company reports, other publicly available information

emerging markets in eastern Europe and the other half from Asia, primarily South Korea, Thailand and Malaysia. What they've done over time is raise capital through sales/leaseback transactions on their mature properties in the U.K. and then reinvest that capital in overseas expansion, taking advantage of their well-honed competency in site selection and development.

A mature store portfolio for Tesco has returns on capital approaching 20%, but the corporate average now is in the low teens because of all the new store development activity internationally. As these new stores mature, we expect earnings to compound nicely as overall consolidated returns on capital increase.

The stock, now around £3.40, has recovered only modestly since falling more than 20% after the January profit warning. What upside do you see from here?

AC: The shares trade at less than 10x next twelve months' estimated EPS of 37 pence. By our estimate, free cash flow is a bit higher than EPS, resulting in a free-cash-flow yield close to 12%. We also expect EPS to grow at a high single digit rate, from volume growth, price growth and operating leverage. That puts our annual expected return in the 20% range.

CF: We spoke earlier about company-specific reasons something can get cheap. This is an example of self-inflicted wounds from trying to grow short-term EPS too fast. When that happens at a company like this with an enduring and long-term business franchise, we try to be ready to take advantage.

From groceries to glass jars, describe your investment case for Jarden [JAH].

BD: This is a company that started in 2001 – with the purchase of the maker of Ball canning jars – to assemble through acquisition middle-of-the-road, high-market-share consumer brands that it could revitalize. It now owns more than 100 brands, from Coleman stoves and Abu Garcia fishing equipment, to Rawlings baseballs and K2 skis, to Mr. Coffee coffeemakers and Sunbeam mixers. For the first eight or nine years it was all about making acquisitions, but management announced a couple years ago that that was over. They said they were going to invest in and manage what the company had, while increasing margins 50 basis points per year. The Street was skeptical but we had confidence in the plan, which so far is right on track.

CF: While it can look like they own a hodgepodge of brands, management has been quite smart about assembling categories of products for which it can leverage existing distribution channels or rationalize manufacturing facilities. They're not just mindless cost cutters either, and are willing and able to invest in product development and marketing when they see potential.

One other thing we like in today's environment is that these are not luxury brands. If you're going to take a family vacation, maybe you skip the expensive resort and go camping in a national park, where you're going to want a trusted lantern like one from Coleman. In general,

INVESTMENT SNAPSHOT

Jarden
(NYSE: JAH)

Business: Manufacture and sale of a broad range of consumer products, including appliances, kitchenware, outdoor gear and sporting equipment.

Share Information
(@9/27/12):

Price	**52.43**
52-Week Range	26.52 - 54.26
Dividend Yield	0.7%
Market Cap	$4.19 billion

Financials (TTM):

Revenue	$6.69 billion
Operating Profit Margin	9.6%
Net Profit Margin	3.4%

Valuation Metrics
(@9/27/12):

	JAH	S&P 500
Trailing P/E	19.2	16.9
Forward P/E Est.	11.2	14.1

Largest Institutional Owners
(@9/27/12):

Company	% Owned
Fidelity Mgmt & Research	6.5%
TIAA-CREF Inv Mgmt	6.2%
Horizon Kinetics	5.9%
JPMorgan Chase	5.9%
Vanguard Group	5.1%

Short Interest (as of 9/14/12):

Shares Short/Float	5.9%

THE BOTTOM LINE

Having put the brakes on acquisitions and focused on optimizing the brands it owns, the company should benefit from steady organic growth and improving margins, says Bruce Donnellan. Bottom-line growth of 7-8% per year plus a free-cash-flow yield of just over 7% would translate into a 15% or so annual return on the stock from today, he says.

Sources: Company reports, other publicly available information

Jarden's brands are well positioned in a tough economy.

With the stock up more than 80% in the past year, the market appears to have bought in. How are you looking at valuation with the shares at $52.40?

BD: We have benefited from seeing the opportunity here earlier than most, but we still believe there's plenty of upside from here. The forward P/E is 11.4x on our 2013 estimated earnings of around $4.60. Estimated free cash flow per share is $3.75, so the free-cash-flow yield is just over 7%.

On top of that free-cash-flow yield we expect the business value to grow another 7-8% per year, from organic growth in the U.S. and internationally and continued margin expansion. Assuming valuation stays constant, that gives us an expected return from today's price of around 15% per year.

Is the balance sheet a potential issue?

BD: This is one of the more leveraged companies we own, but debt is still reasonable relative to EBITDA. Net debt to estimated forward EBITDA is around 3.4x. Management's goal is to get that down to 3x, which we expect them to do in relatively short order.

CF: One reason debt is high is that earlier this year the company did a massive tender offer for more than 15% of its stock. At the time we thought they were buying 50-cent dollars, making the buyback highly accretive for shareholders. Given the stability of the business in a tough economy, we think that was money well spent.

Turning to a small-cap idea, how does KMG Chemicals [KMG] fit your criteria?

CF: We generally aren't big fans of chemicals businesses, which tend to be more commodity oriented. What we like about KMG is its focus on gaining commanding market shares of small niche products where the emphasis isn't all on price.

One area in which they're dominant is chemicals such as creosote and pentachlorophenol that are used to protect railway ties and utility poles. This isn't a growth business, but because KMG is about the only game in town, they have the ability to recover cost increases with price. With little need to spend on capex, these products throw off excellent free cash flow.

The company has more recently gotten into a very small niche in the electronic chemicals business. It supplies acids, solvents and other chemicals that semiconductor manufacturers use in the production process. The smallest imperfection can ruin a batch of products, so manufacturers are not overly focused on the relatively minuscule price of super-pure products that help prevent that. KMG doesn't yet have the market share it ultimately hopes to have here, but it's one of the top three players in a rational and consolidating industry. We think they have a good chance of being the last one standing.

Are these businesses more cyclical than you usually prefer?

CF: The wood-treatment business I'd call more lumpy than cyclical. Railroads may

INVESTMENT SNAPSHOT

KMG Chemicals
(NYSE: KMG)

Business: Manufacturer and distributor of specialty chemicals sold primarily for use in semiconductor manufacturing and for treating railroad ties and utility poles.

Share Information (@9/27/12):

Price	**18.40**
52-Week Range	11.98 - 19.72
Dividend Yield	0.7%
Market Cap	$209.6 million

Financials (TTM):

Revenue	$286.8 million
Operating Profit Margin	7.6%
Net Profit Margin	3.9%

Valuation Metrics (@9/27/12):

	KMG	Russell 2000
Trailing P/E	19.0	33.0
Forward P/E Est.	11.9	16.0

Largest Institutional Owners (@6/30/12):

Company	% Owned
Killen Group	6.2%
AWM Inv Co	6.0%
T. Rowe Price	5.6%
Trigran Inv	5.1%
Rutabaga Capital	3.6%

Short Interest (as of 9/14/12):

Shares Short/Float	3.0%

THE BOTTOM LINE

The market appears to be undervaluing the stability and cash-generating capability of the company's wood-treatment business as well as the growth potential of its electronic-chemicals line, says C.T. Fitzpatrick. Through a combination of earnings growth and a 9% free-cash-flow yield, he expects an annualized return on the stock in the mid-teens.

Sources: Company reports, other publicly available information

spend more or less on upkeep and repair in a given year. Same for municipalities and utilities when it comes to utility poles. But the overall trend line in this business tends to be relatively stable.

The semiconductor-related business is certainly more cyclical, but the growth trajectory for a supplier like KMG is quite positive over time. The company also has been rationalizing the cost base here, which should continue to benefit margins independent of the near-term cycle.

How attractive are the shares, now trading around $18.50?

MD: The free-cash-flow yield, on our $1.65 per share estimate for the fiscal year ending July 2013, is 9%. In terms of value growth, we think overall earnings can grow 5-8% annually, driven primarily by their ability to leverage top-line growth in electronics chemicals into double-digit bottom-line growth in that business. Overall, we think we're looking at a solid mid-teens kind of return from this over our holding period.

We haven't accounted for this, but the compounding could be even better if the company is able to make additional acquisitions. Management has said they're actively looking, but will only act when they can find businesses with similar niche and share characteristics.

ON PLAYING DEFENSE:

We try to own business so entrenched that when times are bad they'll just compound value more slowly.

You have expressed pessimism about the macro environment. How is that manifesting itself in your portfolios?

CF: We just see so many things that can go wrong that we're expecting very little help in the near term for our companies from a "normal" economic environment. We're trying to own businesses that are so competitively entrenched that when times are bad they'll just compound value more slowly rather than see value erode. If things on average turn out to be OK over time, which we do believe, those businesses should come out ahead as investments.

One thing surprising us today is how resilient our companies have been. That could be a United Technologies [UTX], which has a tailwind from a lot of pent-up demand in the aerospace industry. It could be a company like Donaldson [DCI], which makes filter equipment used in mining and off-road equipment and whose aftermarket business is growing very nicely. The message from a lot of our companies is that we're doing pretty well considering how bad everything is. That's what you want to hear. VII

Disclosures

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