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Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

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OID MAILBAG: SEQUOIA FUND'S BILL RUANE ET AL. AND GARDNER INVESTMENT'S TOM RUSSO "MARKETS TODAY OFFER MORE RISK THAN RETURN...."

In their latest client letters, Sequoia Fund's Bill Ruane, Bob Goldfarb and Rick Cunniff and Gardner Investments' Tom Russo lament about the unfavorable tradeoff between risk and reward in today's market and propose their solutions. If the perspectives seem similar, it's no doubt in part because Semper Vic General Partner Tom Russo is an alumnus of Sequoia Fund advisor Ruane, Cunniff & Co.

First, we're pleased to bring you the following excerpts from their latest letters to their clients:

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WALLMAN INVESTMENT COUNSEL'S STEVE WALLMAN "IT'S REMARKABLY SIMPLE. ALL GOOD IDEAS ARE. ITS RETURNS ARE HIGH TODAY & HEADED MUCH HIGHER...."

Wallman Investment Counsel's Steve Wallman runs a one-man advisory firm in the Midwest and has studied Warren Buffett's lessons from afar as diligently as anyone we've ever met with only his results rivaling his scholarship.

His only fully discretionary accounts dating back to 1985 are those of himself and his family. On an unleveraged basis, those accounts grew at a compound rate of 26.6% per year

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BRANDES INVESTMENT PARTNERS' CHARLES BRANDES, GLENN CARLSON ET AL "THE FREE MARKET GENIE IS OUT OF THE BOTTLE AND THERE'LL BE NO PUTTING HIM BACK...."

Clients of Brandes Investment Partners and founder Charles Brandes have earned a compound annual return of 19.8% after all fees and expenses for the 16 years ended December 31, 1993 — well above the 15.1% of the S&P 500 and the 14.1% of the MSCI World Index.

Interestingly, since 1980, Brandes' international stock selections have outperformed by an even wider margin — 23.7% vs. 15.2% for the Morgan Stanley EAFE Index. Here

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MARK COOPER "THE CHEAPEST, HIGH QUALITY BUSINESS OUT THERE. AND MOST INVESTORS MISUNDERSTAND IT IN A BIG WAY...."

Mark Cooper is an unconventional attorney/investment counselor operating in a very low key manner out of his home in the Northwest. In your editor's experience, he's displayed a consistent knack of being in the right place at the right time at a *very* right price.

For example, Cooper last appeared in *OID* in our issue of November 25, 1992 pounding the table about Wells Fargo (in the same feature with fellow contributor Bruce Berkowitz) at less than half its current price. Lest you think that Wells

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BRANDES INVESTMENT PARTNERS'
CHARLES BRANDES, GLENN CARLSON ET AL
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are Brandes' annual return figures after all fees and expenses alongside those of the S&P 500 and the MSCI World Index. (All performance figures were provided by Brandes Investment Partners.)

Year	Brandes Inv Ptnrs Total Return	S&P 500 Total Return	MSCI World Index
1978	+ 8.7%	+ 6.6%	+16.5%
1979	+30.3	+18.4	+11.0
1980	+34.3	+32.4	+25.7
1981	+13.6	- 4.9	- 4.8
1982	+29.9	+21.4	+ 9.7
1983	+39.9	+22.5	+21.9
1984	+ 7.1	+ 6.3	+ 4.7
1985	+35.6	+32.2	+40.6
1986	+20.9	+18.5	+41.9
1987	- 2.5	+ 5.2	+16.2
1988	+26.0	+16.8	+23.3
1989	+13.1	+31.5	+16.6
1990	-11.8	- 3.2	-17.0
1991	+37.1	+30.5	+18.3
1992	+12.2	+ 7.7	- 5.2
1993	+37.8	+10.0	+22.5
1978-93	+19.8%	+15.1%	+14.1%

As *OID* subscribers well know, Brandes scours the globe for Tweedy, Browne and Walter Schloss-style values. And whenever we'd turned to him in the past, he never once failed to produce a lineup of attractive bargains that he was ready, willing and able to share with us.

Thus, with stock prices both domestically and in many international markets offering slim pickings in the eyes of more than a few of our contributors, it was only natural that your editor turned in desperation to Brandes. And while we invite you to judge for yourself, we're pleased to tell you that in our eyes he came through in spades.

Your editor had the pleasure of speaking with Brandes, fellow Managing Partner Glenn Carlson and their associate, Bob Gallagher — among others — in an extended series of conversations about current opportunities around the world. The following excerpts were selected from our conversations. We found them nothing less than fascinating and hope that you do as well.

MYOPIA IS INVESTORS' MAIN PROBLEM — EVEN MORE SO ON WALL STREET.

OID: The last time we spoke, I told you that I was nervous and my knees were shaking. And you correctly deduced that I'd been reading Seth Klarman's letters.

Charles Brandes: I remember.

OID: Well, they're still shaking. Should they be?

Brandes: Only if you have myopic risk aversion tendencies.

OID: I beg your pardon.

Brandes: If you're nearsighted. Over the long term, I don't think you have a darned thing to worry about. Things are great and the outlook is very positive. The world is moving haltingly and jerkily toward free enterprise, free trade and privatization. The rapid increase in technology is increasing our ability to produce food and everything else. And over time, that increase will continue to *accelerate*. It's *extremely* positive.

OID: All of the factors John Templeton and Mark Mobius talk about.

Brandes: That's right. We think the same way. However, one of these days we'll have a nice drop. And that's the way markets behave.

But we're actually looking forward to it. It'll be a tremendous opportunity. Again, it's myopic to fear it.

OID: Templeton says it's losing sight of the big picture.

Brandes: Exactly. More and more, I've come to the conclusion that myopia is the *main* problem investors have. Of course, myopia is even more of a problem on Wall Street — because their incomes depend on it.

OID: Ditto for financial commentators in print and electronic media, etc.

Brandes: That's right.

Glenn Carlson: You just have to focus on the long term and keep doing the same things that made you successful in the past — which is to concentrate on equities rather than trying to time short-term swings in the market.

OID: Even in this day of microscopic dividend yields, stratospheric P/E multiples and historically high multiples of price-to-book?

Carlson: This certainly isn't a November 1990-type market where it was awfully easy to find very cheap stocks. I never know what will happen short-term.

However, over a three to five year period — and if you're talking primarily about foreign markets — my basic feeling is that our rates of return will be adequate. They won't be 20% a year anymore in a diversified portfolio. But maybe they'll be more like 10-15%.

OID: How depressing.

Carlson: But those will be damn nice returns.

AS LONG AS YOU'RE PREPARED FOR DECLINES, THEY CAN'T HURT YOU....

OID: You said that those figures referred primarily to foreign markets. Why do you make that distinction?

Carlson: We're buying less and less in the U.S. market as time goes by simply because we can't find stocks that we want to buy.

Brandes: They're high and we can't find much. But they're not as high as they look — either from the standpoint of interest rates or management talent.

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BRANDES INVESTMENT PARTNERS'
CHARLES BRANDES, GLENN CARLSON ET AL
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OID: Management talent?

Brandes: There've been some major changes, I think, of managements and boards that are very positive. And it may show up on the bottom line more than people expect.

So we don't think U.S. stocks are wildly overpriced.

Carlson: And despite the fact that stocks aren't cheap, it's still possible to find good businesses at very reasonable prices. And you don't need to worry about what happens next quarter or next year if your stocks drop 50% — assuming that you paid the right price for the business. If you paid too much for a rosy outlook, the 50% drop can be very correct. But if you're buying right, you'll be fine.

Brandes: Even if you're paying a reasonable price, expect a 50% drop from time to time. We've seen 50% drops in many good companies that we've bought. Freddie Mac went from $100 to $30 — and back to $160 split-adjusted.

OID: But not before you told our subscribers about it — which we greatly appreciate.

Brandes: Our pleasure. And that all happened within a year or two. Most people don't realize how extreme fluctuations in equity prices can be and not have anything whatsoever to do with companies' underlying values. Therefore, you have to ignore them. Many of our clients make the mistake of thinking that the market is right.

Carlson: However, it's those times when fear and negative sentiment prevail that give you the opportunity to achieve above average gains. Market timing doesn't pay.

OID: You're telling me? Unfortunately, it's de rigueur for newsletter editors...

Brandes: With *very* few exceptions, the most successful investors don't do it. I don't recall seeing any market timers on the *Forbes* 400 list. As long as you're prepared for declines and don't sell into them, they can't hurt you.

WE'RE MORE INVESTED IN NON-US STOCKS THAN EVER — BECAUSE THAT'S WHERE WE'RE FINDING VALUE....

OID: How many stocks are you buying for a new client at today's prices?

Carlson: About 18 names. So a new client would be no more than 80% invested right now.

Brandes: It's a continuing struggle. Right now, we have more money than we have names. But that will change. We have lots of potential names.

OID: Of the 18 names that you'd buy for a new client, how many are outside the U.S.?

Carlson: About two-thirds of them.

Brandes: And we're talking about a global account, of course, where we have the option of investing anywhere — including the U.S. However, more of our money today is in international portfolios than anywhere else.

OID: Which probably says something about sentiment right there.

Carlson: High U.S. equity prices are the main reason why we're more invested in non-U.S. stocks than ever before. We continue to raise our exposure to non-U.S. markets because that's where we're finding value.

Brandes: And a 1993 article in *The Economist* suggests that's where the best opportunities *usually* are. Most foreign investors don't think in terms of fundamentals, earning power, earnings yield, price-to-book and the like. The Japanese and the Europeans tend to be top-down investors. So we basic fundamental investors have the advantage because we don't have as much competition.

OID: And, interestingly enough, that seems to be reflected in the performance of your international portfolios — which have actually outperformed your global ones.

Brandes: That's right.

TELEBRAS IS CHEAP TODAY BY ALMOST ANY MEASURE....

OID: Where are you finding bargains most abundant today?

Brandes: Europe, Latin America, Hong Kong and the U.S. — and that's about it.

OID: Could we trouble you to be specific?

Brandes: A good example is Brazil's telephone company, Telecomunicacoes Brasieiras or Telebras.

OID: Telebras is still a bargain!?

Brandes: We think so. Its ADR is $43.50 today. And we've paid up to $45. It's not easy to pay these prices since we started buying it at $8. But it's *extremely* cheap based on today's fundamentals. And its potential is literally *incredible*.

OID: Could you run us through its fundamentals?

Brandes: Telebras trades at less than 5 times cash flow. But cash flow is sort of meaningless because rates are ridiculously priced. When they restructure rates, they'll get much greater international long distance volume and much less local call volume.

And the local call volume is very expensive to service. In fact, they don't make *any* money on it.

OID: So in other words, Telebras is selling at 5 times ultra-depressed cash flow.

Carlson: *Ultra*-depressed.

OID: That's a mighty fine start.
What's Telebras' price-to-book?

Carlson: Telebras' book value is about $55 per share. So Telebras is selling for roughly 80% of book value.

OID: So far, it sounds like a lot to like.

Carlson: And its debt/equity ratio is about 12%.

OID: And its current P/E multiple?

Carlson: Telebras just announced their '93 results. And they came in at $5.25 per ADR — which means they're

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BRANDES INVESTMENT PARTNERS'
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selling at slightly over 8 times trailing earnings. However, their earnings aren't all that meaningful.

OID: That's OK. Neither are ours.

But why aren't their earnings meaningful to you — because the thesis is more important?

Carlson: Several reasons. First, their '93 earnings included some one-time benefits. Second, their earnings are depressed generally.

OID: We can relate.

Carlson: Even with those one-time benefits, Telebras is only earning about a 9% return on equity.

OID: And if they ever managed to earn 12-15% on equity, that would be $7 to $8.80 of earnings — which on current book value which would give them a P/E at today's price of only 5 or 6.

Brandes: That's right. Our thoughts exactly.

TELEBRAS IS PLENTY EXCITING ALREADY.
BUT ITS POTENTIAL IS TRULY ENORMOUS.

Carlson: So Telebras has a paltry single-digit return on equity. But all of those numbers look at the past. They're all terribly distorted by the ridiculous rate structure under which Telebras presently operates.

If it ever gets to operate under a reasonable rate structure, cash flow will explode. And they'll see much higher returns on equity.

OID: How much higher?

Carlson: I can't give you numbers. I don't know what the numbers could be.

OID: That's never stopped us...

Carlson: The numbers could be enormous. But I don't want to jump up and down and say, "You could see $34 a share in earnings!"

OID: Although it'd make for an exciting feature.

Carlson: It's plenty exciting *already*. Based on current earnings and cash flow, Telebras is very cheap. However, its potential is truly enormous. Its earnings and cash flow are depressed for several reasons.

There are fewer than 7 lines per 100 people in Brazil vs. 8-1/2 to 9 lines in Mexico, 11 in Chile and 14 in Argentina.

OID: There are fewer lines per 100 people in Brazil than there are in Mexico?!

Carlson: And Brazil has a population of 150 million — about twice that of Mexico and three-fifths that of the U.S. Looking at Telebras' enormous growth potential, you should be paying a *premium* price per line — because they have the ability to increase their lines dramatically in coming years.

OID: Assuming it can be done profitably, of course.

Carlson: Clearly, it can be done profitably. There are numerous examples elsewhere — including all around Brazil.

Let me give you some more statistics. Telebras has about $800 of annual revenue per line vs. $1,150 for TelMex and $775 for the RBOCs [regional Bell operating companies].

OID: That seems strange. How can revenue per line be less in the U.S. than it is in Mexico?

Carlson: That's because the RBOCs have substantially more lines. So there are *huge, huge* economies of scale working for them. And if you look at revenue per capita...

OID: Including the entire population.

Carlson: That's right. Revenue per capita is $47 in Brazil. In Mexico, it's $86. And in the U.S., it's $426.

And that's supported by other statistics: Revenues per telephone company employee are $80,000 in Brazil. They're $114,000 in Mexico. And they're $186,000 for the RBOCs.

OID: Interesting.

Carlson: I think so. For example, in Brazil, they have 98 employees per 10,000 access lines. In Mexico, it's 100. In the U.S. — for the RBOCs — it's 42.

OID: That explains a lot about the service.

But in other words, people-wise, the Baby Bells are nearly 2-1/2 times as efficient.

Carlson: That's right. Telebras has an underutilized network that's inefficiently run. They should have 15 phones per 100 people in Brazil rather than 7. They should have a much higher rate structure. And if these changes do occur, then it would be an *enormous* bargain.

And if you figure that Telebras *should* enjoy much better economies of scale down the road in Brazil, you should be paying a much *greater* capitalization per line based on that potential. Yet, you can buy it at a *discount* to the RBOCs and a *deep* discount to TelMex on all the fundamental measures — P/E, price to cash flow and price to book.

TELEBRAS DESERVES A PREMIUM PRICE PER LINE.
INSTEAD IT GETS A PRETTY DEEP DISCOUNT.

Carlson: And to give you an idea of just how cheap it is, let me give you some comparative statistics on Telebras' market capitalization per line — which is probably the most meaningful piece of financial information in this case.

OID: Why do you say that?

Carlson: Because lines have value. Politics and rate structures don't distort price per line. A line is a line.

OID: It's certainly hard to argue with you there.

And as I recall, price per line was one of the figures Templeton used to explain why he liked TelMex so much when its stock was a tiny fraction of its current price.

Carlson: That's right. And with a proper rate structure, you'll see reasonable revenues per line.

OID: And, one assumes, reasonable profitability, etc.

Carlson: Exactly. Here are some figures on Telebras. Its market cap is about $1,050 per line. The market caps per line at TelMex and the RBOCs, by comparison, are about $5,000 and $1,800 respectively.

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BRANDES INVESTMENT PARTNERS'
CHARLES BRANDES, GLENN CARLSON ET AL
(cont'd from preceding page)

OID: Wow.

Carlson: But TelMex's lines are obviously much more profitable...

OID: Because their regulation is much more rational?

Carlson: That's right. In addition, TelMex is a little bit more aggressive in terms of booking profits. For example, they recognize installation fees up front, whereas Telebras amortizes them over something like seven years. But the bulk of the difference is based on the rate differential.

Similarly, Telebras' profit margins are around 11%. TelMex's margins and those of the RBOCs, by comparison, are more like 38% and 28%, respectively.

OID: So TelMex's margins are 3-1/2 times higher!?

Carlson: That's right. TelMex probably can't sustain these levels. We certainly don't expect that. But Telebras' margins are *far* too low.

OID: Again, ultra-depressed.

Carlson: Absolutely.

HOWEVER, INVESTING IN TELEBRAS TODAY
DOES REQUIRE SOMETHING OF AN ACT OF FAITH.

OID: So Brazil's telephone service is actually even less developed than Mexico's.

Carlson: Absolutely.

OID: And it sounds like Brazil's economy is as much of a mess as Mexico's ever was.

Carlson: It's as screwed up as Mexico's ever was in the early '80s. That's exactly right.

And we think that Telebras looks a whole lot like TelMex in the early '80s. It doesn't have quite the potential — although it did a couple of years ago when it was trading at less than 1 times earnings per share.

Brandes: Telebras got down to 25% of book value and below 1 times cash flow. But there was a reason why it was so cheap. No foreign investors were allowed into Brazil at the time. So there was no liquidity whatsoever — nobody could buy the damn thing.

OID: And today?

Brandes: Today, anybody can buy Telebras. It's been that way for a while. It's one of a handful of Brazilian stocks that you can buy through ADRs.

OID: Then why is it still so cheap? Are investors primarily concerned about inflation or that Brazil's economy will stay a mess?

Brandes: It's not inflation fears because they're totally indexed in Brazil — including the telephone rates. It's the political situation. To fully privatize Telebras, they have to change the constitution.

And they were trying to do just that. But the politicians have big problems right now. So investors are worried that it might not get done. And the short-termers bailed out of the stock. But we're not short-termers...

OID: We noticed.

Carlson: To some degree, it requires an act of faith to invest in it.

OID: Similar to the act of faith it takes to wait for each issue of* OID*?

Carlson: I didn't say foolhardiness. The faith you have to have with Telebras is that Brazil will follow the lead of Chile, Argentina, Peru, Colombia and Mexico in taking away state control over industries and privatization.

OID: In other words, Clintonomics in reverse.

Carlson: Exactly. And it won't happen overnight, but it will happen. They're moving in that direction — albeit excruciatingly slowly.

OID: But at least they're moving in the right direction — which I sincerely wish could be said about us.

Carlson: That's right. Brazil's populace is finally getting upset enough to really force some changes. And it looks like the economics minister, who's gaining some power, is doing some reasonable things. He recently put in some policies, for example, that in essence pegged their currency to the dollar.

And the populace hasn't wanted to do that in the past because they didn't want to be "colonized" by the Americans. But pegging their currency to the dollar isn't colonization. And it's the only way that they're going to get their inflation under control.

OID: But what does all of that have to do with Telebras?

Carlson: Until this year, Telebras hadn't had a real rate increase for 25 years. Rates have been set on the basis of politics. The populist government has believed that they're serving their constituents by giving them free local phone calls. And Telebras has to pay for it by completely abusing international long distance rates and businesses.

And the results are quite predictable. Getting a telephone installed in Brazil takes four to six months if you're lucky. And it costs you about $2,000. It's *ridiculous.*

OID: They must be doing something wrong. Maybe the Clintons ought to send Vice President Gore down there to show them how to reinvent it.

Carlson: My thoughts exactly. So they need to dramatically cut the cost of installing phones and they need to improve the networks dramatically. In effect, they need to completely restructure Telebras' rates.

And the only way they're going to catch up is if they privatize the damn thing and put in a decent rate structure so that investors will be willing to put money into it. They need to raise local rates and cut long distance rates.

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BRANDES INVESTMENT PARTNERS'
CHARLES BRANDES, GLENN CARLSON ET AL
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THE FAILURE OF "POPULIST" POLICIES IS SO OBVIOUS THAT THE POPULACE MAY DEMAND REFORM....

Carlson: But that's why it's obviously still very cheap — people can't stand Brazil because you have to put up with the government and everything it does in the name of populism. And they've got 30% a month inflation.

OID: And what protects the Telebras shareholder from the extraordinarily high rates of inflation in Brazil?

Carlson: The Brazilian economy is completely indexed to inflation. So if the Brazilian market doesn't move up 5% a day in local currency terms, then it lost money that day.

Virtually *everything* is indexed to inflation. In fact, the whole economy is an inflation machine. The government does well with inflation. The banks do incredibly well with inflation. People with assets do well because they put them in banks that pay interest at rates greater than inflation.

It's only the poorest of the poor who are decimated...

OID: Because their wages aren't adjusted daily.

Carlson: Right. So the whole policy of inflation is just crushing Brazil's poor. You'd think it would hurt the entire Brazilian economy — and it does in the long run. But the elite have obviously learned to live with it. This supposedly populist government though is in essence killing the largest and most vulnerable part of their population by following illogical, irrational and distorted economic policies.

But Brazil has shown some encouraging signs recently. Brazil's finance minister, Fernando Henrique Cardoso, has been doing some things right lately. And maybe someone will have the will to drive good policies through.

When he was first elected, Fernando Collor had the political capital to implement the right policies. But instead he shut down the Brazilian economy for three or four months in order to stem inflation — which was a stupid thing to do.

OID: You think it's stupid to kill the patient in order to bring down his fever?

Carlson: Exactly. He had enormous political capital — until he implemented these destructive policies, stole money and started sleeping with his brother's wife. You've heard about the stuff this president has allegedly done...

OID: With the state troopers and the telephone records and Gennifer Flowers and all those other women...

Carlson: No. In Brazil.

OID: Sorry.

Carlson: Collor had the potential to do the right things and didn't.

OID: Are you sure this is Brazil you're talking about?

Carlson: Honest — although it does sound familiar. And Brazil now has an incredibly weak president in the person of Franco. But they have what seems to be a reasonably strong finance minister. Unfortunately, it seems like Brazil's finance ministers change every three months. And I'm not exaggerating.

OID: In contrast, didn't Mexico have a party that was very firmly entrenched for decades? And didn't that allow them to administer tough medicine where appropriate?

Carlson: That's exactly right. That's what Brazil doesn't have at this point. The power rests in the representatives' hands. And the representatives all seem to want to bring back pork to their constituents and themselves so they can keep their jobs.

OID: I wish that didn't sound so familiar.

But given the fact that virtually all of Brazil's neighbors have privatized and thereby experienced great success, isn't it obvious to the Brazilian electorate that they're on the wrong track? And if not, why not?

Carlson: That's a great question. That's the question that constantly comes up about Brazil. Brazil has always been the country of unfulfilled potential...

OID: And, as the old joke goes, it always will be.

Carlson: That's the conventional wisdom. The question is why they can't realize it.

OID: And the answer is that they continue with policies that have been proven to be failed around the globe.

Carlson: You know it. I know it. And their neighbors know it. But Brazilians seem to pride themselves on being uniquely Brazilian. And that may be primarily good. But when it comes to economics and politics, it's very bad. Brazil has always been the center for South American industry. But now *they're* the laggard. And they don't like it one bit. But they haven't yet been able to gather the political will.

There does seem to be the beginning of an upwelling of support for privatization, etc. that's yielded fruit for their neighbors. In fact, one of the things that makes us willing to jump in is the fact that they have some role models next door in Chile, Argentina and up the road in Mexico.

But there's an entrenched elite group that benefits from current policies. And it looks like they'll only be taken out kicking and screaming. But the failure of their policies is becoming so obvious that they may soon be kicked out, screaming and all, by a populace demanding reform.

BUT TELEBRAS ISN'T FOR THE FAINT OF HEART. THERE ARE CERTAINLY RISKS....

OID: What could make Telebras a mistake?

Carlson: Other than Brazil repeating its unfortunate economic and political history — which I find hard to imagine — I can't think of anything.

OID: Robert Noel and Mark Cooper suggest that telephone service is on the way to being a much more crowded business. Besides traditional land line and cellular providers, cable and, possibly, broadcast cable could be entering the fray — not to mention technologies currently under development and others undreamed of as yet.

Carlson: That could very well be the case.

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OID: In which case, all bets are off about the value of the existing infrastructure. In other words, the future may or may not resemble the past.

Carlson: That's true. Telephone companies' monopoly positions won't last forever. Competition for phone services will come to Latin America. But the governments won't let them come down soon because they need to get their home networks built up to the point where they can compete as a country and where their telephone companies can compete as service providers.

OID: But if someone like Motorola, for example, comes up with a technology to offer worldwide satellite-based service, might a country not have a tremendous incentive to allow them in with what might amount to instant telecommunications infrastructure?

Carlson: That's true. I agree with that. However, remember the Brazilian government's concern with their historical relationship with the powers up North. They're very concerned about being "colonized". And I think they'd consider that to be technological colonization. So I don't think that's a near-term risk — especially for Brazil or Mexico and even Spain.

Of course, you have to be prepared for the volatility. Telebras' stock is very volatile. One week it's $36. Then it's $31. And then it's $50. It's been something else. In fact, *Brazil*'s been something else. It seems like Telebras' stock moves 10% day to day.

And the Brazilian market could decline 50% overnight if they ever decided to stop their privatization programs. So we're playing it cute by waiting for big downdrafts.

But we keep a close eye on what's going on in Brazil because on a fundamental basis again, it's *extremely* cheap and its potential is literally *incredible*. So we're constantly reevaluating it to decide whether we should buy more anyway and just accept the potential downside.

OID: So it's not for the faint of heart.

Carlson: That's right. And anything could happen. There's always technological risk. There's always price risk. There's always regulatory risk. Right now, however, all seem to pale in comparison to the opportunity.

OID: You make a mighty strong case.

TELEFONOS DE CHILE: THE EARLY '90S EQUIVALENT OF AVON PRODUCTS IN THE '70S....

OID: Telefonos de Chile has really gotten hammered lately. What's going on there?

Carlson: That's a really good question. I don't have the answer for you at this point.

The government announced that they were going to change the rate structure slightly. And they're still arguing about whether it will in fact be put in place. I think it will.

The government is saying that Compania de Telefonos de Chile will make up all of the proposed rate change with improvements in productivity — so it's a wash profit-wise. Meanwhile, the company says that it won't.

It looks to me like they're playing poker and that the truth is somewhere in between. A substantial portion of the rate change will probably be made up through productivity improvements. But they won't be made up completely.

The government is saying it was a reasonable change. The company is saying that it was wholly unreasonable. Analysts are generally saying it wasn't all that unreasonable, simply unexpected. I don't think it was any big deal.

OID: Based on the steep drop in the stock price, it was obviously a big deal to some shareholders.

Carlson: Remember that it had gone from $12 to $130 based on enormous expectations.

OID: And, as I recall, Charles told us about it in 1990 — at 5 times earnings.

Carlson: At book value and a 13% yield. But everyone got so excited that it just didn't matter. Telefonos de Chile, in effect, became the '90s equivalent of Avon in the '70s. But it got a little too rich for our blood and we sold it. Needless to say, in hindsight, we sold it too soon.

Now expectations have been shrunk. And investors' extrapolated spreadsheets have to be brought back into line. But even at $90, it's selling at 20 times trailing earnings and nearly 4 times book. So there are *still* huge expectations.

But to put it in perspective, if Telebras was ever to sell at 4 times its current book value, it'd be trading at $220 — or about five times its current price.

LESS THAN HALF THE PRICE OF THE RBOCS WITH MUCH BETTER PROSPECTS TO BOOT.

OID: Any more bargains like Telebras?

Carlson: Something else that we still like a lot is Telefonica de Espana (TEF/NYSE).

OID: Is it a compelling bargain?

Carlson: I think so. It isn't TelMex in 1983. However, you can still buy the ADRs today at about $40 — which is only 3.8 times cash flow and 12 times trailing GAAP earnings. However, the P/E's only that high because they had some write-downs last year. On our 1994 estimate of about $4.25, their current P/E is right around 9-1/2.

OID: And price to book?

Carlson: It's at book value. But including some unquoted assets, it's at more like 90% of book.

OID: It certainly doesn't sound expensive.

Carlson: That's *cheap*. U.S. telephone companies, by comparison, sell at 8 times cash flow and 16 times earnings.

OID: Or roughly twice as high.

Carlson: That's right. And Telefonica de Espana is about to see much higher free cash flow, earnings and dividend yields and a much higher quality balance sheet.

OID: May we ask your cost?

Carlson: We've paid up to $43 for the ADRs.

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OID: How does Telefonica de Espana stack up in terms of capitalization per line?

Carlson: Telefonica de Espana's currently trading at about $850 per line. That isn't ridiculously inexpensive per line, but it's reasonable. Again, TelMex and the RBOCs have market caps of about $5,000 and $1,800, respectively.

But there's still a low level of penetration in Spain. As I recall, there are about 48 lines per 100 people in Europe. In Spain, it's about 37 per 100.

However, it's not exactly correct to compare it that way because Spain is similar to Italy in that children live with their parents. So lines per household can be deceiving. But penetration is still less than it is in Britain, for example, where you don't have much organic growth from new lines.

In Spain, people haven't been willing to use the phone very much or spend much money on the phone because service has been so terrible. And it's absolutely the case that the better the service, the more people use the phone. Probably *twice* the level of calls per line come through phones in the U.S. than come through per line in undeveloped networks like Spain, Italy and Latin America.

So there's the potential for real volume growth in Telefonica de Espana.

OID: Which, given an appropriate regulatory environment, would justify a higher price per line.

Carlson: Exactly.

A VERY IMPORTANT POINT FOR TELEFONICA —
REGULATIONS ARE ABOUT TO IMPROVE BIG TIME.

OID: What's the regulatory environment like in Spain?

Carlson: It's crummy. You're looking at a *terrible* regulatory environment. But you're not looking at something that's going to get worse. It will only get better.

OID: I'll have to remember that line the next time we're looking for credit.

Carlson: Telefonica has to go to Spanish authorities every year to beg, plead and cajole for a rate increase — which is ridiculous. There's no set cap.

That's what was interesting about TelMex. We bought TelMex when it was ridiculously cheap — at about 25% of book value. It moved up to one times book value in 1990. And we thought that was fair value because the regulatory environment was similar to Spain's.

And then the regulatory environment changed completely. Instead of making TelMex beg for rate increases every year, they allowed a CPI minus x-factor rate increase — which meant that they could become as efficient as possible and bring as much to the bottom line as they could because they knew their pricing environment.

Today, Telefonica doesn't know it's pricing environment. And that's the case with Telebras and, to a certain extent, Italy's phone company. But it's going to get better — because there's lots of political pressure on Spanish authorities to change it.

Within the next couple of years you're going to see an inflation minus x-factor regulatory environment. And that's really attractive. In fact, it's *terrific.*

OID: You went through this the last time we spoke. But would you explain to us again why that would be such good news?

Carlson: Because it allows them to make money based on improving efficiency rather than just allowing them a flat return on their capital. U.S. utilities are generally allowed a certain maximum rate of return on equity. So there's absolutely no incentive to improve productivity because it simply means that they get less in the way of rate increases. Becoming more efficient doesn't help either management or shareholders.

In contrast, the "inflation minus x" regulatory scheme offers all the incentive in the world to improve productivity. And productivity improvements flow directly to shareholders. So it motivates utilities to knock themselves out in order to run as tight a ship as possible all the time.

OID: In other words, it offers utilities incentives that more closely resemble those of a regular business rather than a government agency with its unique lack of incentives.

Carlson: That's exactly right. Meanwhile, you're basically buying it at less than half the per line price of U.S. phone companies and less than one half the price on a cash flow basis — despite the fact that cash flow is about to grow very significantly.

OID: What sort of ROE do you think they'll be allowed to earn?

Carlson: Right now, they're sub-10%. But I think you can expect a lot higher ROE down the road. They've gone through a lot of problems. Over the last couple of years, they've had to restructure their pension scheme — which was very expensive for them. That hit their ROE pretty hard. And they've been making huge investments.

But their capital expenditures will decline. And their earnings will increase. So I think you'll see a much nicer ROE.

BANESTO PLACED A PALL OVER SPANISH EQUITIES
AND A RECENT $1 BILLION FAUX PAS HASN'T HELPED.

OID: Why is it so cheap?

Carlson: There are several reasons. Many worry that Telefonica de Espana won't fare well in an open competitive environment. I disagree. I think they'll do fine. And the government's not going to let that happen yet anyway. The European Economic Community recognizes that they need to allow Telefonica to become more competitive. So they've agreed that they don't have to open up just yet.

But when they do, we're convinced that they'll be able to fund capital expenditures, serve their customers better and bring a lot more money to the bottom line.

Second, the Bank of Spain recently took over Banesto — which is one of the three or four largest Spanish banks. Banesto had bad loans that resulted from making big bets and things like that. So they *should* be going out of business. But if the economy had turned around dramatically over the last year, they'd still be around.

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But they're not. So that's put a pall on the price of Spanish equities generally.

OID: You said that there were several reasons?
Carlson: Telefonica de Espana is the majority owner of the phone companies in Chile, Argentina and Puerto Rico. They've made a lot of money and been very successful in these participations.

But they may have started believing their own press because they paid a pretty high price for Peru's phone company. So the market hit 'em for overpaying — which I agree they did.

OID: How much did they overpay?
Carlson: It's not that big a number. They probably overpaid for it by about $1 billion — or about $3 per ADR. It's not going to kill 'em by any stretch of the imagination. But it's a black mark on their record.

OID: And investors fear that they'll make it a habit.
Carlson: Exactly.

OID: Why aren't you worried, too?
Carlson: They've been *extremely* successful in their acquisitions. They're making a bet on the future instead of getting a good price today. However, if the Peruvian phone company's experience is in any way similar to that of the phone companies in Chile and Argentina in terms of growth in lines, revenues, etc., then the price won't look that bad.

THE MOST IMPORTANT MISPERCEPTION —
UNDERESTIMATING TELEFONICA'S CASH FLOW....

Carlson: Telefonica de Espana is also cheap for one more reason.

OID: Are you sure this is a long and not a short?
Carlson: Capital expenditures have been eating up all their cash flow in the past — and the world believes that it's going to continue. Their earnings growth never seems to meet expectations because those expectations have been ridiculously rosy.

They've had to dramatically restructure. Telefonica's made *enormous* capital expenditures for the last 6 or 7 years because their network was so backward. And it's still not in terrific shape, but it's gotten better. Their services now resemble the quality level of the other major European networks. They're not on par with British Telecom, but they're getting close.

OID: What's Telefonica's debt/equity ratio?
Carlson: Because of those capital expenditures, Telefonica's debt/equity ratio is about 130%. They've been far from self-financing for a long time. And the world expects that to continue.

But I've been convinced for the last year or two that they would be self-financing in '93 and that we'd start seeing debt levels getting chopped down. In fact, we met with management last year and they confirmed that they were going to have free cash flow in '93 in a substantial way.

OID: There's the misperception.
Carlson: Absolutely. In fact, they said that they're going to show even *more* free cash flow in '94. And they said that they were going to reduce their debt/equity ratio from 130% to about 45% by 1998.

In fact, what surprised the world about Telefonica in 1993 was cash flow — which is exactly what we expected. And it's going to be bigger this year. Most analysts are showing a nickel or a dime or 50¢ of free cash flow this year.

OID: Would you like to set them straight with a more accurate estimate?
Carlson: No. But we think it's going to be a *lot* more. Their cash flow will be much better than anyone thinks and they'll pay their debt way down. And Telefonica is carrying such an enormous weight of interest expense that as their cash flow expands, it's going to be lifted rapidly and interest expense will be chopped down dramatically.

So ultimately it's going to mean an increased dividend. That's the way the domestic market looks at Telefonica — for its dividends. And I think that's going to happen much more rapidly than the market seems to think it will.

Therefore, they'll have very decent earnings growth, a higher quality balance sheet and a higher dividend. Meanwhile, everybody hates the stock.

STET'S AT 1-3/4 TIMES CASH FLOW.
THAT'S ALL WE NEED TO KNOW....

OID: What else remains compelling?
Carlson: STET — Societa Finanziaria Telefonica, the Italian phone company.

OID: Again?
Carlson: Absolutely. When we spoke about STET in early 1992, it was around 1100 lire — or less than 1 times cash flow. Later that year, it dropped to about 800 lire — at which point investors were willing to give the company away at about only 1/2 times one year's cash flow per share. Obviously, that's ridiculous.

It was "time not to be in Italy". That's all that mattered. So the brokerages sold everything in Italy. And, of course, they sold Italy's bellwether — the phone company. And they didn't give a hoot about the fact that it was trading at a low single-digit P/E multiple, at a discount from book and yielding 7%. It just didn't matter.

OID: And STET's price today?
Carlson: Today, it's trading at about 5,000 lire — which is still only 1-3/4 times cash flow.

OID: That still sounds very cheap.
Carlson: It is. We've been buying it for a long time. The cheapest we bought STET was at $8 a share. Right now, it's trading at about $30. And we're still buying it.

OID: Then we're all ears.
Carlson: In some ways, STET is another emerging

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telephone stock — à la Telebras or Philippine Long Distance. It's a telephone monopoly that's been poorly run. It's been said that the Italian government is owner and manager of the greatest portion of a modern economy in the world.

Previously, the closest contender for that title was Portugal — clearly a socialist state up until very recently. But even Portugal has fewer economic assets tied up by the government than Italy.

That's changing though. And it's going to change rapidly. In fact, you're already starting to see dramatic changes in the Italian economy. They're committed to privatization. And Italy's telephone infrastructure will be one of the first things they privatize.

OID: What's the one-line investment rationale for STET?

Brandes: It's two lines: They're going to be allowed to earn a decent rate of return on their investment because they have such huge investments to make.

Second, I believe that they'll privatize it. And when they privatize it, not only will they get a higher capitalization rate, but they'll get more efficient.

OID: You've got our attention — again.

Carlson: STET is really a holding company for a number of Italian telephone assets. So with STET, you're not only buying the telephone operator — you're also buying their Yellow Pages, telephone equipment manufacturers and a host of other things.

OID: That's all fine and good. But what makes it a compelling bargain?

Carlson: STET is selling for 1-3/4 times cash flow. That's all I need to know.

OID: You obviously don't publish a 64-page newsletter.

Carlson: In 1993, STET was even selling at a discount from cash flow.

OID: So it's roughly doubled?

Carlson: Does that matter? No. It's still very cheap. Even if nothing good happens, it deserves a multiple of *three* times cash flow. However, good things *are* happening. So it probably deserves a multiple of closer to five times cash flow.

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Remember, the RBOCs are selling for *eight* times cash flow.

OID: So STET is selling for less than a quarter of the price of the RBOCs as measured by cash flow!

Carlson: Right. Like I said, that's all you need to know.

IT'S THE SAME OLD STORY —
RATE LIBERALIZATION PLUS PRIVATIZATION.

OID: What else can you tell us about STET's fundamentals?

Carlson: STET has 4.6 billion shares outstanding.

OID: Billion with a "b"?

Carlson: Right. But there are 10 shares per ADR. So there are, in effect, 460 million potential ADR-equivalents. With its ADR at $30, STET's equity capitalization is therefore just under $14 billion.

OID: What's the book?

Brandes: As of year-end 1993, book value was about $23 per ADR. So STET is trading at about 1.3 times book.

OID: For a stock to justify a premium to book value purchase price, shouldn't it earn above average returns?

Carlson: Right. Over the extreme long-term, I don't think a regulated business like this *should* command a huge multiple to book value. However, in the case of TelMex where there's huge growth and huge returns on equity or STET where we expect dramatic improvements in earnings and efficiency, we think that it *certainly* justifies a higher multiple of book value.

Brandes: But we're not buying STET for its book — because the infrastructure that they have on their books is generally antiquated. We're buying it because it's selling for 1-3/4 times cash flow and they're going to privatize it. They're going to liberalize its rates. And they have a lot of room for efficiency improvement and so forth.

It's the same old story over and over again.

OID: And Italy will have to make it a model success investment-wise in order to attract capital?

Brandes: Yeah.

OID: Then why is it so cheap?

Carlson: They've been experiencing huge demands for capital expenditures. And they haven't been self-financing.

OID: We can relate.

Carlson: They've had a number of rights offerings over the past few years, although they should be self-financing this year for the first time.

There is no *free* cash flow — cash flow after deducting capital expenditures — because they're eating up everything right now. But they showed negative free cash flow of about 50¢ a share for 1992. And although we think it'll be flat in '93, we expect them to show actual free cash flow in '94.

OID: Why have they been in that circumstance?

Carlson: Because they've been behind in terms of upgrading their network. And if you've ever used the phones in Italy, you know that to be a fact.

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OID: There's very poor service.

Carlson: It's been *very* poor. Aside from Portugal, they're the worst telephone company in Western Europe. But it's improving. And it will get much better once it's in private hands.

OID: And the standards that exist throughout Europe will benefit them.

Brandes: Exactly. And have individuals signed on to Prodigy? No. Do they have fax machines in their homes? No. But they will. That usage is still to come. It's the same old story — quality improves, technology advances and telephone usage and lines go way up.

ITALY, AS USUAL, IS VERY MUCH OUT OF FAVOR.
HOWEVER, IT MAY BE SOLVING ITS PROBLEMS.

OID: The absence of free cash flow sounds like a negative, but it hardly sounds like it would justify such a bargain basement price. Why else is STET so depressed?

Carlson: Because people don't like Italy. In Europe, there are times when each country is in favor and times when they're not. And that's what drives European institutions' investment decisions.

I truly believe that many of our European competitors don't look at companies' fundamentals.

OID: And you think they do in the U.S.?

Carlson: It's all relative. But in Europe, they go in and out of countries based on short-term expectations. And they're measured by consultants and clients based on an index of European securities. And as long as they beat that index by 25 basis points, they get to keep their jobs.

Everybody I've met over there — everybody — spends all of their time focusing on currency, interest rates and political machinations.

OID: And I gather that most of them don't do it as well as George Soros.

Carlson: You bet. The other thing they look at is momentum. Business fundamentals are tertiary in their minds — if they're in their minds at all.

OID: And right now, Italy is very much out of favor.

Carlson: Very much.

OID: What makes you think it shouldn't be?

Carlson: To a certain extent, it should be. However, not 1-3/4 times cash flow.

OID: In all fairness, however, isn't there a great deal to be out of favor about?

Carlson: Sure. There's the budget deficit.

OID: A monstrous budget deficit.

Carlson: And there's currency risk. I think the lira is expensive — part due to Italy's relatively high interest rates. So there is substantial risk of currency losses.

OID: Agreed.

Carlson: And since we bought STET, the currency has gone dramatically against us. We're still ahead though despite that — because the stock's moved up dramatically since we bought it. But we still have *huge* potential for multiple expansion, revenue expansion and operating margin improvement.

So talk to somebody else about currency risk, not me.

OID: Hasn't there been corruption on a grand scale?

Carlson: Absolutely. And the corruption has, in essence, been a huge tax on society for the last 50 years. However, it looks like they're now making big strides in cleaning it up — which is exciting.

OID: So that Italy's problems are being recognized by investors at the same time they're being solved — which, as I recall, Noel has observed is usually the case.

Carlson: That's exactly right. Italy is making dramatic economic and political changes for the better. And it looks like the political will exists to do it. People are finally fed up. They're willing to risk their lives and put up with bombings in order to continue moving towards wiping out the corruption. And that's a big positive for their future.

NEW REGULATORY SCHEME WILL BE VERY POSITIVE
FOR STET CUSTOMERS *AND* SHAREHOLDERS.

OID: What's the regulatory environment like?

Carlson: Crummy. But it should get better. The Italians don't consider themselves one of the emerging European economies like Greece, Spain or Portugal.

OID: No doubt, the feeling is mutual. But how do you mean that?

Carlson: They consider themselves part of the more developed economic community — the Dutch, the French and the Germans...

OID: Whereas their phone service more closely resembles service in the emerging economies of Europe with relatively poor infrastructure.

Carlson: That's right. And like other countries around the world, they realize that they need first class telecommunications to avoid being left in the dust by the rest of Europe. Thus, they need to make massive expenditures. And the only way to get the resources for those expenditures is to enable private owners to reap some benefits from the expenditures. Therefore, we expect a more liberal tariff environment for STET.

They're in the process of negotiating it. And it's not quite finalized yet. But it looks like they'll see an inflation minus x regulatory scheme. The Italian government has basically agreed to it. They just haven't figured out what the x-factor will be. But that is extremely positive news.

Brandes: They'll have to let them earn a pretty decent rate so that they can attract the capital that they need — because they need a hell of a lot of capital.

That's the reason why Jim Rogers is very negative on

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these telephone companies right now — companies like Telebras and STET and the other developing ones. He seems to think that they need so much in the way of investment that they're just going to need *too much* money. So they're not going to be attractive investments.

OID: You obviously don't agree.

Brandes: I don't. Whether you look at TelMex, Telefonos de Chile, Malaysia Telecom or the telephone companies in Argentina, Singapore or what have you, they've all been allowed to earn a rate of return that's high enough so that they *can* attract the capital to make the required big infrastructure investments. Depending on the country, you're probably talking anywhere from 12% to 20%.

OID: But if they get their rate regulation straightened out, you don't really need to know exactly what the normalized earnings are likely to be, do you?

Carlson: That's exactly right. It's actually immaterial.

OID: Because whatever it is, they're going to have the incentive to be more efficient. And if they can't squeeze more earnings out of something that's selling at 1-3/4 times cash flow...

Carlson: Then they deserve to be out of business — which is where the market is basically pricing STET's stock.

And they *don't* deserve to be out of business.

PRIVATIZATION = GREATER EFFICIENCY, MORE USAGE, HIGHER MARGINS AND A MORE VIBRANT ECONOMY.

OID: How efficient are they currently? And how much remains in the way of potential cost savings?

Carlson: A bunch. It looks like they're being run terribly inefficiently. And from the zillions of trucks you see out there, it looks like lines are breaking down way too often.

OID: Because the equipment may be way out of date?

Carlson: That's right. And management told me that they have a long way to go efficiency-wise.

OID: A good sign.

Carlson: But they are better managers than most investors think. We don't go out and visit companies necessarily *before* we buy the stock. Although we generally visit them at some point, most of our decision is based on looking at the numbers. I may give them a call. But I'm not going to go out and sit down and really get to know them.

Well, a few months ago, I went to Italy and visited STET's management. And before my visit, my impression of them was that STET was a government bureaucracy — and that they were more concerned about how to make the government feel good and keep a lot of people employed than they were about shareholders.

But my visit convinced me that I was wrong — that they're pretty sharp, but they've had their hands tied. Once their hands are untied, I think that they'll demonstrate how capable they are.

OID: That's all well and good. But Charlie Munger and others suggest that European companies have to pay laid off workers for many years afterwards.

Carlson: It is expensive. And with STET being part of a government that has an unemployment problem, it's hard to turn around and say, "Oh, by the way, we're going to put more people on your dole." So they can't do that right now. But they won't be owned by the government much longer.

OID: How can you be so sure that privatization will change that?

Carlson: The government knows that STET is inefficiently run today. And they *know* that if they want to retain some measure of control and have an Italian-run phone network, they *better* let them become competitive with companies like Cable & Wireless and British Telecom — which they know will come knocking on their door over the next five or ten years when all of the walls are knocked down.

So I'm very confident that they'll allow that to happen. Plus we've seen it happen in the past.

OID: What's the planned timetable for privatization?

Carlson: This summer.

OID: So there's not long to wait.
What can you tell us about it?

Carlson: It's really complicated. Previously, each piece of the telephone industry was run by a separate government entity — local and long distance, telecommunications equipment, etc. And STET is a very substantial owner of each of these various independent entities.

But as we speak, they're restructuring the telephone industry and putting all of these individual operating entities into a single company called Telecom Italia.

OID: And that company will be spun off to the public except for the portion that STET owns.

Carlson: That's right. And STET will remain a very substantial owner of Telecom Italia.

OID: Why are they keeping STET separate from Telecom Italia?

Carlson: All of the pieces that I mentioned are owned substantially by the Italian government — as is STET itself. So the Italian government will in effect sell off both the pieces of these companies that it owns and its ownership of STET.

OID: So that it will create the Italian version of what AT&T used to be before the breakup.

Carlson: That's right. Then the Italian government will sell its shares in the privatization. Italy, with its large budget deficits, would clearly like to make some decent money on the sale of their shares. So in order to do that, a number of things will happen. And we expect one of those will be a liberal rate structure.

OID: That makes sense.
In Beating the Street, Peter Lynch observes that privatizations have tended to occur at bargain prices. Is that your experience, too?

Carlson: That tends to be the case. That's especially so in the case of *early* privatizations — because governments

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BRANDES INVESTMENT PARTNERS'
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with a lot of assets to sell want to encourage investors to come back for more.

OID: What do you think the most important implications are of the privatization — other than the likelihood of a more favorable rate regulation scheme and the ability to pare down their work force?

Carlson: From a macro view, privatizing the telephone company and reducing statist control of the economy should produce a more vibrant economy in Italy long-term.

OID: Which implies more telephone usage.

Carlson: Exactly.

ONE THIRD THE PRICE OF THE BABY BELLS
PLUS OTHER ASSETS FOR GOOD MEASURE....

OID: What's STET's market cap per line?

Carlson: Their market cap per line is less than $600. By comparison, TelMex and the Baby Bells are around $5,000 and $1,800, respectively.

OID: So STET is dirt cheap on a per line basis, too.

Carlson: It really is. And some people argue that you should include some other trunk that I'm not including. But they're really surplus lines — which are excess lines available in case of emergency. If you included them, its market cap per line would be even cheaper. But it's definitely dirt cheap.

Meanwhile, STET has $539 of revenue per line — which is much less than the RBOCs, Telebras and TelMex at $775, $800 and $1,150, respectively. And STET only has $221 of revenue per capita — vs. $426 for the RBOCs.

OID: That's great. They're earning monstrous cash flow relative to their current stock price. And their revenues per capita look like they're bound to grow dramatically.

Carlson: That's right. Italy has 39 lines per 100 people. So you don't have the potential bang of Mexico at 9 lines per 100 people and $86 of telephone revenue per capita.

However, I think that there's less political risk in Italy — although some might argue otherwise. And the U.S. has about 65 lines per capita — or 67% more than Italy's 39.

OID: So that does give them room for some growth.

Carlson: Oh, absolutely. No question. They're going to have much greater revenue. And much more revenue is going to come to the bottom line. For example, domestic telephone earnings were up 46% in 1993. Meanwhile, you're

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really getting this thing at a cheap multiple.

OID: Especially if the revenues are as depressed as you describe. In fact, it's hard to understand how they can be profitable with revenues per line so much lower even than the RBOCs — which enjoy much greater efficiencies because of higher penetration.

Carlson: That's right.

OID: How do they do it — tin cans and string?

Carlson: That's about right. They have about $130,000 of revenue per employee — which is even more than the RBOCs.

OID: That's very interesting. Is that because of all the ancillary businesses?

Carlson: Exactly. STET isn't just the phone lines.

OID: So their other businesses account for much of their cash flow.

Carlson: That's exactly right.

OID: In which case, there must be huge hidden earnings power in their telephone business.

Carlson: We think so. The most important engine that will drive their profitability will be their network services. But they really do have substantial revenues coming from elsewhere. And they're quality revenues, not junky stuff.

OID: No investment publishing.

Carlson: Exactly. STET owns big pieces of publicly traded businesses which include SIP — the domestic phone network, Ital Cable — the international phone network, Telespazio — which provides satellite telephone services, Sirti — which provides telephone installation, SEAT— the Italian equivalent of our Yellow Pages/advertising division, Italtel — their telephone equipment making operation, and Finsiel — a telephone software company.

I saw a 1993 analysis by Union Bank of Switzerland which showed that if you valued their publicly traded companies at their current market prices, it would have accounted for 97% of STET's market capitalization. However, they represented only 42% of their reported earnings.

OID: Wow. And it's not like stocks are exactly expensive in Italy right now.

Carlson: Absolutely. Although that's not the way we look at it, it's certainly cheap by that measure. And then they have a lot of unquoted businesses that have pretty substantial values.

OID: Speaking of other businesses, do any of these companies also provide cellular service?

Carlson: STET, Telefonica and Telebras are the majority providers of cellular in their countries.

OID: And do you include them in your calculations of the current capitalization per line?

Carlson: No, they're not included in any of the figures we discussed. Many people think the cellular represents a lot of value. But we have no idea how to calculate it. And we're not going to spend our time trying.

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OID: But aren't those things likely to have significant value at some point?

Carlson: Probably. But I'm not smart enough to figure out how much.

OID: So it's just a little unpaid-for extra.

Carlson: That's right.

THE BIGGEST RISK IS DUMB LEADERS
— AND THEY'RE NOT THAT DUMB.

OID: What could turn STET into a mistake?

Carlson: As you mentioned earlier, a huge technology change. But almost anything can be a mistake based on that criterion.

OID: Some more than others. Also, some companies are in a position to stay ahead technologically.

But are there any other risks?

Carlson: If the Italian government were to turn around and say, "We actually do want to stick with statist policies. We want to control STET."

But that's highly unlikely because they'd in effect be saying, "We want it to be an inefficiently run company and we don't care about the quality of our country's phone service."

It's just not going to happen. They're moving quickly towards privatization. But the stock is priced as if it will.

OID: Any other negatives?

Carlson: STET is heavily leveraged. So they need to bring their balance sheet more into line — which is what they're planning on doing with their free cash flow over the next few years. They expect to be able to get their debt/equity ratio down to 1:1. Right now, it's about 1.5:1 — which is pretty high.

OID: It's all relative...

Carlson: But that should be coming down fairly quickly. So we view that as another positive. But even if you use their estimates and give that cash flow a multiple only half that of the RBOCs — say 4 times — that would still represent more than a doubling of STET's stock price.

OID: We could live with that.

Carlson: That makes two of us. And 4 times cash flow would still represent a very substantial discount. And we believe it doesn't have a tremendous amount of risk.

MEDEVA DIDN'T MEET STREET EXPECTATIONS.
SO IT WAS TAKEN OUT AND SHOT.

OID: Do you have any more bargains to share with us?

Carlson: Medeva is a *really* interesting company.

OID: Interesting is for **National Geographic**. ***What we're interested in is whether it's a bargain.***

Carlson: I really like it a lot. Medeva's management came to San Diego on a road show about 2-1/2 years ago when their stock was trading at 24 times earning. Obviously, we stayed far away.

But they were a *very* impressive group of businessmen. And everyone was expecting enormous monthly compounded earnings growth — which hasn't happened. It's been good. But it didn't reach Street expectations.

Brandes: And since Medeva is a pharmaceutical/medical company, investors just killed their stock.

OID: A promising start. We're all ears.

Brandes: Medeva PLC (MDVL/Lo) is a British pharmaceutical company. It was formed by Bernard Taylor — who was one of the founders and main players in Glaxo. I believe Taylor left Glaxo in 1988 or 1989 for the opportunity to build another major company.

The idea behind Medeva was to focus on patentable products in areas that the bigger pharmaceutical companies wouldn't be interested in — to pick up products which to a small company like Medeva would be much more significant than they would to a Merck or a Glaxo.

OID: In other words, a small niche strategy — hitting 'em where the big guys ain't.

Brandes: Exactly. Taylor also planned for Medeva to buy other pharmaceutical companies and get into the more complex generics. So they're in products where gross profit margins are considerably higher than typical commodity generics.

That was the plan. And it worked quite well — until July 1993 when they announced that two of their U.S. pharmaceutical divisions were having some problems.

One of them, IMS (International Medical Systems), does critical care medicine — primarily respiratory-type pharmaceuticals. And its management let its inventory levels build up. So they had to take a hit to earnings to get their inventory levels down. But they've gotten rid of that management and put in new people.

The other problem was at MD Pharmaceuticals — which was another U.S. company that they bought. Its main product, methylpheridate, is used to treat hyperactive children. They greatly expanded their production. And when you expand your production beyond certain levels, the FDA requires products to be revalidated. They didn't do that. So they had to shut down operations for a couple of weeks. It wasn't FDA-mandated. They shut it down themselves while they got their revalidation done. But it nonetheless hit their earnings in the meantime.

OID: They sound very decentralized.

Brandes: They are. Medeva's management got into too many different areas and Bernard Taylor wasn't able to handle it well. So they had management problems at IMS and at MD. They weren't keeping a close enough eye on inventory at IMS and on the FDA revalidation at MD.

OID: What's to keep that from happening again?

Brandes: Again, they've replaced management. And they've hired extra people. They promoted William Bogie from Hoechst — who's supposed to be excellent — to run the company. And Bogie will report to Taylor.

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Taylor's said that this will give him the opportunity to step back and focus on the big picture issues of how to make Medeva grow while Bogie handles the nitty gritty day-to-day management. And Medeva needs both of those functions.

OID: Who doesn't?

MEDEVA'S GOT THE RIGHT STUFF — HIGH GROWTH, HIGH RETURNS AND A LOW P/E.

Brandes: Before these problems, Medeva was considered a premier growth stock — a glamorous up and coming pharmaceutical company. But once they suffered an interruption in earnings growth, it was all over — at least as far as the momentum guys were concerned.

So the stock, which had been as high as £3.83, is trading at £1.44 today and the ADR went from the $20s down as low as $6. Now it's back up to $8-1/2.

OID: And the range of what you've paid?
Carlson: As I recall, we've paid up to $10-3/8.

OID: What makes it a bargain?
Brandes: First of all, I know you'll be pleased to learn that it has a single-digit P/E multiple.

OID: Music to my ears.
Brandes: And we think their problems are temporary. Even though its '93 earnings were depressed by these temporary difficulties, we think that their growth will once again be reasonable — in the range of 20-25% per year.

OID: That sounds more than reasonable — if it's real.
Brandes: Especially at that kind of P/E multiple.

OID: Absolutely. But what makes you think that they'll be able to achieve such rapid earnings growth?
Brandes: Lots of reasons. First, one of their products I haven't mentioned is a Hepatitis-B vaccine — which could be a major part of their earnings growth. They actually bought the firm that developed the vaccine. But they haven't made a dime on it yet. And there's a controversy over this product, too — which has also hurt the stock price.

OID: It's sounding better and better.
Brandes: The basis of the controversy is that Biogen has a conflicting patent claim on this particular Hepatitis-B vaccine. Even though Medeva won in a lower court in Great Britain, the British High Court upheld Biogen's patent over the Medeva patent on Biogen's appeal in late October. And that knocked the stock.

However, if Biogen winds up winning the whole thing, it still wouldn't knock Medeva out of the market because the patent wouldn't cover the Far Eastern markets. And Medeva would just negotiate a royalty agreement with Biogen. So they'd still benefit from the product.

And Medeva's potential with this Hepatitis-B vaccine worldwide could be double their current sales.

OID: Why then aren't other investors as sanguine as you are about their vaccine's prospects?
Brandes: I don't know. However, SmithKline Beecham has a vaccine called Energex B which is the largest selling Hepatitis-B vaccine. But Medeva's is supposed to be superior by far. And I can't give you rhyme and verse why, but that's what we're told by independent analysts.

And, then, besides the Hepatitis-B vaccine, Medeva's into other vaccines in a big way. They're apparently working on lots of new stuff. For example, their British subsidiary, Evans Pharmaceuticals, has one of the main flu vaccines in Europe. And that business seems pretty attractive.

Also, their respiratory business is well diversified and owns a lot of different products, although they're all small.

OID: And I imagine this is a very high ROE business.
Carlson: *Very* high ROE. It was 28% in '92. And in '93 — which, of course, was depressed for a variety of reasons including a dilutive acquisition — it was 18%.

Brandes: Their ROE's depressed. It's going to go up.

BUYING A PHARMACEUTICAL CHEAP AND GETTING THE POTENTIAL BLOCKBUSTER FOR FREE.

OID: What can you tell us about their earnings?
Brandes: As far as Street projections go, the range is fairly wide. On an ADR basis, they earned 82¢ in 1992 and about 70¢ in '93 — which is what we were expecting.

Carlson: Medeva just reported its '93 earnings. And they had good results on their operating profit line and on their net profit line. But their earnings per share weren't so great because they experienced pretty substantial dilution.

But they reported 12p in earnings — which gives them a P/E of 12 for trailing earnings.

OID: And for 1994?
Brandes: Estimates range all the way from 83¢ to $1. But as you know, we're not earnings forecasters. So we're not trying to pin it down any more than that. And in 1995, we're expecting more like $1 to $1.25.

Carlson: But that doesn't include any contribution whatsoever for their Hepatitis-B vaccine.

Brandes: That's right. Much of their future earnings will be a function of their Hepatitis-B vaccine and what happens there — which is unpredictable.

Union Bank of Switzerland recently came out with a negative forecast for Medeva. They don't think their earnings will grow much over the next few years. But I believe that the Hepatitis-B vaccine could be a big thing for them.

And the P/E on a real low estimate is still only 10. On an enthusiastic estimate, it's 8 or 9. So if you simply split the difference and say it'll earn 90¢ in 1994, at $8.50 per ADR, it's trading at a little under 10 times 1994 earnings.

OID: Actually more like 9-1/2, but who's counting.
Brandes: It's not selling at 5 times earnings. But pharmaceuticals aren't going away.

OID: And this business clearly sounds like it deserves a premium P/E multiple.

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Carlson: Absolutely.

Brandes: And there'll be growth in pharmaceuticals — Hillary or no Hillary. I hate to bring up the demographic thing, but people *are* getting older.

OID: It's hard to argue with you there.

THE FEARS ARE IN THE STOCK PRICE.
THE OPPORTUNITIES AREN'T.

OID: What's are Medeva's total revenues?

Brandes: They have revenues of about $240 million and a market cap of about $1.7 billion.

OID: Doesn't just about everybody they compete with have much bigger R&D budgets?

Brandes: They do.

OID: What protects them from those big competitors?

Brandes: Again, just their strategy. The niche areas that they're in aren't generally viewed as interesting to the bigger pharmaceutical companies because the markets just aren't big enough for them.

OID: Price controls on drugs aren't looking very likely right now. However, if they do come to pass, how much would they impact Medeva?

Brandes: The U.S. accounted for about 64% of their sales in the first six months of 1993. And 69% of their profits came from the U.S. So Hillary could hurt Medeva. But, of course, it's already damaged Medeva's stock price.

OID: What's the worst case scenario here?

Brandes: From its current price, I can't think of one. Something else that we like — they don't have lots of debt. In fact, they have *no* net debt.

Of course, one of the challenges is the current environment in which margins are declining.

OID: Which we're told are less the result of political developments and more the result of competition and accounting changes which force public companies to recognize their health care liabilities.

Carlson: Absolutely. However, again, Medeva's in little niches in the generic area that aren't as competitive because they're too small to interest the big guys.

Medeva's in pretty solid lines of businesses. They get pretty decent profit margins. But again, the real wild card is their Hepatitis-B vaccine. If it works out well, their earnings and their ROE could go through the roof.

But even if it doesn't — these guys are really excited about their business.

OID: There are negatives in every situation.

Carlson: And I think Taylor's goal is to have a rapidly growing business that normalizes at a very high ROE.

OID: Isn't everybody's? If wishes were carriages, newsletter editors would...

Carlson: I like their business a lot. I think it's an awfully low P/E to pay for a very good business with excellent prospects and the possibility of a home run if their Hepatitis-B vaccine is successful.

OID: You make a mighty strong case.

*OVER*PRICED?! IF HONG KONG IS A TRUE TIGER,
IT DESERVES A *PREMIUM* P/E MULTIPLE.

OID: You mentioned that you're still finding bargains in Hong Kong. That seems to fly in the face of the tremendous move in Hong Kong stock prices and comments by Mark Mobius and Mark Holowesko.

Brandes: I read that in your last issue. We disagree. We *have* to be there. Developments in China's economy are some of the most dramatic in all of recorded history. What's going to happen is unprecedented.

OID: You've told us that before. And so far, you've been right.

Brandes: As we've discussed in past issues, Hong Kong is one of our biggest plays. When we started buying it, I think the Hang Seng index was around 3,500 — and I didn't even know what the Hang Seng index *was*.

But by January 4th of this year, it was over 12,000.

Carlson: The Hong Kong market was up 110% in '93. And so far this year, it's down about 25%.

Brandes: And on 1994 earnings, Hong Kong is still selling at only 12-1/2 times earnings.

OID: Given that market's extraordinary performance over the last several years, how is that mathematically possible?

Carlson: There's been enormous earnings growth.

Brandes: *Tremendous* earnings growth. Earnings for the Hang Seng grew about 25% in 1993. And you're still not paying through the nose at today's prices.

Carlson: In fact, Hong Kong's getting slaughtered right now — which is great.

OID: I had no idea you sold short.

Carlson: We don't. But we're looking out 5 years or so. And we like what we see.

Brandes: After all, the prices are nothing like Japan or Taiwan at the height of excitement there — or even Singapore and Bangkok today. At 12-1/2 times earnings, it's still cheap compared to anywhere else in the Far East. If it's truly a Tiger, its P/E will be over 20.

It deserves to trade at a *premium* to some of these other Far Eastern markets. Today, it's still selling at a big *discount*.

CHINA'S FUTURE REMAINS BRIGHT —
AND WE WANT TO PARTICIPATE.

OID: On the other hand, isn't the reason it's cratering fears that China will lose its Most Favored Nation

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status?

Carlson: That and fear of rising interest rates and just because it's time to sell Hong Kong — at least in the minds of most people.

Brandes: Apparently, Warren Christopher went over there the other day and said, "Hey, you guys! You've got to do something about human rights."

And Li Peng, the new president of China, said, "You're going to withdraw our Most Favored Nation status? OK. Go ahead. Lets see who gets hurt most."

OID: But wouldn't losing Most Favored Nation status seriously impact China and your Chinese investments?

Brandes: Yeah. And if it were permanent, it would be a disaster. So I don't think it's going to be permanent.

We just think China will continue in the same direction — probably not without some major interruptions. But we just view those as bumps along the way.

Investors just worry about one thing one month and something else the next month. Right now, there are two fears: One is Chairman Deng Xiaoping. He was on TV last month for the first time in about a year. And he looked frail. Deng is the architect of the whole capitalistic transformation in China. So right now, investors are worried about what happens when he dies.

The other thing people worry about is inflation and whether the Chinese government will clamp down on it and what the effect would be on the economy.

And some time in the future, people will worry about resentment of those Chinese who are getting rich by those who aren't.

OID: I didn't realize they had New Democrats in China.

Brandes: Exactly. I'm sure some of that will happen. It always does. But I don't think it's going to stop China dead in its tracks.

OID: Maybe so. But haven't most of mankind's troubles (at least those of investors) originated from double-digit P/E multiples — Communist dictatorships aside?

Brandes: As I said before, we want to be there. In the scheme of things, it's still cheap. Its future is very bright. And we want to participate in it.

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HOPEWELL HOLDINGS' GORDON WU —
A TALENT FOR GETTING THINGS DONE....

OID: Might we trouble you to get specific?

Carlson: One company that we like a lot and are buying currently is Hopewell Holdings.

OID: Is it among the best bargains you're finding anywhere?

Carlson: Absolutely. We really like Hopewell a lot.

OID: Have you bought it at today's prices?

Carlson: It's currently trading at HK$4.80. And we've paid up to HK$6.

OID: Then fire away.

Carlson: You'll be glad we told you about Hopewell. It's run by a Princeton educated engineer by the name of Gordon Wu.

OID: Nobody's perfect.

Carlson: He started out as a real estate developer. And he built the subway lines in Hong Kong. He's been an extraordinarily successful entrepreneur for a number of years and built himself a very successful property company.

But let me bring in our resident expert on Hopewell — Bob Gallagher.

Bob Gallagher: In the 1950s, after graduating from Princeton, Gordon Wu returned to Hong Kong and started developing residential, apartment and office buildings — which he continued through the '70s. He already had good contacts throughout China and continued to cultivate new ones during this time.

They resulted in a contract to build the China Hotel in China's Guangdong Province. The crown jewel of his accomplishments and still one of the country's largest, it displayed his ability to get things done in China.

There was a problem though. This one hotel used about 2% of Guangdong Province's total energy capacity.

OID: Wow.

Gallagher: The area wasn't built-up at all back then and this was a huge 1200 room hotel. So Wu went to the provincial government and said, "Look, if I pay you a little extra money, could you give me preferential treatment in getting power — because I'm having these horrendous blackouts and brownouts. People don't want to stay at my hotel."

And they did. They gave him preference in getting electrical power. And that gave him two ideas: Number one, he realized that the Chinese, even though they're communists, have always been highly pragmatic businessmen — and if they can make some money one way or another, they'll do it.

Second, he realized that the Chinese would need a tremendous amount of electrical power. So he went back to the provincial authorities and said, "Look, I can build you a power plant. I'll also provide the expertise and financing.

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And I'll get it done quickly and under budget."

Brandes: He's legendary for completing construction projects under budget and ahead of schedule.

Gallagher: His first power plant was known as the Shajiao A Project. Wu finished it in 33 months — 11 months ahead of schedule — and brought it in well under budget.

So he has a talent for getting these things done. And that is a valuable talent indeed because it takes some doing to get construction projects done in China.

THE CHINESE WILL NEED LOTS OF ENERGY.
AND THAT'S ONLY ONE OF HOPEWELL'S BUSINESSES.

Gallagher: But that's not the end of the story. He set up this project under an arrangement called "build, operate and transfer" that gives him the contract to build the project, operate it for a set period of time and then hand the keys over to a governmental entity or whatever entity owns the project at that time.

And before he agreed to do the project, he went to the governmental entity and said, "I'll do it under these conditions. You have to sell me fuel under a fixed contract. And you have to sign an offtake agreement to buy the electricity at a fixed price."

So the costs are fixed and the revenues are guaranteed. In effect, he created an annuity.

OID: Did he retain any excess energy to sell?

Gallagher: No. But there's a guaranteed offtake. Whatever he produces, they buy.

And China — especially the Guangdong Province — has a shortfall of about 10 million kilowatts per year. They have a huge, crying need for additional electrical capacity. Wu saw that and said, "Look, I can do this again." And that resulted in the Shajiao B Project. And both of those projects are big 350 to 400 megawatt plants at the mouth of the Pearl River.

He also signed another build, operate and transfer contract which worked out really well. So he's finished three of them so far — and they've all come in under budget. And two more are in the process of being built in China and in the Philippines.

Brandes: They're having a few blackouts in Manila.

OID: And poor infrastructure generally, we hear.

Gallagher: Absolutely. In fact, it's a sign of status for plantation owners to have their own electrical power generator because blackouts and brownouts are so frequent.

And generally, Hopewell gets between 50% and 70% of each project.

Brandes: And you have a business where the demand for the product is definitely there.

Gallagher: And there's nothing but huge growth ahead for energy needs throughout China for many years to come.

Another thing we like about Hopewell is that it has contacts in China that other people *don't* have. And it has a reputation for building these plants on time, under budget and for keeping them working.

Furthermore, Hopewell isn't building state-of-the-art power plants. They're not sophisticated with super-scrubbers and so forth. They're just plain vanilla coal or oil burning plants that are relatively simple to build.

Wu is trying to make them all the same so that he can achieve economies of scale. He's negotiating with makers of boilers, turbines and contractors and engineers around the world — setting up a consortium so he can just punch these things out. And it looks like it's going to work because these suppliers have had a shortage of business for so long.

HEADS, HOPEWELL HOLDINGS WINS.
TAILS, THEY DON'T LOSE MUCH....

OID: How does Hopewell finance these power plants?

Gallagher: It depends. Generally, these plants are financed by either limited or no recourse project financing. So they'll come up with approximately 10% of the monies needed for the project's financing. And then they'll go to a consortium of international banks to finance the rest.

OID: So they have extraordinary amounts of leverage.

Brandes: Yeah. Big time.

Gallagher: But it's all off balance sheet because it's non-recourse or limited recourse. Limited recourse means that there's a maximum liability on their part. No recourse, of course, means they can just walk away and lose only their equity.

OID: So they have most of leverage's positive impact without most of its negative impact.

Gallagher: Oh, yeah. And that's just the way that these projects are financed all around the world. Cogeneration plants in the U.S. and elsewhere are financed with very little equity and huge amounts of debt.

AND IF THE FORMULA WORKS FOR POWER PLANTS,
WHY NOT USE IT FOR SUPERHIGHWAYS?

Gallagher: Hopewell also owns real estate in Hong Kong — although it's starting to reduce its holdings there. More importantly, it also owns equity in the Shenzhen-Canton-Zhuhai superhighway.

OID: Superhighway?

Gallagher: Through his travels in the Guangdong Province, Wu saw that the highway between Guangzhou and Shenzhen — its two main cities — was horribly congested. It's about an 80-90 mile trip — roughly the same distance from San Diego to L.A. But traveling between these two cities took about 8 or 9 hours — basically all day — when it shouldn't have taken more than a couple hours.

Carlson: The roads were just ridiculous. You couldn't move. A two lane road was supposed to handle commerce for 60 million people.

OID: Wow.

Carlson: There was enormous manufacturing going on

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BRANDES INVESTMENT PARTNERS'
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and people just couldn't move product up and down the road.

Gallagher: He saw the crying need for a new highway to facilitate the huge commerce coming through this province as China and Guangdong continued to prosper. He recalled his Princeton days when he was enamored with the New Jersey Turnpike.

OID: He was enamored with the New Jersey Turnpike?

Gallagher: Let me rephrase that. He was enamored with the concept of charging people for using roads.

OID: Gotcha.

Gallagher: So he approached the Guangdong government with his idea.

There were numerous negotiations back and forth. And they finally reached an agreement in principle about eight or nine years ago on this project. They finalized the contract a couple of years later and Wu began to build it.

And this is a major engineering feat because we're talking about going through huge tracts of marsh, mountains and farmland. It's a big project. But it appears that they'll wind up finishing it on time. Completion is scheduled for June 1994. They've already completed portions of the highway. It can be driven from beginning to end — only not by the traffic loads that it will ultimately support. So it's not completely open, although Wu has reached many of the benchmarks necessary for completion.

OID: In other words, so far so good.

Gallagher: Exactly.

Carlson: We have a client who's a substantial global businessman with contacts around the world. When I chatted with him about Hopewell, he said, "Oh, I know them. I have a number of close friends in the steel business." Those friends, coincidentally, run huge steel companies.

And he said, "They can't keep up with Gordon Wu's orders for reinforced steel bar." Gordon Wu is trying to buy reinforced steel bar all over the world because he's building this highway so fast. And no one's been able to keep up with his orders.

OID: Fascinating.

Gallagher: Another anecdote about that highway — Gordon Wu proposed a fee structure based on usage to the Chinese authorities.

Carlson: And since he was dealing with a communist government, he quoted a very low figure for the tolls. Unexpectedly, the Chinese authorities, who were going to participate in the toll revenue as a 50% owner, said, "We're not going to make any money at those prices. You're not charging enough."

OID: So the Chinese authorities* didn't *attend Princeton.

Carlson: Exactly. So he upped the tolls substantially. Today, all the usage projections they made five years ago about traffic levels have been completely blown away.

Gallagher: When they originally did the calculations, they figured they needed 10,000 cars or trucks per day to earn an 18% return. But they also figured there were closer to 14,000 or 15,000 cars and trucks per day that would have to use it. And you know the magnitude of the growth that's occurred in Guangdong over the last five years. It's been *huge*.

Carlson: Actual traffic is at least 25% above what they expected five years ago.

Gallagher: Now they figure there's no way they won't make far more than the 18% return.

Carlson: Way, way more...

THERE ARE ONLY 14 WAYS OFF THIS SUPERHIGHWAY.
HOPEWELL (SORTA) OWNS THEM ALL....

Carlson: Even more interesting is that Hopewell retains the development rights for all the exit ramps between Canton and Hong Kong — a distance of roughly 70 miles.

OID: Which sounds like it could be some mighty valuable property.

Carlson: You bet.

Gallagher: That's the kicker. The thing that really sold us on this whole concept was the fact that Gordon Wu negotiated the right to develop all of the real estate along the 14 major interchanges on this superhighway.

OID: That's sounds pretty wild all right. But what does develop mean? And what is the state of private property rights within Guangdong?

Gallagher: He won't have ownership. He'll have the opportunity to develop it and keep 80% of the net income these properties generate.

OID: Not bad. But are the toll and the development rights for a specific term or in perpetuity?

Gallagher: I understand that the toll is for 30 years, but that the development rights are in perpetuity.

OID: Wow.

Brandes: The concept of private property in China is still very, very immature. And the concept of private property and free enterprise go hand in hand. So China's prosperity depends on China eventually coming up with a legal framework that works. And the fact that it's still so immature is one of the reasons why we're not investing directly in China at this point.

OID: It sounds like it may sometimes be better to invest where property rights are immature than in places where they're past their prime — like Great Britain or California — where they've almost come full circle back to socialism.

Carlson: That's true. However, the suggestion that there isn't any private property in China is wrong. One of the hottest property markets in the world right now is in the city of Shenzhen — which borders Hong Kong. And that's where this superhighway begins.

Brandes: The legalities remain very nebulous. But developers are simply ignoring that and are going ahead because Guangdong Province is the fastest growing

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economy in the world by far. Last year, it enjoyed growth of close to 18% in real terms.

OID: Wow.

Brandes: And this is a province with a population of 60 million. It's unbelievable. And it's growing faster and faster all the time.

Gallagher: To give you an idea of what can happen, the San Diego Freeway was nothing but miles and miles of orange groves in the '60s. Today, it embraces the cities of Irvine, Costa Mesa, Huntington Beach, Garden Grove and Fountain Valley. That's the type of freeway that Wu's building in Guangdong Province.

Wu's connecting two major cities — relatively similar to Los Angeles and San Diego. Think about what could happen along that thoroughfare given what happened along the 405 Freeway.

OID: Of course, maybe the Chinese will learn from California's mistakes...

Carlson: And they've built 10 to 12-foot walls all along the superhighway to prevent people from wandering along the road and obstructing traffic. So these 14 off-ramps are *the* only off-ramps. Walls will keep people from getting off anywhere else.

And I don't have to tell you what impact that's likely to have on the value of the real estate along those off-ramps.

OID: That sounds pretty wild all right. And will they have the right to future intersections?

Gallagher: There are no current plans for future intersections. So that's a little bit up in the air. But it appears that they will.

HOPEWELL'S SELLING AT 13 TIMES *TRAILING* EARNINGS WITH *BIG* PROSPECTS (HOPEFULLY) TO FOLLOW.

OID: What can you tell us about Hopewell's fundamentals?

Gallagher: The ADR is selling at $4.50. There are 4.3 billion Hong Kong shares. And there are five Hong Kong shares per ADR. So that's 860 million potential ADRs.

OID: And total equity capitalization of about $4 billion. Is there net debt?

Gallagher: There's only minimal debt. Most of it is project-related debt so it's not on the balance sheet. And again, it's limited recourse and well covered on a project basis. Their total debt is only about 6% of equity.

OID: What about earnings?

Gallagher: Hopewell's earnings doubled in 1993. Their trailing 12-month earnings are 35¢. Not much of their current earnings are from those power plants. Most of it comes from their real estate and from selling some of it. I'd guess 10-20% of that 35¢ comes from the power plants. So it's trading at about 13 times trailing earnings — and 12 times estimated 1994 earnings. However, the superhighway's earnings don't kick in until June 1994.

Also, the earnings from their third, fourth and fifth power plants won't come in until 1995 or 1996. So you're paying a not unreasonable multiple for past earnings which don't begin to reflect this company's true earnings power.

OID: And I suppose projecting future earnings would be a crapshoot at best.

Gallagher: It's hard to do right now because they're coming up with new projects all the time. So the projections are getting bigger and bigger.

OID: At least the direction is encouraging.

Gallagher: But let me give an idea of the value of those power plants. Hopewell recently put them into a separate entity called CEPA (Consolidated Electric Power Asia Ltd.) and floated it on the Hong Kong market and also floated 144-A ADRs. The public portion of CEPA alone was about $800 million for only about 38% of the company.

OID: Which implies a total capitalization for CEPA of $2.1 billion.

Gallagher: That's about right. And that's for the power plants alone which have had negligible earnings for Hopewell Holdings because they're still being built. They're negotiating contracts with China to build 12 more on top of the three that are complete and the two they have under construction.

Incidentally, Hopewell, Gordon Wu and affiliates own 62% of CEPA which owns these contracts.

OID: How much does Hopewell own?

Gallagher: Hopewell itself owns 42% of CEPA.

OID: So there's an asset that's apparently worth close to $900 million.

Gallagher: When the superhighway comes on line and they develop those property projects along it and when the annuities from the other power plants come on line, they have the potential to be many times their current size with many times their current earnings.

And they don't have to worry about somebody coming up with a new product that makes theirs obsolete. Their services are in clear demand and will be for many years to come. The revenues and earning streams are clearly there.

OID: Never say never.

Carlson: And they have a similar, but even more ambitious infrastructure project in Bangkok that they're negotiating right now.

Brandes: They want to build a multi-level highway and rapid transit area around Bangkok which is sorely needed — probably even more sorely needed than their projects in Guangdong Province.

OID: That's a mouthful.

Brandes: It is. Bangkok is one big traffic jam.

Gallagher: It's probably one of the most congested areas in the world. They want to build a multi-level project where one level is a highway and another level is a light rail system that's basically in the form of an "X" through downtown Bangkok and then extends into outlying areas.

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They plan to have retail stores on the lower level and residential projects along the rights of way.

Carlson: So some pretty exciting things are staring at you at a pretty cheap price in relation to future earnings. Even though we can't give you a very good estimate for future earnings, we do know that they're going to be much greater than they are today.

OID: Is it possible to bracket the profitability of these power plants?

Gallagher: The best I can come up with is that the return on equity of these plants is well in excess of 20% because of their significant leverage. They're very, very profitable.

OID: And is the superhighway likely to be much more profitable than the power plants?

Gallagher: Their pro forma net earnings for 1994 superhighway tolls are about HK$687 million — or about US$90 million — and are projected to escalate at about 10%.

And the superhighway project should generate earnings at least ten times those of all five power plants that are completed or under construction.

OID: Do I get the impression that you're saying that Hopewell's earnings potential dwarfs its stock price?

Gallagher: That's correct.

Carlson: That's right.

Brandes: But we're not going to give you a figure. Forget it.

OID: No problem. I'll just name numbers — and you say high or low...

Carlson: Let's just say *BIG*. And Wu told me that they expect earnings to grow at least 25% per year — *at least*.

OID: For how long?

Gallagher: Through the year 2000 at least. That isn't his goal, but more his minimum expectation.

OID: Nobody's perfect.

POLITICAL RISK IN CHINA IS VASTLY OVERESTIMATED.
THEY'RE COMMITTED "FOR THE NEXT 100 YEARS".

Brandes: This is entirely different than the opportunities in U.S. utilities. And we like that because it's a basic infrastructure play with a lot less business risk — at least in our opinion.

OID: There may be less business risk. But isn't there a great deal of political risk?

Carlson: We don't think so. We believe that that risk has been greatly overestimated for a long time. And that's why we've been able to invest in Hong Kong so cheaply.

OID: It may look like that right now. But what says it has to continue?

Carlson: There's a true commitment to capitalism — and they're reaping its benefits.

Brandes: And if we're wrong and hard liners in China come back when Deng Xiaoping dies and shut down the country, we apologize.

Carlson: You're laughing. But it's a nervous laugh. Just let me say that we think it's *exceedingly* unlikely.

OID: What makes you think it's so unlikely?

Brandes: Li Peng just recently said, "For the next hundred years, we're going in this direction."

OID: Of course, candidate Bill Clinton said that he was a "New Democrat"...

Carlson: Deng Xiaoping said the same thing as Li Peng and purged everyone who disagreed.

OID: But how can you place such confidence in a Communist dictatorship — no matter how pragmatic it may be?

Carlson: Any time there's complete *comfort* in anything, there's complete *discomfort* in its price. There's price risk in everything — including regulated utilities and even wonderful businesses like Coca-Cola and Gillette.

But when we look at it from every angle, including the government angle, we conclude that because of their enormous population, the Chinese really have no choice. They need to provide enormous numbers of things to their people. They need to eat. They need clothes. They need schooling. They need shelter. And they're seeing the benefits. Everybody in China has a radio. They're seeing people with cars. And they all want a TV.

Will there be blips? There's no question about it. However, it's the only way they can meet the long-term needs of their population.

OID: In other words, they're embracing capitalism for one reason — namely that they have no choice.

Carlson: Exactly. In fact, almost no matter what happens, it doesn't have any long-term implications for either of them. Privatization *will* happen. And the same goes for STET and TelMex. That's why we don't worry about the impact of elections and assassinations....

Brandes: There *are* all sorts of potential problems though in China — including market cycles. And they do have problems involving monetary growth and inflation and the challenge of dealing with such fast growth. Over the last ten years, China has grown 12-13% in *real* terms.

CONTRACTS MAY NOT ADJUST FOR INFLATION
BUT REAL ESTATE IS A PRETTY GOOD HEDGE.

OID: Speaking of inflation, are Hopewell's contracts tied to inflation?

Gallagher: Unfortunately not. They're flat annuities.

OID: That sounds like a mighty big negative. What about taxes?

Gallagher: They get a tax break on all of these projects as part of the deal that they negotiated.

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OID: Permanently?
Gallagher: That's right.

OID: That could be quite an advantage.
Gallagher: We think it will be. And they'll be getting tax breaks on their real estate development as well.

OID: Since you've pooh-poohed my negatives, what could turn Hopewell into a mistake?
Brandes: I guess that there are a couple of things. First, infrastructure projects are risky by their very nature. We've seen that historically.

Gallagher: They can run into engineering hurdles that keep them from doing the things that they want to do.

Brandes: And their mega-project in Bangkok has some risk to it. It's a *very* big undertaking. And it's a pretty big engineering problem as well because a lot of the rights of way are along or over the canals that go through Bangkok. So there are complications involved.

OID: How well do they protect themselves from those kinds of risks?
Gallagher: So far, so good. But this is a different type of project. They haven't broken ground yet. They're still in the negotiation process.

And that brings us to another risk — the Thai government which is sort of like the flavor of the week. You never know who's going to be in power from week to week. Even though Hopewell hasn't committed a huge portion of their assets yet, that's a potential risk if they push forward.

OID: Do they have to bring substantial capital into the country or can they finance it locally?
Gallagher: They'll have to bring *some* capital to the plate — at least 10% and maybe more.

OID: So there really is the potential to lose money.
Gallagher: And we're talking about a multibillion dollar project here.

OID: How big is the Bangkok project supposed to be relative to the Chinese superhighway?
Gallagher: It's *much* bigger.

Carlson: *Much* bigger is right.

Gallagher: There are huge amounts of traffic. And again, it involves two modes of transportation — not just a highway, but also light rail — with the potential to develop real estate not only along the interchanges, but also along the rights of way.

OID: Wow!
Are there any other risks?
Gallagher: There's always a risk that competitors will throw their hats into the ring on these projects. Right now, Gordon Wu has the market essentially to himself because he has experience in these projects there. But everybody sees the crying need for energy throughout Asia.

[Editor's Note: George Soros recently established a similar company in partnership with GE Capital.]

Gallagher: He'll probably be able to build these twelve power plants. But if he runs out of projects, it does turn into an annuity with a defined life...

OID: But without inflation adjustments — at least for the most part.
Gallagher: That's correct — unless he adds clauses in the build, operate and transfer contracts which provide for inflation increases.

OID: And I imagine that the risk of high inflation is especially worrisome since the annuities may be generally fixed aside from volume increases.
Carlson: Although the volume increases could certainly outstrip inflation.

OID: And I'd worry about fixed tolls being inadequate to fund operating expenses and repairs of the superhighway were it not for the real estate income. From what you've said, however, it sounds like Hopewell ultimately thrives or suffers based on the real estate.
Carlson: Eventually, that's right. And you have to believe that real estate is a pretty good inflation hedge — especially this real estate.

OID: Assuming they don't sign stupid leases, it's hard to argue with you there.

EVERYONE'S CONCERNED ABOUT CHINESE INFLATION
— BUT SO ARE THE CHINESE AUTHORITIES.

Brandes: Your question about inflation in China is a pretty good one. Generally, there is quite a bit of discipline in China. And the authorities in Beijing have been extremely concerned about the inflation problem that they have right now — which is about 12% a year. And with the kind of controls that we know can take place within China, it would be interesting to see how that whole thing plays out — especially with the Chinese economy moving towards more freedom.

I suspect that it's going to more closely resemble the kind of controls that the Bundesbank has had in Germany since the 1920s rather than the lack of controls that you've seen in Brazil and Italy.

OID: That's a radical thought. In fact, I've never heard anyone else suggest that high inflation in China was anything but a given.
Brandes: It's impossible to know what will happen. But we suspect Beijing will keep a close watch on inflation.

THERE'S LESS FINANCIAL DISCLOSURE IN HONG KONG,
BUT WE'RE COMFORTABLE TRUSTING WU.

OID: Isn't another negative the relative lack of financial disclosure in Hong Kong?
Gallagher: Hopewell's disclosure is pretty good. But there is less financial disclosure in Hong Kong than in the U.S. So you have to get to know the people in the company

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to see behind the veil a little bit.

We also have a lot of confidence that some of the people we talk to in Hong Kong know quite a bit about the company. So we do a lot of cross checking.

There are plenty of guys in Hong Kong with crummy reputations. Wu comes with one of the best reputations in Hong Kong. He's supposed to be extremely ethical and all of that. And he's 55. So he's still in the prime of his life and should continue doing deals for a while.

OID: And one would think that there might be some value associated with his experience and reputation and the inside track it gives Hopewell in the future.

Carlson: We think so. Plus, he's a hell of an operator.

OID: This sounds like a case where an individual couldn't hope to be as nearly well informed as you or Julian Robertson or some other professional investor.

Brandes: That may be true. We're a major holder of Hopewell ADRs.

OID: May I ask how many shares you own?

Gallagher: We own in excess of 12 million ADRs.

OID: Do you know who your fellow shareholders are?

Gallagher: Wu owns around 36%. Cheung Kong, which is a Hong Kong company, owns about 6.4%.

Carlson: Cheung Kong is run by the same guy who runs Hutchinson Whampoa — billionaire Li Ka-shing.

OID: Are there any other U.S. money managers in it that you're aware of?

Carlson: They include Wanger Asset Management and Capital Research.

Brandes: I believe that Brandes Investment Partners is the biggest non-Chinese stockholder.

[Editor's Note: Tiger Management is also a shareholder.]

OID: One more negative — according to* The Economist, *China has dramatically reduced its allowed rates of return on power plant projects.

It's reduced them so far, in fact — they suggest — that some providers have even ceased seeking power projects since the returns aren't all that different from American utility returns.

Carlson: I hadn't heard that. However, Hopewell's biggest client is actually the Philippines. And it doesn't matter what country you look at in Asia. They need power — and they need it quickly and cheaply.

And how do you get power quickly and cheaply? You get it by turning to Hopewell. It makes sense. Everybody gets power. Hopewell makes money. Everybody's happy.

OID: So I gather that you expect Hopewell to undertake many more projects in lots of countries.

Carlson: Absolutely.

Brandes: Yeah.

OID: And you obviously expect them to be intelligent about the risks that they take.

Gallagher: So far, they have been.

Carlson: In essence, because of the way that they've developed these projects, there's very little risk associated with them.

Gallagher: It's very interesting how they negotiate these contracts. Hopewell is the general contractor. And they subcontract people to do most of the building with very stringent time requirements and liquidated damages on the subcontractors.

Just about the only risk that they take on the construction site is completion date risk.

OID: And what happens if they miss it?

Gallagher: They're generally liable for liquidated damages. And those damages tend to consist of the contractor meeting interest payments on the project debt until it's completed. That's the general form.

OID: If one of these projects turns out to be a nightmare and a money pit, are they insulated from being wiped out?

Gallagher: They're relatively insulated. As I said earlier, they generally use either no recourse or limited recourse debt to fund all of their projects.

Carlson: These are very reasonable, very conservative projects. Their earnings just haven't started to stream in from these projects yet. But when they do, look out.

OID: Are there any other negatives we haven't covered?

Carlson: None that I can think of. Hopewell's done real well for us. We believe it still has tremendous potential. And it still looks like a terrific bargain to us today.

Brandes: We really like Hopewell. And we really like that story. And we really like Gordon Wu. We think he's doing things right. And he's doing it in a part of the world where we want to be for a long time.

JARDINE MATHESON IS IN THE CATBIRD SEAT FOR ASIAN MONEY MANAGEMENT, RESTAURANTS & MORE.

OID: It looks like Jardine Matheson hasn't gone up very much since you told us about it in '92.

Carlson: That's right — on a net basis. But since December 31st, it's gone from HK$87 to HK$47.50. It's really gotten knocked.

OID: Now you're talking.

Do you consider it a compelling buy today?

Carlson: We like it a whole lot. We really do.

OID: What's the range of what you've paid?

Carlson: We've paid up to about HK$70.

OID: Then we're all ears.

Carlson: As I told you last time, Jardine Matheson is in a wide array of businesses. They have the Mercedes Benz

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dealership in Hong Kong. They own Jardine Fleming — the big Asian fund management and stock brokerage outfit. They own a lot of insurance companies, insurance brokers, reinsurance companies, etc.

They also own hotels including a famous hotel in Hong Kong called Mandarin Oriental Hotel and a chain by the same name with branches in San Francisco, Singapore and Malaysia. And they own restaurant franchises — including Sizzler's Restaurants and Pizza Huts located throughout Asia.

OID: Including the franchise rights for China.

Carlson: That's right. Plus they own a big chunk of Dairy Farm which is one of the world's largest grocery and supermarket operations. They have 60% of the market share for supermarkets in Hong Kong a 10% share of the market in Spain and a big market share in Taiwan, New Zealand and Australia.

They're also a significant owner of Hong Kong Land — which is *the* blue chip property owner and developer in central Hong Kong. They own *the* name properties. They have a big interest in construction. They also own the security guard services for airports throughout the world.

And they're distributors of branded wines and spirits. They have a private business in spirits marketing and a joint venture with Moët Hennessy. In fact, they're the largest whiskey marketer in Asia right now.

OID: Each of those could be very valuable turf as Asian living standards rocket upwards. However, they don't exactly sound like related businesses.

Carlson: The last time we spoke, you commented on the apparent absence of synergy between their businesses. However, as I told you then, although they do a whole lot of things, they do a whole lot of things very well.

OID: And you told us that they'd compounded earnings at 30% per year for the second half of the '80s after a rough first half.

Carlson: That's right. They're terrific managers. I'm not sure that you could find better managers anywhere. And they're very levelheaded, too.

HERE'S AN OPPORTUNITY TO BUY A GOOD BUSINESS WITH GREAT FUNDAMENTALS AT A VERY CHEAP PRICE.

OID: Why, then, has their stock gotten hammered so badly of late?

Carlson: Part of the answer is that Hong Kong stocks generally have been weak. However, as we told you, there was a big deal made of the fact that Jardine Matheson wanted its primary listing in London *and* a secondary listing in Hong Kong. The Hong Kong Stock Exchange insisted that if they had a Hong Kong listing at all, that it must be their primary listing. And so they were fighting back and forth.

And for some reason, the market hated the fact that it might not be listed in Hong Kong anymore — only in London.

OID: Go figure.

Carlson: At that time, they came to some sort of compromise. Jardine was listed in London and Hong Kong — London being their primary exchange and Hong Kong being their secondary listing.

And it's been going swimmingly ever since.

OID: What does that have to do with the last few days?

Carlson: Jardine announced their earnings in the last half hour of trading on March 23rd. And their earnings were up 21% — which was great.

But concurrently, they announced that they were going to delist from the Hong Kong Stock Exchange because of continued disagreements with the regulatory authorities regarding their takeover code. Jardine currently has two different codes governing their shares — the Hong Kong takeover code and the London takeover code. And the London code is more supportive of management.

And investors greeted the news the same way they did the first time — despite the fact that Jardine simultaneously announced great results.

OID: What more could you ask for?

Carlson: Exactly. So we're happy campers. Here's a good business with great fundamentals at a very cheap price.

JARDINE MATHESON ISN'T EXITING CHINA ALTOGETHER — AND CHINA PROBABLY WON'T BAN PIZZA....

OID: They must be selling it for some other reason.

Carlson: Some sellers have no choice but to sell. Portfolio managers running an Asia or Hong Kong fund may be required to own only Hong Kong listed companies.

OID: So they're possibly losing a good chunk of their shareholder constituency and have to build another one.

Carlson: That's right. And, interestingly, there's a company very similar to Jardine that's listed in London called Inchcape. It's a conglomerate/trading house, too. Only it trades at a much higher multiple — about 14 times expected earnings — versus 9 times for Jardine.

And it's very similar — similar growth, similar market exposure, etc. It's not the same company by any measure. But analysts will use it as a comparison. And when they do, Jardine Matheson will look very favorable price-wise.

OID: And isn't Britain one of the less expensive markets today?

Carlson: Yeah. The average P/E in Britain is 12-ish.

OID: A not-so-expensive market in an apparently expensive world.

Carlson: Exactly. So we're pleased.

OID: But doesn't their delisting from the Hong Kong Stock Exchange burn their bridges — or at least impair their opportunities — in China?

Carlson: People are worried that Jardine Matheson is walking away from Asia completely and that they won't have any more Hong Kong investments, etc. But that's not so. They're making too much money there to do that.

In fact, I'd say that 75-80% of the reason why they're

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doing this may be the takeover code and 20-25% may be a message to the Chinese government — because Jardine is one of the oldest companies in Hong Kong and the largest component of the Hang Seng Index. Moving away is being interpreted as a signal — correctly, I suspect — that Jardine wants to keep their dealings with the Chinese government to a minimum. And by walking away from the Hong Kong regulatory authority, they're doing that.

OID: But don't they retain significant exposure to China?

Carlson: Not in China directly. They do in Hong Kong, absolutely. But will it impact their Hong Kong businesses? And do they need to have very good relationships with the Chinese government to do business in Hong Kong? No.

If they were Allcatel, Siemens or AT&T trying to get big telecommunication contracts, they'd need very good relationships with the Chinese government. But Jardine sells dishwashing liquid and pizza. It isn't the sort of activity that requires substantial support from the Chinese government. You're not talking about sensitive, large government contracts. You're talking about basic, day-to-day businesses.

OID: You're not worried about health inspectors closing their restaurants or, say, banning pizza altogether.

Carlson: No. Could they make it hard on Jardine and be something of a pain in the neck? Yeah. But they're very pragmatic. In a couple of years, it'll be over.

On the other side, they're not actually delisting until December 31, 1994. And they may be posturing as a negotiating ploy with the Securities and Futures Commission — which is the governing body of the Hang Seng. And the Hang Seng may cave in and give them the exemption from the Hong Kong takeover code that they're seeking.

One reason why Jardine's stock is getting hit so hard is that it's somewhat unclear why they're doing it. They've stuck to their story for the last three years — that they don't want to be governed by the Hong Kong takeover code. But there's got to be somewhat more to it than that because they had to know what the reaction was going to be in the market.

So there's probably more to the story, but probably nothing nearly as significant as the market reaction would seem to suggest. However, we're very pleased that some shareholders disagree — *very* pleased. Again, it's good news because it gives us an opportunity to buy a good business with great fundamentals at a very cheap price.

THE P/E IS LOW AND THE RETURNS ARE HIGH — AND THAT'S WITH *DEPRESSED* EARNINGS.

OID: Why do you say that?

Carlson: As I mentioned last time, Jardine Matheson's businesses are extremely well positioned to participate in the growth that's going on in China and the rest of Asia. Clearly, we'd prefer it if they stuck to their knitting and focused on Hong Kong. But they have lots of exposure there as it is. And they're not going to diversify in a wild way.

Plus they generate lots of cash. And they're paying down debt. They'll soon be almost exclusively equity-financed.

OID: But what makes you believe it's cheap?

Carlson: Jardine closed yesterday at HK$47.50. That puts it just over 8 times '94 earnings and just under 7 times '94 cash flow — which we think is very low given their prospects and high returns. Jardine's currently earning 18% on equity.

Meanwhile, we believe the quoted portions of their business — Dairy Farm, Hong Kong Land, Mandarin Oriental and the Mercedes Benz distributor Jardine International Motor Holdings — are currently generating depressed earnings.

In '93, their growth was only in the mid-to-high teens because they made some related acquisitions that diluted earnings per share growth. And those acquisitions may negatively impact '94 earnings as well.

But we expect their growth to accelerate very soon because some of their business lines are starting to expand even more rapidly. For example, Dairy Farm made an acquisition in Spain which has hurt their earnings so far. But long term, I think it's going to generate good results.

OID: So not only is the ROE high and the P/E low, but earnings are depressed, too.

Carlson: Exactly. Dairy Farm has been having trouble in Spain, Australia and New Zealand. But it's a terrifically well-run business. And once these businesses recover, it'll be clear how very cheap this thing really is.

A LOCK ON THE ASIAN MUTUAL FUND BUSINESS AT A DISCOUNT TO LIQUIDATION VALUE.

OID: Could you give us a sense of Jardine Matheson's private market value or its intrinsic value?

Carlson: Most of its businesses are quoted separately. And adding the current stock prices of those businesses — not their values, but their current stock prices — to the value of their private businesses, we come up with a liquidation value of about HK$62 per share. The public companies alone at their current stock prices comprise about HK$28 of that.

OID: Why is that so impressive? That's not even a 50% discount?

Carlson: Because the private companies are in interesting substantial lines of business — and because we're using *very* conservative multiples on the private firms. For example, Jardine Fleming is their money management and brokerage arm. They have a little over $20 billion of assets under management. Jardine Fleming earned US$202 million in '93.

If you put a Franklin Resources-type P/E multiple on this thing, it's a 50¢ dollar. I put a Merrill Lynch-type brokerage multiple on it.

OID: And that's appropriate?

Carlson: Probably not because only a small piece of Jardine Fleming is brokerage and underwriting. The bulk of

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BRANDES INVESTMENT PARTNERS'
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it is asset management and mutual funds management — which I would suggest deserves a higher multiple.

OID: How rapidly is it growing?
Carlson: Very rapidly. Last year, they increased the number of pension accounts they have under management by about 60%. And their total assets doubled.

OID: I think that qualifies as very rapidly.
Carlson: And these guys have a lock on the Asian mutual fund business.

OID: Which is one great business to have a lock on.
Carlson: It's an awfully attractive business.

OID: But you just wanted to be conservative in your valuation estimates.
Carlson: That's right. I just lowballed the P/E.

OID: That's OK. It's customary for us to add a zero.... What kind of P/E multiple did you apply to the mutual fund earnings?
Carlson: About 9 — or half of Franklin Resources' P/E multiple. Meanwhile, it's a bigger firm than Templeton — which, as I recall, sold for $700 or $800 million. And I think this business is worth substantially more.

If you put a Franklin Resources-type P/E on it, you'd be talking about a $2.8 billion business. That would add $1.4 billion — or nearly $2 per share — and would increase my estimate of liquidation value from HK$62 to HK$77. So I've probably lowballed the valuations on their private businesses. And their public holdings are also undervalued.

OID: What's your rationale for paying up to HK$70?
Carlson: Their businesses are growing very nicely. And they have a very conservative liquidation value of HK$62. Because some of their businesses are very difficult to get a handle on, I could be lowballing them dramatically.

For example, they have a construction group in China called Gammon Construction which is doing gangbusters. They don't even break it out, but you can back it out one way or another. And I think it's probably going to be doing big numbers.

They also have a division called Jardine Schindler which is a joint venture with Schindler — which is one of the largest escalator and elevator manufacturers in the world.

OID: And you think they may give Jardine Matheson's earnings an unexpected lift.
Carlson: There'll be ups and downs. But officials at Jardine and Schindler are very excited about its prospects. In fact, Schindler would like to buy Jardine's piece out. And they'd like to do that not because they aren't getting along — because in fact they're working together very, very well. Schindler just sees the enormous potential. But then again, Jardine does, too.

There's a ridiculously paltry number of escalators and elevators in China. And I don't recall the exact statistic. But as I recall, if every Chinese town with 30,000 people bought one escalator, they'd sell around 1 million escalators.

OID: On the other hand, what makes you think that they can earn decent money in that business?
Carlson: Actually, one of the real beauties of this business is the maintenance contracts on the bank end. That's the annuity. You can make some money building 'em. But it's the maintenance contracts that are the annuity in the escalator and elevator business.

OID: I didn't know that. Have elevator businesses generate decent returns historically?
Carlson: Schindler's doing well.

OID: What sort of ROE?
Carlson: It's cyclical.

PORTFOLIO REPORTS estimates the following were Brandes Investment Partners' top ten purchases during the quarter ended 12/31/93:

1. NORWEB PLC
2. STET — SOCIETA FINANZIARIA TELEFONICA
3. BBC BROWN BOVERI LTD.
4. HEINEKEN
5. HANSON PLC ADR
6. GRAND METROPOLITAN ADS
7. NESTLE
8. UNILEVER
9. TELEFONOS DE MEXICO
10. TELEFONICA DE ESPANA

OID: In other words, there are ups and downs. But what kind of return have elevator companies generated historically?
Carlson: In a good year, they can do maybe 23% — something like that.

OID: And over a full cycle?
Carlson: About 16-17%.

OID: I had no idea.
Carlson: It's going to be an extremely valuable business at some point. It isn't yet. But they have the upper hand and will do very well at some point. But I'm not valuing it that way. So I'm probably substantially lowballing the values of their private businesses, too.

OID: And are all their businesses growing rapidly?
Carlson: Absolutely. And we don't think that an equity capitalization of $4 billion is too much to pay — especially considering how rapidly they're paying down debt.

OID: It certainly sounds cheap — given its apparent market position and prospects.
Carlson: We think so. We've paid a lot more than the current price — and we're still buying it today.

OID: We'll take it already.

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THE OPPORTUNITY IN SAVINGS BANKS IS ALMOST OVER, BUT SOME COMPELLING SITUATIONS REMAIN.

OID: As I recall, you've told us about opportunities in mutual savings bank conversions in past issues of* OID. *Do opportunities remain in that area?

Brandes: I think some of them are still *very* attractive. Because we're really finding very little in the way of bargains in the U.S. right now, nearly *half* of the domestic portion of a new client's account would be invested in savings banks today. So I think they remain compelling.

OID: Then we're all ears.

Brandes: When we talked about this whole area before, I thought it was pound-the-table compelling. And we've made an unbelievable amount of money the last two years on these small savings and loans.

I know you'll be skeptical about them. And the game *is* a lot closer to being over now. But it's not over yet. There's still a lot of money to be made in some of these.

OID: You overcame our initial skepticism last time. So we'll listen closely again this time.

Brandes: I really thought it was an unbelievably unique opportunity. They were trading at very significant discounts to book. And, therefore, one of two things had to happen: Either the stock would get back up to book value or the banking business was finished.

And if these companies were only worth 50% of book, there was no reason to start a bank ever again. I didn't think that was a reasonable assumption.

OID: Although a surprisingly large number of investors and onlookers apparently did.

Brandes: Banks' book values generally represent true liquidation value. And so it didn't make any sense to me for them to be trading that cheaply — unless you felt like the leverage was going to kill them because they had bad loans. But we were looking at banks that were trading at those prices with no bad loans at all.

OID: But isn't the horse out of the barn? Haven't those stocks run up already?

Brandes: Yeah. Very good ones that aren't in play yet are trading around book — some at 110% of book. And we've been seeing takeovers lately at anywhere from 1-1/2 to 2 times book — whereas you couldn't *give* them away a couple of years ago at 50% of book. The change is incredible.

Carlson: In fact, in one week this month, about three of our banks got taken away from us.

Brandes: There's a bank outside of Philadelphia called Germantown Savings. I bought it for $13 a share. And we were just taken out at $62.

OID: Congratulations.

Brandes: So I really like these things.

OID: I can certainly understand why. But isn't the very fact that you've done as well as you have an indication that the game is over?

Brandes: It's true that we're starting to get to the opposite extreme. And it's amazing how we could experience both extremes in only a 3-year time span.

And yet you can still buy some savings banks and savings and loans that aren't in play yet for anywhere from 70% to 80% of book. In some cases, these banks have a *huge* amount of equity. And they don't have much leverage. They make plain vanilla loans on single family homes — no commercial stuff or anything else with much loss potential. So they don't have asset risk.

Some of them simply get lost in terms of investor visibility because there are hundreds and hundreds of banks. That's real nice.

CONVERSIONS OCCUR AT A DISCOUNT TO BOOK AND THEN BEEF UP THE BOOK....

Brandes: And these mutuals are increasingly converting to stock ownership. So more and more names are entering the public market.

And that's another phenomenon. The conversion of a mutual to a stock company is unique. We've talked about this before. They're converting these things considerably below book. And then most of the money raised goes into the coffers of the bank and increases the bank's capital.

OID: But isn't there a line of investors trying to get into those conversions?

Brandes: There is. But good banks are still being offered at 60% of book once you factor in the new monies raised in the offering. And nobody gets hurt by these things being converted at these ridiculously low prices. And, of course, they immediately go up from 60% to 80% of book. But only depositors are allowed to buy stock on the IPO.

And the managements love it as well because they get all kinds of options at the initial offering price at 60% of book.

OID: Talk about the fox guarding the hen house.

Brandes: But the mutual shareholders also get the opportunity to buy the stock at a nice discount. And then the stock immediately pops after the IPO. So they're happy. The officers of the bank are happy. And the shareholders are happy. Everybody's happy.

And, incidentally, the price doesn't immediately adjust to a par with how equivalent banks are trading. Why that is, I don't know. Maybe the PR isn't up and running yet and investors who bought their stock on the conversion got it cheap and are selling without understanding the long-term potential of what they own.

But once the buyout rumors start, the stocks move up to book value. Then, of course, when the bank announces it's looking to sell, they immediately go to 1-1/2 times book. And then the actual buyout comes at 1.7 or 1.8 times book. At least that's what's been happening.

Again, this game's been going on for quite some time. Needless to say, it was best at the very bottom of the trough in 1990. But it's continued to this day.

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OID: I got the impression from two different articles that there was a moratorium on mutual conversions.

Brandes: There is a moratorium on conversions that go directly into mergers. But there is no moratorium otherwise. In fact, the biggest guys out there on the Street are coming out with new issues on conversions as we speak. They're happening. And they're happening at a rapid clip.

Frankly, I don't care that much about all that stuff anyway — so long as the price is right.

OID: Exactly what Walter Schloss says.

Brandes: As I told you, virtually every one of these things have historically gone to a premium following conversion — because they've always been brought public at a price that ensures that they will.

But as Peter Lynch points out in *Worth* magazine, only about 1.2% of these banks' depositors have subscribed for stock. It's been a giveaway. But depositors have had no idea of the opportunity being presented to them.

Of course, what lots of investors used to do was to open an account in hundreds of banks around the country where they thought there was a potential for them to convert. It didn't matter how much money they had in the bank. They just had to be depositors to participate in the IPO.

But the banks have really clamped down on that practice. First of all, they don't allow out-of-state depositors to buy stock. Then they put a restriction on requiring anyone to be a depositor for a certain period before they could buy any stock. So it's a tougher game.

OID: But as Peter Lynch and Bruce Berkowitz suggest, anyone wishing to participate in these conversions can still go out and set up a savings account at as many of their local mutual savings banks as possible.

Brandes: Absolutely.

[Editor's note: See Peter Lynch's excellent article in the April issue of *Worth* for more on this subject. Lynch and Berkowitz both mention that the names and addresses of mutual institutions in your area are available from Charlottesville, Virginia-based SNL Securities.]

ST. FRANCIS CAPITAL CORP
HAS ALL THE RIGHT INGREDIENTS....

Brandes: But even though I can't buy the IPOs, I think we'll do just fine buying selected ones *after* conversion. There are hundreds of these banks. And I look at it somewhat Peter Lynch-style. I don't buy *all* of them. I pick and choose. But I do buy a *lot* of them. I probably own 30 — and I'm always looking at new ones.

Generally, they're small cap — anywhere from $100 million to $300-400 million. So I can't just hone in on one and buy it and buy it. But I don't *need* to hone in on one — which is nice. I can buy a whole bunch of them. And I try to diversify geographically because, as we know, real estate is a local phenomenon.

So maybe I'll give you two interesting names — from two different regions.

OID: That's a full service interview.

Brandes: The first one, St. Francis Capital Corporation (STFR/NASDAQ), is a bank that converted in June at $10 a share and is now trading at about $15-1/8. It's Milwaukee's 5th largest bank. They have a book value of about $18 or $19.

OID: So that you can still buy it nearly 20% below book.

Brandes: That's right. And they have an equity-to-assets ratio of around 17% after conversion and they're 100% reserved against non-performing loans — which are only around 1% of their portfolio.

OID: So far, so good.

Brandes: And St. Francis is buying back its stock — which is something else I like to see. That's important because buying back stock goes straight to the bottom line when it's trading at a significant discount from book. It increases book and earnings.

OID: And I guess it says something about the profit motive of the management.

Brandes: Oh, sure. Absolutely. And I want the management to be thinking about making a lot of money — because if they do, so will I.

OID: But aren't they restricted on how much stock they can buy back?

Brandes: They're not allowed to buy back more than 5% of their shares every six months.

OID: What do you think St. Francis is worth?

Brandes: In theory, it's worth 1 times book. And like I said, they're being taken out today at 1.7 or 1.8 times book. But that's too high. I would be extremely surprised if that continued. Banks aren't worth that.

OID: So the market's overheated.

Brandes: That's right.

OID: Historically, how high have the premiums to book been in bank takeovers?

Brandes: These kinds of prices were being paid in 1988 and 1990. At that time, some smaller commercial banks were being taken out at 2-3 times book. But commercial banks tend to get a higher price than S&Ls.

OID: Why?

Brandes: Probably because they have more flexibility.

MOTIVATED MANAGEMENT AND 10% EQUITY-TO-ASSETS
AT LESS THAN 70% OF BOOK VALUE....

OID: And you said that you had another?

Brandes: Something else that we think is compelling is TR Financial (ROSE/NASDAQ). It's the holding company for Roosevelt Savings Bank. It has branches in Brooklyn,

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Queens, Nassau and Suffolk. They're another recent conversion — converting in 1993 at $10. Today, it's only trading at $11-5/8 despite having a book value is $17.

OID: So that it's selling at less than 70% of book value. Not bad.

Brandes: Yeah. And their equity-to-assets ratio is around 10%. It's the same old story. Insiders have given themselves around 16% of the stock one way or another.

OID: And I understand that they've recently bought shares in the open market, too — at higher prices no less — between $12-3/4 and $13-1/4.

Brandes: That's right. And they're another potential takeover target that could be taken out at 1-1/2 times book.

OID: You left out "interested".

Brandes: Again, all in all, we still think it's a compelling story.

THESE AREN'T EARNING PLAYS —
THEY'RE TAKEOVER PLAYS, WE HOPE....

Brandes: The assets of both of these institutions are basically plain vanilla, single family home mortgages. And they have very high equity levels.

Most of these banks are selling at 10-12 times earnings. But they're not earnings plays. When you get down to it, they really aren't in that great a business. But the banking industry consolidation will continue for some time.

OID: And if they're not taken over...

Brandes: All they'd be worth is 1 to 1-1/2 times book.

OID: What are the odds that they aren't taken over?

Brandes: I don't know how to put a number on that. But I'd guess that the odds are probably around 50/50. I don't think the consolidation of the banking industry is going to stop anytime soon.

And these takeovers will happen today not for cash, but for stock. It'll happen to banks that are also trading at a premium to book so that it won't be dilutive.

If a bank's selling for 1-1/2 times book and it can buy one of these at 1-1/2 times book, then it's not dilutive. And meantime, they get a lot of equity capital, branches and market presence. They'll get savings from consolidating branches, reducing headcount and so forth — depending on where the branches are located.

OID: Do these takeovers tend to be driven more by the desirability of the assets, market position, the deposits, cost savings or something else?

Brandes: All of those factors are generally involved. But I think it's more for the cheap capital than anything else. And these banks I've mentioned are all well situated from a takeover standpoint.

SOME BANKS WILL *BENEFIT*
FROM HIGHER INTEREST RATES....

OID: And it sounds like you have limited downside.

Brandes: I think we do.

OID: So what could go wrong — aside from your banks not being taken over?

Brandes: Margins have been expanding with interest rates coming down. And that play is just about over. So interest rate increases will squeeze their margins a little. And each bank's management will handle that problem differently.

Many of them have positive one-year gap positions though. In other words, they should be able to raise rates on their assets more than the cost of their liabilities will go up. Their spreads will actually *widen*. So rising interest rates — at least on a one-year basis — wouldn't hurt them for a while.

OID: Something that's been pointed out to us repeatedly by Bruce Berkowitz and Mark Cooper.

Brandes: But there are so many factors involved that it's impossible to know. For example, I can't tell you how much rising interest rates will impact housing starts and banks' ability to make new loans, etc.

A dramatic increase in interest rates would put a *temporary* kabosh on this area from a valuation standpoint. When interest rates go up, investors tend to get scared of financial stocks of *all* kinds.

OID: Whether they should or not.

Brandes: Exactly.

A 50% DISCOUNT AND 7-1/2% GROWTH
MAKE FOR A SURPRISINGLY HIGH RETURN.

OID: As I recall, Buffett has described banking as a business where you can go to lunch with the business in fine shape and return to find out that some young MBA has flushed your equity. That has to be another thing that could always go wrong.

Brandes: That's true. However, we've already been through a horrendous period of time.

OID: You, too?

Brandes: I'm talking about the banks. And it usually takes longer than three years for them to forget the lessons and go back to making the same mistakes that they were making in the past.

OID: More like five years?

Brandes: They *will* forget the lessons — but not yet.

OID: How would you assess management at these two banks?

Brandes: That I don't know. I hope it won't matter. They survived 1989-91. To me, that's good management — because hundreds of them made bad loans and didn't.

OID: If you're right, these are 50¢ dollars today. And

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although their intrinsic value will generally compound at a mediocre rate, they will compound some.

Brandes: Most of them don't pay a dividend. So earnings increase their book value as do share repurchases below book value. TR Financial, for example, with its book value of $17 will probably earn about $1.25. So a year from now, TR Financial's book value will probably be around $18.25. And the year after that, $19.50.

OID: So TR Financial's intrinsic value should grow something like 7-1/2% a year.

Brandes: That's right.

OID: In the past, what has your average holding period been in your bank stocks?

Brandes: Three years.

OID: So if they compound 7-1/2% a year and they're a 50¢ dollar today, you stand to make 2-1/2 times your money over three years.

Brandes: That's right.

OID: Which would be a compound annual return of 35% before tax.

Brandes: Yeah. And I like that. I've done better than that in these stocks since the bottom in 1990 — *considerably* better. But that is what we're hoping for on these two.

OID: And you're still buying these two?

Brandes: I'm not buying St. Francis because we'd wind up owning too much of it. If we ever did decide to sell, we might not be able to do so very easily. But that's the only reason we're not buying it.

Also, I wouldn't worry about that if there weren't others that I could buy. But there are a lot of these things that meet the same criteria — a whole bunch of 'em. So I don't need to buy a whole lot of any one of them.

[Editor's note: Another institution which Brandes reported buying in the fourth quarter of '93 which seems to fit his criteria was Astoria Financial (ASFC/NASDAQ). Like TR Financial, Astoria's $29 stock price is 30% below its $41 stated book, it has an equity-to-assets ratio around 10% and its insiders are buying shares.]

POLITICS DOESN'T GIVE ME PAUSE,
BUT MOST STOCK PRICES DO....

OID: You've told us about some very exciting bargains around the world. However, doesn't the assassination in Mexico — especially in the wake of riots in Chiapas — make you worry about the possibility of a backlash against free market reforms?

Carlson: Not at all. It obviously worries other investors — based on the way these stocks have taken a hit recently. But the Chiapas region was moving very, very slowly in its reforms. So, naturally, they weren't seeing much in the way of results.

Of course, the assassination of Colosio was a tragedy. However, there are other very qualified candidates.

People are seeing the fruits of privatization and other free market-oriented reforms. So I think you'll see continuing support for those policies in Mexico and elsewhere for years to come.

OID: But doesn't politics have a way of overwhelming reality? After all, the U.S. had more job creation and lower unemployment, I think, by far than any country in Europe in "the decade of greed". And yet, despite that fact, Europe's clearly failed policies — which they seem to be running away from — are being touted here as the panacea for our problems.

Carlson: What you've said is absolutely true. But we as a country haven't been through the kind of abject poverty and runaway inflation that the Latins have. So are they willing to reward good results? I think so. As a result, they're going to see good stuff coming down the road.

They had to learn the hard way. They had to get frustrated enough to allow the free market to work.

OID: What will it take here?

Carlson: Good question. Arthur Laffer recently said, "I voted for Clinton as a down payment for Jack Kemp." Hopefully, this administration will be the depths we have to go through in order to see good things on the other side.

OID: It's also been suggested that U.S. foreign policy today leaves a tremendous amount to be desired.

Brandes: I'd agree with that.

OID: And that further Whitewater revelations might not exactly wind up doing wonders for investor confidence — even if it were actually good long-term for America and its investors.

Carlson: I think that's exactly right on both counts.

OID: And that's not enough to make you sell everything and buy puts?

Brandes: We don't really think in those terms. Frankly, what gives me a lot more pause is stock prices. We don't do political, top-down analysis.

Carlson: But we wouldn't mind a drop in stock prices. Not only aren't we margined, but we have plenty of cash. So we'd be happy to see stock prices drop a lot.

OID: On that cheery note....

Thank you, Mr. Brandes and Mr. Carlson for a truly global assortment of exciting ideas.

—OID

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