Outstanding Investor Digest

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

Volume XI Numbers 1 & 2 April 30, 1996

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We can generally count on Pacific Financial Research's Jim Gipson and Peter Cundill & Associates' Peter Cundill to call it like they see it in their letters to shareholders and have come to rely on both for perspective on the current financial and investment scene.

We're thus pleased to bring you their latest letters — along with the latest reported equity purchases of each:

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FPA CAPITAL FUND'S BOB RODRIGUEZ "THIS SIMPLE FORMULA HAS WORKED AMAZINGLY WELL. I DON'T KNOW WHY *EVERYBODY* ISN'T DOING IT."

When we first featured Bob Rodriguez in March 1989, we said he wasn't among the managers we regularly follow (because his track record was only four years long), but that he'd been handpicked by *OID* contributor George Michaelis to run FPA Capital Fund and that the insights and ideas he'd expressed at his annual meeting had caught our eye.

Little did we know that his two favorites in that feature — Green Tree and NIKE — would wind up to be a 25-bagger and a 12-bagger, respectively, and that he'd go on to become

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RAVENSWOOD'S BOB ROBOTTI "NOBODY FOLLOWS THESE THINGS OR BELIEVES THEY'RE FOR REAL. BUT THEY WILL."

Ravenswood Investment Company has managed a compound annual return before fees of 19.1% versus 13.2% for the *Ibbotson* Small Cap Index for the 13 calendar years since its inception — despite lagging the index significantly during two of its first three years. In fact, it outperformed that same index in nine of the last ten years — outpacing it for the full ten years by a margin of 20.6% to 11.9%.

Here are Ravenswood's year-by-year returns for the

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THIRD AVENUE FUND'S MARTY WHITMAN "MJ WHITMAN ADVISORS VS. GRAHAM AND DODD AND SIX IDEAS THAT FIT OUR CRITERIA TODAY."

Morningstar Mutual Funds' Catherine Voss Sanders says, "Perhaps the most sophisticated [fund letter] writer is Third Avenue Value's Martin Whitman." And, as you know, he's no slouch at picking stocks either.

Whitman's latest letter to MJ Whitman Advisors' clients includes both his excellent writing and six of his latest ideas. Thus, we thought you'd like to read it as much as we did.

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OID MAILBAG:
CLIPPER FUND'S JAMES GIPSON
(cont'd from page 1)

MEDIA MAY SEE THE GLASS AS EMPTY, BUT IT LOOKS MIGHTY FULL TO US.

Philip Morris seems to stay in the news — in the *bad* news.

James Gipson: Any news is bad news for Philip Morris. Three years ago the company cut cigarette prices on Marlboro Friday, causing its share price to sink. The stock's price then doubled, but declined again last quarter on news of a competitor's highly conditional attempts to settle lawsuits against it. [However,] while the media concentrates solely on bad news, there are some positive facts to consider in arriving at a balanced analysis of the situation:

What a difference shareholder-oriented management makes.

Philip Morris is doing a great job of operating its business. Domestic market share is approaching 50%, international tobacco is growing at a remarkable rate and the company is using its huge cash flow to benefit shareholders in the form of generous dividends and share repurchases.

Even without domestic tobacco, Philip Morris is cheap.

Its non-U.S. tobacco operations (Kraft-General Foods, Miller Beer, and international tobacco) are so profitable that their value of about $95 per share exceeds the current stock price of approximately $88. Even in the very unlikely case that the U.S. legal system renders their domestic tobacco operations worthless, the stock is still cheap today. We continue to monitor the relevant risks as they unfold. And our conclusion is that an investor is paid very well to take those risks.

USUAL SUSPECTS ARE LOOKING TOOTHLESS. HERE'S THE RELEVANT RISK TODAY...

Traditional executions of business cycles appear toothless.

Old soldiers may just fade away, but old business cycle expansions usually die in front of a firing squad. The current expansion at five years is the third longest of the post war period, but it shows no sign of falling to the two traditional executioners. Inventory fluctuations can cause a short recession, but better inventory management ("Just in time" instead of "just in case") reduces the size of that problem. Monetary policy is an even more powerful executioner of expansions; the severe recessions of 1974 and 1982 both flowed from monetary restraint. This time, however, the Federal Reserve has done its job much better

(continued in next column)

so there is no need to slam on the monetary brakes to stop inflation and the economy along with it.

The relevant risk today: a profit recession....

The economy may not be at risk of a traditional recession, but corporate profits are not out of danger. An unusual feature of this expansion is the large role played by capital spending — a role which creates the potential for excess capacity, price-cutting and margin erosion. Profit recessions following periods of booming capital spending were more common in the 19th century and that appears to be the relevant risk for investors today.

VOLATILITY CAN BE AN OPPORTUNITY — ONLY NOT A COMFORTABLE ONE.

Marx may eventually get something right....

The most famous and influential economist of the 19th century was Karl Marx — a man whose dogma and followers now have joined him in the "dustbin of history."

PORTFOLIO REPORTS estimates the following were Clipper Fund's largest equity purchases during the quarter ended 3/31/96:

1. WAL-MART
2. TYCO INTL LTD
3. GOLDEN WEST FINANCIAL CORP
4. MORGAN STANLEY GROUP INC
5. PHILIP MORRIS COS INC
6. REEBOK INTL LTD
7. TOYS R US INC
8. MCDONALD'S CORP
9. OLD REPUBLIC INTL CORP
10. FEDERAL HOME LOAN MTG CORP

The irony is that, now that Marx is thoroughly discredited, some of his favorite concepts are useful in understanding the present economy:

•Declining returns on capital. This seems like a safe prediction since return on equity for corporate America now stands at the highest level in history. Much less safe predictions involve the extent and speed of the coming decline.

•Impoverishment of the proletariat. The belief that workers do not get their fair share is undergoing a revival as the income distribution in this country widens to favor the rich. Those in the lower half of the income distribution are losing ground in relative terms and, possibly, in real terms as well.

•Reserve army of the unemployed. Marx believed that the poor get poorer because unemployed workers across the street are willing to work for less pay. Today those unemployed workers are across the globe. Japan and the four tigers (Taiwan, South Korea, Hong Kong, and Singapore) had a major impact on the world economy with a combined labor force of about 90 million. As China and India enter the world economy with a combined labor force nearly ten times as large, their impact is likely to be far more powerful.

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OID MAILBAG:
CUNDILL VALUE FUND'S PETER CUNDILL
(cont'd from preceding page)

(Gipson continued from page 2)

Profitability likely to decline and volatility likely to rise.

Just as corporate profitability is likely to decline from record high current levels, the volatility of stock prices is likely to rise from its record low ones. The two dominant passions of investors — greed and fear -- usually produce higher levels of fluctuation in stock prices than have been seen in the 1990s. Last quarter may have been the beginning of a return to higher volatility as the norm.

Volatility can be an opportunity, but not a comfortable one.

Volatility can be an opportunity for a rational and patient investor, but not a comfortable one. Bear markets often make an investor feel that he has been shanghaied on to Mr. Toad's Wild Ride — a ride which lies somewhere in the future.

—OID

U.S. MARKET IS NOW OVERVALUED AND FRAGILE — AND OUR PORTFOLIO IS STRUCTURED ACCORDINGLY.

"The thing that will separate the men from the boys is how we do when the music stops."

— Peter Cundill, November 1993

PORTFOLIO REPORTS estimates the following were Cundill Value Fund's largest equity purchases during the quarter ended 3/31/96:

1. MARINE-WENDEL
2. COMPAGNIE FINANCIERE DE PARIBAS
3. GENDIS INC CL A
4. REITMAN'S LTD CL A
5. SOCIETE ALSACIENNE DE PARTICIPATIONS
6. SEMI-TECH LTD
7. INTRACO LTD
8. SOCIETE EURAFRANCE
9. NORD-EST
10. COMPTOIR LYON ALLEMAND LOUYOT

The market has swung clear through fair valuation levels.

Peter Cundill: As the U.S. market continues its bull ride, the question is asked more and more frequently: When will it end?

We do not pretend to know the answer and in fact stay away from trying to predict markets or securities prices. But what we do see is a market that has swung through fair valuation levels riding upward on the 'see-saw of value'.

In the short run, prices *usually* don't stop at fair value.

One of the fundamental tenets of value investing is that the market is a weighing machine in the long run — that is, undervalued securities will eventually rise to reflect fair value and overvalued ones will decline.

Experience has shown us, however, that prices don't generally stop at fair value. They go through it. In this way, valuing a market can be likened to one end of a see-saw.

We believe the U.S. market is overvalued and fragile.

We are finding some select buying opportunities in non-North American countries. At the same time, it is our view that the U.S. market has moved through fair value and is now overvalued. North American stocks are expensive — as evidenced by high price-to-earnings, price-to-book ratios and low dividend yields.

We regularly screen 10,000 North American companies to see how many trade below our definition of fair value. And in March, there were [only] 41 candidates. Volatility is increasing — and U.S. investors seem complacent and over-optimistic. This makes for a potentially fragile situation.

PORTFOLIO REPORTS estimates the following were Cundill Security Fund's largest equity purchases during the quarter ended 3/31/96:

1. REITMAN'S LTD CL A
2. DYLEX LTD
3. SCOTT'S HOSPITALITY INC
4. NEWFOUNDLAND CAPITAL CORP CL A
5. HAWKER SIDDLEY CANADA INC
6. COMPAGNIE FINANCIERE DE PARIBAS
7. M-CORP INC
8. ROSES STORES INC
9. GENDIS INC CL A
10. OROAMERICA INC

Our lowest U.S. exposure in Cundill Value Fund's history....

Given this scenario, we're taking a cautious approach. We hold approximately 27% cash. And we've shifted the portfolio away from U.S. securities and are buying offshore. U.S. holdings currently account for 11% of the portfolio — our lowest U.S. exposure in the 21-year history of the Cundill Value Fund.

We have also hedged our U.S. market exposure with a combination of Index put options and futures. These futures and put options should increase in value if the stock market falls.

We're not making a prediction, just staying prepared.

There is no way of knowing when the see-saw of value will reach its peak and start moving down again. However, when it does, we are positioned to protect the value of our unitholders' accounts and to take advantage of buying opportunities as they present themselves.

—OID

ERRATA:

In introducing Manhattan Funds' Andy Weiss and Howard Golden to you in our November 21st, 1995 edition, we mistakenly told you that Manhattan Equity Partners had earned a gross annual return of 25.5% during the three years since its inception. We took their name in vain. That return was actually *net* (of all fees and expenses).

Also, we said Manhattan International Partners had approximately 24% of its portfolio in the Czech Republic. The figure was actually 16%.

—OID

FPA CAPITAL'S
BOB RODRIGUEZ ET AL.
(cont'd from page 1)

one of the most highly regarded money managers on the investment scene today or that he would go on to earn a compound annual return of 21.3% after all fees and expenses (versus 13.5% per year for the Russell 2000) during the seven years that followed.

Here are the year-by-year performance figures for FPA Capital alongside those for the Russell 2000 Index. (All performance figures provided by First Pacific Advisors.)

Year	FPA Capital Total Return[1]	Russell 2000 Total Return
1984[2]	+ 7.0%	+ 2.4%
1985	+28.9	+31.1
1986	+12.6	+ 5.7
1987	+11.0	- 8.8
1988	+18.1	+24.9
1989	+25.3	+16.3
1990	-13.8	-19.5
1991	+64.5	+46.1
1992	+21.6	+18.4
1993	+16.7	+18.9
1994	+10.4	- 1.8
1995	+39.0	+28.4
1984-95[3]	+19.6%	+12.6%

[1] Returns are calculated at net asset value after all fees and expenses.
[2] For the period 6/30/84 through 12/31/84.
[3] For the period 6/30/84 through 12/31/95.

While revisiting Rodriguez was already long overdue, Michaelis's tragic death served as the specific catalyst for us to pick up the phone, express our personal sympathies to Michaelis's associates at First Pacific Advisers [FPA] and, hopefully, capture some of Rodriguez's memories of exactly what made Michaelis the special man that he was.

Naturally, we couldn't resist the opportunity to also catch up with Rodriguez's latest thoughts on the current investment scene and see if he couldn't pick out a couple of future 10-baggers and 20-baggers. (Fittingly enough, Rodriguez finished selling out his NIKE position during the course of our conversations.)

We'd like to extend a special thank you to Rodriguez for making time to speak with us during a uniquely busy and challenging time — challenges which not only included dealing with the loss of Michaelis, but which also included assuming the mantle of chief investment officer at FPA.

The following comments were selected from a series of conversations with Rodriguez and associates Dennis Bryan and Steve Romick. We found some of them to be particularly enlightening and hope that you will, too.

IT WAS A FITTING TRIBUTE TO GEORGE MICHAELIS.
THE SAME WORDS CAME UP AGAIN AND AGAIN.

OID: We were shocked and saddened to learn about the tragic accidental death of Source Capital's George Michaelis.

Bob Rodriguez: It was unbelievable. I was probably as stunned as I've ever been — in a state of absolute shock for a few minutes. But then we all had to get hustling on what we were going to do the following day — getting all the board members notified, getting a press release out prior to the opening of the exchange, etc.

In fact, that week would have been George and Mimi's 10th anniversary. And they planned to spend it in Hawaii. Actually, my better half and I were there in December and we stayed in a bungalow at the Hana Plantation — which is way down at the tip of the island of Maui. It's really out there and isolated.

So I told George how delightful it was. And he said, "Mimi and I are going there for our 10th anniversary."

And I said, "Which bungalow did you go for — the one on the oceanfront or the one just a few feet removed?" And he said, "Well, the oceanfront bungalows were $550 a day when just 50 feet back, they were only $300. So we went for the $300 one."

And I had to laugh because he'd gone through exactly the same thought process I did. It turned out that he was going to stay in almost exactly the same spot that we did.

OID: And I understand that you were one of the people who made some comments at his memorial service.

Rodriguez: I did. And among other things, I mentioned that I still recall the first time I met him and how obvious it was immediately that here was a man of tremendous sincerity, integrity and intellect and how I only came to appreciate those qualities more with the passage of time. All you ever needed from George was his word. He was totally trustworthy.

Another of George's fine qualities was his ability to create an environment in which a free exchange of ideas could occur. Because of his own powerful analytical skills, he was able to regularly challenge us intellectually. He really made us think.

And because he was intellectually honest and confident, he never feared the exploration of alternative points of view.

OID: In other words, he had tremendous integrity personally and intellectually.

Rodriguez: That's right. And to his credit, he hired individuals. He'd say, "I can't manage all of the nuances. What I have to do is hire people I trust and let them go." And he always did. That's one of the reasons why the firm's turnover in key positions has been so low. His trust and respect allowed people to operate independently and grow to as much of their potential as possible.

For example, I joined the firm in early 1983. And we acquired the management contracts of the two funds I manage — FPA Capital and FPA New Income in July 1984. And right away, George told me, "Those are *your* funds.

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FPA CAPITAL'S
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You do what you want with them."

And there was clearly a lot of similarity in our personal makeups — we were both value investors. However, we were very *dissimilar* in the specific companies we bought and even the selection methods we used. Nonetheless, he let me manage FPA Capital my way.

OID: Clearly one of his best decisions — along with his choice of Bill Sams to manage FPA Paramount and let him do it his way.

Rodriguez: I could have joined several other firms along the way. And the reason I didn't is that George created a rare environment.

So yes — I was one of those who spoke about George. I stayed up the night before and reflected on our 13 years together. And it made me realize just how lucky I was to have worked with him. Most of us never get the opportunity to work with truly great people.

OID: Exactly what I keep telling our associates...

Rodriguez: I feel quite blessed that not only did I have the pleasure and honor of working with him, but that I also had the privilege of having him as a very close friend.

OID: It was certainly both a pleasure and a privilege to have had him as a contributor to OID.

Rodriguez: Actually, the most interesting aspect of the service was that there were five or six of us speaking — each of us coming from different venues, but that we used so many of the same adjectives. I think George would have been very pleased about how people spoke about him. Among the words used again and again were integrity, intellect and comments about the way he treated people.

OID: That sounds like the George we knew, all right.

[Editor's note: Another one of Michaelis' associates, Julio de Puzo, also spoke at his memorial service. And while space constraints prevent us from including it here, we hope to include a lightly edited excerpt therefrom at our soon-to-be website (to be located at http://www.oid.com).]

SOURCE'S APPROACH WILL BE UNCHANGED
— EVEN CONTINUITY IN MANAGEMENT.

OID: I imagine it would be overly crass at a time like this to stoop to asking you about investment ideas...

Rodriguez: Not at all. George would *want* us to move forward. In fact, three years ago, someone hypothesized, "If two key principals such as George and Chris [Linden] were materially impaired or eliminated, what would happen to the firm?" And they concluded that the firm would cease to exist. So we've always worried about the 100-year storm.

And in the last six months, I think it's clear that it hit. Health difficulties forced Chris to step down from his money management responsibilities last September. And that was a difficult thing for George because they were so close. In fact, I'd watch them have a conversation. And neither of them would ever have to finish a sentence. They were that much on the same wavelength. So that hurt. And now we've had George's tragic death.

But lo and behold, we're not another South Florida. We've informed all our employees that nothing will change. Even under a worst case assumption — i.e., if every one of George's and Chris' accounts left — not a single person would be terminated.

OID: What about your married associates?

Rodriguez: And First Pacific Advisors (FPA) has been restructured. Operational responsibilities will be handled by Julio de Puzo as chief executive officer. And I'll be heading the investment side as chief investment officer.

OID: Congratulations.

Rodriguez: We've created a board of directors composed of four principals: Bill Sams, Chris Linden, Julio and myself.

And Eric Ende — who succeeded Chris Linden as chief investment officer of FPA Perennial Fund — has become chief investment officer of Source Capital Fund. He'll be responsible for Source's equity investments and will sign the letter. Eric worked closely with George for the past 13 years as senior analyst. And George expressed his confidence in Eric by giving him his own portfolios to manage during the height of the stock market festivities in 1987. And he's done a tremendous job — actually outperforming George.

OID: Remind us to edit that portion out.

Rodriguez: The numbers are there. But he's actually remarkably similar to George in his investment approach and the securities that he's selected over the years — even before joining our firm. And, incidentally, we believe the George Michaelis/Eric Ende style of investing is particularly appropriate in today's environment because it's historically outperformed the overall market during downturns.

OID: And now back to our interview...

Rodriguez: I'll also be responsible for the fixed income side assisted by Steve Romick. He officially joined us on March 1st — although he was actually working with us before that. And with him, he brought a balanced mutual fund called Crescent Fund and a small limited partnership. Steve started that fund. And it's had a very good record — albeit a relatively short one.

Actually, a couple of his ideas have already percolated into George's accounts and mine. He brings value to the firm in the classic sense in both stocks and bonds.

WHAT WE'RE LOOKING FOR IN OUR RETAILERS:
MARKET SHARE, GOODWILL AND PERCEIVED VALUE.

Rodriguez: And our growth plans haven't changed. Our equity staffing will continue to increase as assets grow. For example, three years ago, I brought in an assistant, Dennis Bryan, to help me. And he's done a wonderful job in the retail area — where we've been prospecting for the last two years.

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OID: What does "wonderful" mean — that you didn't lose very much?
Rodriguez: No. In fact, we earned a tidy return. We picked five retailers — three of whom are up 100% or more.

OID: Wow.
Rodriguez: However, two of them are still selling right around our cost.

OID: And you still think they're bargains?
Rodriguez: Absolutely. And I'd be happy to tell you about it. But first, let me get Dennis to tell you about our general approach to the retail area and about one that's literally been having a fire sale. And we've been taking advantage of that fire sale to add to our position.

OID: We're all ears.
Dennis Bryan: When I started looking at this area, I was looking at it purely from a valuation point of view. But Bob [Rodriguez] had a somewhat different perspective on the area than I did. He had greater insight and was looking at it with a macro view in mind, too.

OID: I'm sure the fact he's your boss played no part...
Bryan: So I've since come to see the importance of his thesis that the retailing industry is consolidating for a number of reasons — one of those being our society's changing demographics. In a nutshell, we're getting older. Women have gone from being 25 to 45 and don't need to buy as many dresses, skirts, blouses and so on. So that was the broader macro fundamental belief.

From there, our next step was trying to decipher which companies were going to survive and why: What characteristics are there in companies that have succeeded in the past and will succeed in the future? And we looked at a lot of companies. I know I looked at 75 companies or more myself.

Rodriguez: And including the ones that I looked at, we looked at twice that many at least. So we tore the area apart, boiled it down to a couple of fundamental insights and decided that there were several key characteristics that we should be looking for in companies we might buy — namely:

[1] a good market share or market representation;

[2] an eminently recognizable identity with positive associations in the mind of the consumer; and

[3] the perception in the mind of the consumer of delivering extremely good value.

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Bryan: In other words, they weren't only seen to be delivering a product with value, but that they were seen to be providing it at a good value, as well.

OID: It sounds like you were looking for companies with goodwill and price moats.
Rodriguez: Exactly. One that had a good image and a destination quality to it — because, as you know, when you go through a mall, there are so many small apparel retail concept stores that could disappear from the face of the earth and leave nearly no one missing them. Those aren't the ones we wanted.

Bryan: We basically wanted to avoid fashionable, faddish, trendy retailers that might look good today, but that might not be around two years from now.

Rodriguez: And a good example of that might be an Ann Taylor...

Bryan: Or a Merry Go Round — which was really hot in 1993 and went bankrupt in 1994.

So we try to find companies that dominate either a region or a marketplace, are a destination in themselves and have an identity with the consumer who has a compelling reason to be there.

REMARKABLE RETURNS CONSIDERING
— IN BOTH GOOD TIMES AND BAD.

Rodriguez: And that brings us to two ideas that we're buying today. The first is barely above what we've paid for it and is at a price level where we initially started buying it in October of '95 — and that's MacFrugal's. And the second is The Good Guys — both of which are selling today right around our average cost. And we think both are timely from a long-term perspective.

OID: To hell with timely. Are they bargains?
Rodriguez: Absolutely.

Bryan: MacFrugal's [MFI/NYSE] is in the closeout retail area. Its corporate name is actually MacFrugal's Bargains & Closeouts. Southern Californians are very familiar with this business as Pic 'N Save.

OID: This is the old Pic 'N Save?!
Bryan: Yeah. Unfortunately, they didn't trademark the name. And there's an operator in Florida and one or two other places with the right to use the Pic 'N Save name in their areas. So outside of Southern California, they use the name MacFrugal's Bargains & Closeouts.

OID: When did they change their corporate name?
Bryan: In the late '80s. They were expanding out to other parts of the country. And all of a sudden, they got sued by somebody in Florida. So they lost the lawsuit. And that's when they came up with the name MacFrugal's.

OID: Gotcha. Tell us about 'em.
Bryan: They buy closeout merchandise that other retailers and manufacturers don't want and sell it at prices which are substantially lower than you might see at a typical discount store like Target, Wal-Mart or K-Mart.

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For example, I used to buy my school supplies from a Pic 'N Save. There was one literally down the street from where I grew up. So I feel very familiar with the business.

OID: We only have 64 pages. So you'll have to save the reminiscing...

Bryan: MacFrugal's had been very profitable from the early '60s until the mid '80s. They used to have 25-30% operating margins and absolutely incredible cash flow generating capacity.

OID: Which Value Line shows quite clearly.

Bryan: But the family brought in their attorney to manage the business in 1986. And under his management, they began doing all kinds of stupid things. For example, they started to bring in merchandise that wasn't close out-oriented — everyday household goods, supplies and toys that you might see in a discount store — nothing that would differentiate them from K-Mart, Target, any other discounter or even a neighborhood convenience store, for that matter.

And it showed up in their results — operating margins took a big dive from 25-30% down to the low teens.

OID: Actually, it looks like this company earned incredible returns on equity — maybe 25% or so on average equity — up until 1988.

Bryan: Despite a business that was very poorly run.

OID: Very interesting.

Bryan: Now let's fast forward to 1990. A guy named Len Williams comes aboard. The company's somewhat in a state of disrepair. And he tries to stabilize the business. He's not a merchant, but he does a decent job of trying to improve the systems. For example, he brings in a CFO who, we understand, ran his own very successful close out company in Australia. And Williams brought in some new merchants, as well.

So he tried to stabilize the business by bringing in more professional management who really understood consumer needs and the marketplace. And he did a decent job considering the economic environment in California. But one can only do so much. You can't control the economy.

OID: You noticed.

Bryan: But as Buffett has said, some businesses don't need good management to have good results. And this is a classic example. It achieved good results despite mediocre management at best.

They even managed to sustain mid-teens ROEs and a 10-11% operating margin in the late '80s/early '90s through the terrible recession here in Southern California where 55-60% of their stores are located.

Rodriguez: And if a company can operate in a terrible environment with ineffectual management, then what could they do if the environment *and* management both improve?

OID: We'll let you know if and when that day comes.

NEW MANAGEMENT WITH AN OLD STRATEGY
— THE GOOD OLD VIRTUOUS CYCLE.

Bryan: Anyway, Len Williams retired in early 1995. And the CFO — Phil Carter — was named CEO. So there've been some recent management changes. But it's not like this guy came in cold. He worked with and helped Len. But Len was a very conservative man and didn't want to rock the boat, move people around and do the other things that were needed.

OID: Gotcha.

Bryan: But when we were talking to the new CEO and the new merchandising fellow there, you could see they wanted to get back to the original closeout business. When I started looking at this company back in 1993 when I joined the firm, I didn't hear that. At that time, they still wanted to do what they'd been doing — namely, running lots of seasonal goods — not close out type merchandise.

Rodriguez: Another factor is that they were managing by margin. They didn't want to take their discounts — their markdowns — which you have to do.

OID: In order to offer compelling bargains.

Isn't there a saying in the retail industry that your first markdown is your best one?

Rodriguez: Exactly. So they were running at 45-46% gross margins. And then they migrated upwards...

Bryan: To 50%.

Rodriguez: Because their expenses were rising. And because their expenses were rising, they wanted to earn a particular spread over expenses. So that dictated what their *gross* margin would be. In other words, they were managing exactly the opposite way.

OID: Instead of the virtuous cycle of lower expenses allowing them to offer lower prices leading to higher turnover and so forth, they were doing the reverse.

Rodriguez: You've got it. So Phil Carter comes in and wants to turn their direction around 180 degrees.

Bryan: He says, "We have to get our gross margin of 50-51% down to 44-45% in order to get more competitive."

Rodriguez: And then lower expenses accordingly so that they can maintain their margins. They want to drive their expenses down, lower their gross margin and thereby offer a more compelling value to their target consumer.

Bryan: Also, he was talking about not only becoming more competitive price-wise — again trying to add value for the consumer, but also bringing in new merchandise — getting rid of the old merchandise that had been around the stores or the warehouses for quite a number of years and bringing in new fresh closeout merchandise — be it electronic products or brand name household products that you might never have seen in the store in the past.

Rodriguez: Branded products reinforce their value image. If you see a branded product at a big discount, you think, "I've seen it elsewhere. It was so many dollars. And I can buy it at Pic 'N Save for a small fraction of that." So

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it emphasizes that they're a bargain, closeout retailer.

OID: Gotcha.

Rodriguez: And I can give you a personal anecdote in that regard. I recently bought a Braun electric razor there. The cheapest you can buy these things in the marketplace is $70-80. And I went into Pic 'N Save and paid $26. It's that kind of thing.

OID: How is their strategy the same and how is it different today than it was during the glory days?

Bryan: The strategy is the same in that they're buying closeouts now. They're waiting for opportunities to arise in the marketplace.

For example, Disney Stores had some memorabilia Waterford Crystal medallions engraved for the 25th or 30th anniversary of Disney World. Disney sold them in their stores for $50 a pop. And they did quite well. But they produced too many of them. MacFrugal's bought a truckload for $3.99 apiece and put them on sale in their stores for $9.99.

Well, you wouldn't have seen those medallions in a Pic 'N Save three to five years ago, whereas you would have seen them twelve years ago. So they're getting back to their original closeout, bargain, liquidators' strategy of taking merchandise that manufacturers and other retailers need to get rid of pronto.

OID: How is their strategy different?

Bryan: I would say that it's different in the sense that apparel is a lower percentage of their product mix. They're moving more towards hard goods — toys, electronics and household goods. It's just been very, very difficult for almost anyone to make a buck in apparel.

Rodriguez: With the discounters coming down in price level, the relative spread on some of this apparel merchandise has contracted.

Bryan: Back ten or twelve years ago, there were some T.J. Maxxes and some Marshall's, but you didn't really have the kind of dominance that a Ross Stores or a Marshall's or a T.J. Maxx does today on the apparel side. You really don't have an off-price hard goods retailer. So that's how it's different.

OID: Is part of Carter's strategy clustering stores?

Bryan: Most of their stores — about 55% of them — are located here in California. And one of the problems that the previous management ran into is clustering them *too* closely. Instead of putting them 6-8 miles apart, they got down to 3 and 4 miles apart — which was too close. So when they open up into new markets, they're going to continue to cluster, but not so close as to cannibalize their other stores.

Rodriguez: More in the 7-mile range.

OID: I get the impression that clustering is critical unless you're pursuing a single mega-store strategy.

Rodriguez: You can cluster in a region, but you don't have to sleep next to one another.

Bryan: These guys aren't opening one store in Atlanta, another in Chicago, another in Seattle...

Rodriguez: *God*, I hate that.

Bryan: They're opening up stores in the Chicago area. They're going to infill that market and slowly move down the Mississippi Valley to St. Louis and that whole area — most of which is prime territory.

Rodriguez: That area is *so* ready for MacFrugal's. Consumers in Alabama, Mississippi and that whole area are just *perfect* for MacFrugal's. I should know. I manage money for clients down there. And I spend a reasonable amount of time going through some of the backwoods. So there's plenty of good market opportunities.

OID: Back during their glory days, it looks like they were earning net profit margins of 12-16%. If your optimistic scenario comes to pass, what kind of net profit margins might you expect in the future?

Bryan: First of all, I don't expect them to ever again achieve net profit margins of 12-16%. They've changed their economic model slightly lowering their gross margin and their SG&A. But I would expect this company to eventually get their net profit margin up to between 6% and 7-1/2%.

OID: And your expectations for their returns on equity and capital?

Bryan: Eventually, I'd expect MacFrugal's to earn 16-18% on capital and maybe 20% on equity.

MACFRUGAL'S IS ALSO A PLAY ON CHAOS —
ONE FIRM'S PROBLEM IS THEIR OPPORTUNITY.

Rodriguez: What also attracted us to this investment is all of the chaos that's going on in retailing and what that implies for the manufacturer. It means overruns and retailers going bankrupt and leaving the manufacturer holding the goods without a place to deliver.

MacFrugal's is there with cash. And they bring their own trucks, pick up the merchandise and take it to their own warehouses. The manufacturer doesn't have to worry about it. As a result, this company is a way of participating in and playing on the breakdown, consolidation and dislocation of the retailing/manufacturing area.

OID: In other words, they benefit from chaos.

Rodriguez: Exactly. One person's problem is another's opportunity.

Bryan: They provide the liquidity to help someone with inventory problems. Let me give you an example: There was a retailer who had some Rubbermaid trash cans, baskets and things like that. Well, Rubbermaid changed the color of its product. And this big retailing chain had oodles and oodles of the wrong color Rubbermaid products. So they paid MacFrugal's to pick up truckloads of this stuff. And MacFrugal's got the product on the cheap.

On the other hand, they actually turned down a batch of Apple Computers two weeks ago — despite the fact that they were available at a very good price. Why? Because

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they didn't think that the consumer would pay what they'd have to sell them for at their store.

Rodriguez: The key to this company going forward — how it can become a big stock — is to reduce their costs, reduce their gross margin, maintain or improve their operating margin and, also, improve their working capital management. They were at approximately 1.7 inventory turns. Their goal is to move it up to 2-1/2 or, potentially, even 3 turns. That would free up tons of cash.

They're in the process of doing that right now. And we're already seeing the improvement.

OID: Speaking of management, you mentioned that Phil Carter had run the same kind of business in Australia and that he'd done it with some success.

Rodriguez: That's what we understand.

OID: How long and how well?

Rodriguez: It was for five or ten years. Then he sold the company for a profit and decided to come to the U.S.

And my understanding is that he did reasonably OK. Did he do exceptionally well? I can't say — because it was a private company.

OID: What's your sense?

Rodriguez: Well, our sense is that so far we like what he's doing. He's followed through so far on everything that he said he was going to do. And the strategy seems very reasonable.

Bryan: He has a systematic plan. And the plan is reasonable. It makes a lot of sense. And he's sticking to it. He's not going willy nilly in all of these different locations and managing by the seat of his pants.

Rodriguez: Exactly. And when he talks, it's not this touchy feely stuff that many retailers talk — you know, "the flow, the feel, the touch". A friend of mine told me a long time ago that most managements in retailing are nothing more than frustrated entertainers.

OID: That's funny. I'd heard exactly the same thing about money managers and newsletter editors...

Rodriguez: Plus, I should mention that they have a good staff of buyers that they've expanded and incentivized over the last couple years. And that is a key element here.

OID: Speaking of incentives, what can you tell us about insider ownership?

Rodriguez: Insiders own about 7% of MacFrugal's, although Phil Carter only controls about 75,000 shares. And only 10,000 of those are real stock. So his ownership is negligible today.

OID: That sounds like a negative.

Rodriguez: Certainly, I'd like to see him own more. And we'll look with interest when we get the new proxy statement to see if that's changed or not. It should be out around the middle of May.

MACFRUGAL'S HAD A MEMORABLE FIRE SALE.
AND WE TOOK ADVANTAGE TO STOCK UP.

OID: And the range of what you've paid?

Rodriguez: In typical FPA fashion, we started buying it at $15-1/8. And it went down and down and down.

OID: That happens to you, too?

Rodriguez: At September 30th, MacFrugal's was selling at $14 or $15 per share. Then in December, it closed around $11-3/4 or $12. At $11-1/2, we decided, "At this price, we'll buy every available share." And we did.

If you check the volume in December, you'll see that there were two days when it was extraordinarily high. During that two-day period, we bought somewhere between 1.1 and 1.4 million shares. And we took our position from 700-800 thousand shares at September 30th to roughly 2.1 million shares at December 31st.

And then, its stock had recovered up to around $16. But then they had a fire sale.

OID: A fire sale?

Rodriguez: I arrived in here at 6:30 in the morning and hadn't been here over 30 seconds when I get a call informing me that there's a major fire going on at MacFrugal's warehouse. So I watch its stock go down from $15-3/4 to $14-1/8 on zip volume. And we were familiar with the facility and we knew its relative importance. So we took advantage of the opportunity to acquire an additional 150,000 shares at an average price of $14-5/8. Our weighted average cost is now between $13-1/4 and $13-3/8 — which, again, is where it's selling today.

And believe it or not, MacFrugal's had another fire the very next day at that same distribution center.

OID: You're kidding.

Rodriguez: No, I'm not. An eyewitness told us that the distribution center literally blew up. There were flames 100 to 200 feet in the air.

We understand that the fire marshal told them that the original fire was out and that they could go back into the building. So they did. And they opened the windows to air it out and get the smoke out and turned on the computers and the air came flowing in, it reignited the fire.

And, unfortunately, the fire marshal had sent away several of the fire trucks. Also, because the fire trucks had been there to put out the original fire, the sprinkler system had been shut off. As a result, the roughly 300 people there just dropped everything and started running — like a scene out of the movie *Backdraft*. And the building's gone.

OID: Do they have any idea what caused the fire?

Rodriguez: I understand that they're investigating to see whether it was possibly arson.

OID: If it's motive the investigators are looking for, then it sounds like both of us should be suspects.

Rodriguez: That's true. Frankly, we looked at it as a gift. We only wish more of that kind of thing would pop up — human tragedy aside, of course.

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OID: Talk about an attitude of gratitude...

Rodriguez: Which brings the total number of shares that we own in MacFrugal's up to about 2.4 million.

OID: What are the investment implications of the fire, if any?

Rodriguez: Well, it's certainly one way for them to liquidate inventory.

OID: I'll thank you to leave the tasteless jokes to us...

Rodriguez: We've been on it since it happened. Dennis has been tracking down the reporter who covered the story in the *Times Picayune* — which is the leading newspaper in the area. And he's also tracking down the fire marshal along with several other people.

Bryan: Including the landlord.

Rodriguez: We're just trying to cover all of our bases to make sure that what we get from the company is being corroborated by other people. And, so far, we haven't found anything that would cause us to have any anxiety. In fact, we feel quite comfortable that we've taken advantage of the fire sale prices in the stock market.

Before the fires, we figured that if Carter's game plan worked, we saw no reason why they couldn't get back to a 20% return on equity. If so, then we figured that we were looking at a company down the road — whether it's one year, two years or three years — that could be earning in the neighborhood of $2-3 per share.

The fire probably capped that number for a brief time. But they then get a lot of cash in from insurance — which can help finance their working capital requirements and/or purchase additional shares in the market.

OID: You don't make it sound like much of a disaster for MacFrugal's — financially speaking, anyway.

Rodriguez: It wasn't serious. And because it happened in the largest parish down there, if incompetence on the part of the fire department turned out to be a factor, there'd be a deep pocket for the insurance company to sue. We were hoping that they'd close down this facility anyway and move it to a better location.

OID: And yet I understand a company press release says that they have the obligation to rebuild the plant and pay rent through sometime in 2009.

Rodriguez: That's true. But everything's negotiable. So all in all, the fire may keep the share price contained in here for a time. But in no way does it detract from the long-term reasons why we acquired it.

NO APPARENT PROBLEM WITH COMPETITION.
IN FACT, THE COMPETITION ISN'T EVEN APPARENT.

OID: So here's a company that's apparently continued to earn decent money at the trough of its cycle. But are they really a market leader?

Rodriguez: The best way to answer that is to go out on the street and ask a consumer, "What do you think of Pic 'N Save stores?"

And, first of all, you don't have to explain to 'em what a Pic 'N Save is. They have a consumer brand identity.

Bryan: People already have the image in their mind.

OID: What type of image?

Bryan: I think it's an image of a store where they can get really good bargains if they're willing to hunt around. It's a treasure hunt type of atmosphere.

Rodriguez: And they really do offer big bargains — which creates a different type of mentality.

Bryan: If you could have seen how excited Bob was to find his razor that cheap, you'd know what I mean.

OID: And there's no killer competitor either in their markets currently or on the horizon.

Rodriguez: No way.

Bryan: Quite the contrary. There aren't *enough* competitors really to keep 'em on their toes.

Rodriguez: There are a lot of mom-and-pop types — small, independent players.

Bryan: With 15-20 stores each. MacFrugal's has something like 320 stores.

Rodriguez: There's amazingly little competition. Effectively, there are only two public companies in the area — the other being Consolidated Stores in the Midwest.

Rodriguez: It's really a two-company horse race. And I even hesitate to use the term race — because they pretty much operate in different regions. That's considerably different than most other areas of retailing.

OID: Perhaps because, as one contributor recently pointed out to us, it's not a glamorous business.

Rodriguez: I think that's right. It's a doggy business. You go into the stores and trip on their merchandise. And in the morning, they look OK. But by the middle of the afternoon, it looks like 10,000 small children have gone in and mixed up the shelves. So they have to redo it again.

You're talking about linoleum floors, no amenities whatsoever and shelving full of merchandise. People go there for one reason and one reason only — to buy something really, really cheap.

OID: One of the best possible reasons, I'd say.

Rodriguez: But it's also an image of a store that's kind of run down, unkempt and so forth. And they aren't exactly targeting high-end customers.

OID: Nothing wrong with that — like the old saying, "Live with the classes by serving the masses."

Rodriguez: Exactly. All you have to do is look at the cash flows on this thing to see that — done properly — they can generate nice returns on assets and equity.

Bryan: And with size comes advantage. For example, when Wal-Mart wants to blow out of its Rubbermaid trash cans, they can't dump it to some guy with only ten stores. They may have $10 million worth of inventory to unload.

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The guy with only 10 stores may be very lucky to generate $7-8 million of total sales for the whole *year*. MacFrugal's has the cash flow to buy the merchandise and the volumes to move it. Therefore, they can accept that phone call and take in all of that inventory. Most small guys can't.

OID: So MacFrugal's — far from being in the path of Wal-Mart — actually counts it among its customers.

Bryan: I don't view Wal-Mart as a threat. And I don't know whether Wall Street does or not. But when we were buying Ross Stores, the biggest competitive threat that everyone was telling us about was outlet centers.

OID: Based on your laughter, I gather you think that was an absurdity.

Bryan: Absolutely. They were worried about people driving 80 miles to outlet centers.

Rodriguez: We just don't see Wal-Mart as a threat. Wal-Mart is an everyday low-price store in the middle-to-lower middle market segment of the buying public. It isn't a treasure hunt-type store.

THEY HAVE A LONG WAY TO GO
TO GET BACK TO WHERE THEY WERE.

OID: So what could turn MacFrugal's into a mistake?

Rodriguez: The biggest thing that we worry about is merchandising. The operational side of the company looks very solid. Controls look great. Inventory management is improving. The inventory at the store level got too high under the prior management — and they're bringing it down now. All of that looks good.

But merchandising is the key.

Bryan: The leverage in this business is in comp store sales — i.e., sales at stores that have been open for more than a year — because there isn't a proportional increase in expenses. Today, MacFrugal's revenues are running at roughly a $700 million run rate. We believe they can achieve a 4% comp store sales gain. In fact, it seems particularly reasonable considering the fact that they're already seeing 5-7% gains in hard goods sales.

Rodriguez: But let's just say they achieve *4%* gains. If we apply a 45% gross margin on that, we'd be talking about additional pretax profits of nearly $13 million. There are 25-1/2 million shares outstanding. So we're talking about 50¢ of incremental profit pretax — or 30¢ after-tax. And absent any negative fallout from their recent fires, their earnings could easily be $1.70 to $1.75 *this* year.

OID: Which would be a mid-to-high teens ROE.

Bryan: Of course, you could say merchandising is the key for *every* retailer. So far, the new strategy of carrying branded items is moving through the stores. I keep a file of the circulars that are going out. And you can see the merchandise mix change as new products come in.

Every two weeks, they send out a circular to their customers to tell them what new products have been brought into the store. And the progression in the quality of the merchandise is obvious.

Rodriguez: And we're starting to see preliminary numbers coming out for comp store sales being impacted by the newer products. There's still a transition phase, mind you, in progress...

Bryan: Although that may have just burned up. Instead of being three or four months away from a turn in comp store sales, they may be over the hump right now.

OID: I presume that there was no history of warehouse fires in Australia...

Rodriguez: Over the course of the next year, we expect to see even more of the new product merchandise flowing through. And that should get translated into higher comp store sales figures.

OID: And that's what you're hoping for.

Bryan: What we're hoping for is for these guys to put together a consistent plan — where their comp store sales don't jump around like crazy, but rather show a persistent gain year after year. Certainly, there will be years where there'll be spikes for one reason or another that's out of their control — or because they hit the sweet spot, so to speak, and they're up 10% or something of the sort. But I'm just hoping for consistent 4-5% comp store sales gains.

Rodriguez: Their stores are still a little bit in a problem state. They have too many SKUs.

OID: SKUs?

Rodriguez: Stock keeping units. A 19-inch TV is one stock keeping unit. They have too many different kinds of inventory. However, that's in the process of being corrected. And as they reduce their SKUs, store productivity also increases.

Bryan: I want to point out that the company did take a $35 million non-cash charge to write down their inventory in November of '95...

Rodriguez: To clean out some of their FISH inventory — you know, "First In, Still Here".

OID: Which suggests that they're recognizing the problem and dealing with it.

Rodriguez: Bingo.

Bryan: You've got it. So they have a long way to go before they get back to where they were. But I think a 4-5% per year comp store sales gain is a reasonable assumption.

EVERYTHING THAT *CAN* GO WRONG ALREADY *HAS*.
SO THE RISK/REWARD RATIO IS STACKED.

Rodriguez: Although there could be some negative short-term impact from the warehouse fire that just occurred — because they're going to have to go out and replace some of their inventory that was destroyed. And that means they'll probably have to pay higher prices than they otherwise might have to get faster delivery. So their gross margins will likely take a hit for a few quarters.

OID: So the fire may be a short-term negative.

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Rodriguez: That's right. But offsetting that hit to a degree we can't predict is 400 fewer employees they'll have on the payroll. That should cut down on SG&A expense. And, in all likelihood, their higher freight charges to move merchandise from California to their other stores should be covered by business interruption insurance.

In essence, our estimates are in a state of flux because we just don't know the magnitude or timing of some of these items.

OID: In other words, you don't know.

Bryan: Maybe not. But what we do know is that this company has had just about everything go wrong — that they've had the economy go against them, they've had their merchandising strategy blow up in their face — *everything*.

Could things get worse? Sure. Maybe competition does get stronger. It's possible. But when I'm buying something at 50% of sales — and *depressed* sales at that — and still seeing the kind of profitability they're achieving, I figure my downside risk is fairly small and my margin of safety is quite large.

Only two or three people follow this company today. In fact, in IBES, there's only one earnings guestimate for them for their fiscal year ending January 1998. However, if they get their earnings and their returns back up to where we think they can, then Wall Street will rediscover this stock.

Rodriguez: So we've bought MacFrugal's aggressively.

Bryan: At slightly over 10 times depressed earnings, 1-1/2 times book and 50% of sales.

OID: That sounds mighty cheap, all right.

Bryan: And if they do what we expect — if they earn the $2.50-3.00 per share that we think they can — and the market puts a P/E multiple of only 10 on it, then we have a $30 stock.

Rodriguez: Over a couple of years holding period, it wouldn't surprise us to walk away with at least a double — and possibly something more — in the share price. That's over the long term, of course. Short term, who knows. The largest shareholder in the company may still be Fidelity. They reported ownership of 3.1 million shares as of

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September 30th, 1995 and they sold some of their stock in the fourth quarter. Maybe they'll decide to sell some more — I have no idea. But if they ever decide to punt and run, they could definitely cause some short-run damage.

OID: You noticed that, too?

Rodriguez: On the other hand, MacFrugal's was in the market within the last few weeks buying stock. And they could take a good 30% of what Fidelity could potentially sell. However, clearly, Fidelity could impact the share price short term.

OID: MacFrugal's share shrinkage is very impressive. It looks like they've actually shrunk their shares outstanding by nearly 50% in the past twelve years.

Rodriguez: And they're in the process of buying back nearly two million shares right now.

OID: Starting from the 25.5-odd million shares that they have outstanding today?

Rodriguez: Yeah. And that cap shrinkage is another reason why we like it.

So MacFrugal's is just starting to move up. And people are starting to say radical things like, "My God! California isn't dead. It isn't going to fall into the ocean."

OID: There's no need to jump to conclusions...

Rodriguez: For example, Merrill Lynch just issued a recommendation on McLatchy Newspapers. And one reason why they're positive is that California's turning around.

OID: That kind of talk doesn't surprise me. Lots of people invest in communist countries these days...

Rodriguez: I'm not talking about Santa Monica. But my point is that besides everything else, MacFrugal's is also, in effect, a play on the California recovery.

A GOING-OUT-OF-BUSINESS STOCK PRICE
FOR A COMPANY THAT'S BEEN TESTED.

OID: Any other bargains you can tell us about?

Rodriguez: One that's basically flat on its bottom — both in terms of financial ratios such as price to book and trailing P/E and in terms of market cap to revenues — is The Good Guys [GGUY/NASDAQ]. Its book value is almost $10.50 per share. And it's selling at $9-1/8.

They'll do over $1 billion in revenues this fiscal year. And yet it has only a little over $100 million of market cap. You don't see things get much cheaper than that.

OID: Unless I own 'em, certainly...

Rodriguez: For this price to be reasonable — for the valuation to be correct — this company would essentially have to be going out of business. And that's hard for me to imagine — especially when their franchise is quite solid and they don't have any debt on their balance sheet. Much of their inventory is basically provided by manufacturers with what amounts to interest-free loans.

So the only debt that they have at all is their leases. And if you were to capitalize all of them, The Good Guys

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would still only be at about 56% debt to total capital — which is low for retailers.

OID: Everything's relative.
And, as I recall, this isn't some dog either...

Rodriguez: Not at all. In fact, Wall Street was hyperenthusiastic about this company in '91. At the time, they bid it up to $30 per share — or nearly 5 times book, 30-35 times earnings and 1 times revenue. Fully diluted, it had something like 12-1/2 million shares outstanding. So The Good Guys' market cap approached $375 million. Wall Street just *loved* it.

OID: What accounts for the apparent sea change in investors' perception?

Rodriguez: As you know, I like to look at what a company does in a bad period. Well, The Good Guys has been in just such a period since 1992. They made the mistake of expanding from Northern California into Southern California just as the California economy — and especially the Southern California economy — experienced a severe downturn. So they got hit by that.

However, even with that expansion and the downturn in California, they were still able to earn a profit. Their same store sales increase hit its low point at 0%. That was in fiscal 1993. And that was with everything going wrong.

OID: Sounds impressive.

Rodriguez: So even with everything going wrong, they still managed to continue earning a profit. And their low point in earnings was at 29¢ per share in 1992.

So if they can go through a major expansion, the worst recession in 70 years and *still* earn money, then they're probably doing a few things right.

Plus, it's an even clearer play on the recovery of California than MacFrugal's, although it probably does have more risks.

OID: And you're buying it at today's prices.

Rodriguez: And higher — absolutely. In fact, we've paid all the way up to $11-1/2 per share and all the way down to $7-7/8. And, again, it sells for $9-1/8 today.

OID: Then we're all ears.

I UNDERESTIMATED THE NEGATIVE IMPACT
THAT BEST BUY WOULD HAVE ON PRICING.

Rodriguez: I started following The Good Guys in 1991. However, at that time, I thought it was a little rich. So I didn't start accumulating the stock until 1993 — with my first purchases right around $11-1/2 per share.

Then we got a run in late 1994 — into the $17 range. And I was really debating what we should do. But I tend to think in terms of investing in companies for long periods — and California hadn't really started to turn. And it was my expectation that California would be a very attractive geographic region in which to have capital deployed over the next decade even though most people at that time felt otherwise — worrying about tax rates, infrastructure and a host of other problems.

OID: No doubt including a socialist government, plague, famine, pestilence, floods, earthquakes and a criminal justice system run amok. Imagine that.

Rodriguez: My expectation was and is that California will be a dynamic entity over the course of the next decade. Plus, you don't get the big home runs by selling a stock at $17 that you bought at $11. And I felt like The Good Guys' earning power hadn't really come through yet. So I held on.

OID: Generally the best action.

Rodriguez: That's very true — but not this time. I knew Best Buy was coming into California. I'd followed them for some time and I'd watched the various types of concept stores they'd developed and how they'd changed their company over the years. So I realized their entry into California would disrupt pricing to some extent. However, where I made my mistake was not appreciating how much.

I figured California would be expanding by that time and that we'd have a few more competitors falling out — which we did. Silo went bankrupt — taking 20-25 stores out of the L.A. basin. Pacific Stereo went under. And there were others. So I thought that Best Buy would come in, other players would fall out, the market would be expanding and that there'd be room for three players — Circuit City, Best Buy and The Good Guys.

Frankly, I underestimated the negative impact that Best Buy would have and how they would destroy pricing.

OID: How much of that disruption do you believe was Best Buy's entry rather than the severe downturn in California, the competitive response by Circuit City and/or less than perfect execution by The Good Guys?

Rodriguez: The Good Guys was in the process of expanding and getting back up to north of $1 per share of earning power last year. Then, Best Buy comes in, really hurts pricing and The Good Guys suffers a contraction in margins and a flattening out of their earnings. And the California economy was actually improving at that point. So I really do believe Best Buy had a significant impact on The Good Guys' profitability.

FORTUNATELY, BEST BUY MAY BE CHANGING.
AND ANY CHANGE WOULD BE AN IMPROVEMENT.

OID: So The Good Guys is going to face a brutally competitive market whenever Best Buy has access to equity markets?

Rodriguez: Not necessarily. That has been the situation. However, something seems to be changing. Just recently, Best Buy has started to change its compensation — instituting commission payouts. And they're reviewing how they're pricing long-term warranties that they were discounting massively only six months ago or less.

Also, Best Buy's balance sheet is extremely leveraged. And not long ago, they were asking for extensions of terms from their suppliers. Those aren't good signs.

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OID: For Best Buy, anyway — certainly.

Rodriguez: I'm not suggesting that Best Buy is going to go under tomorrow or anything like that. However, what it does suggest to me is that Best Buy is going to have to contract their expansion plans and reevaluate how they're going to manage the boxes they've brought into California and a few other places — because what they're doing today doesn't appear to be working.

And if there's any alleviation of that pricing strategy, one of the prime beneficiaries would be The Good Guys.

OID: Also, it looks like Best Buy's gross margins have taken a pounding — dropping from the 25% range down to more like 15%.

Rodriguez: And I'd argue that their marginal return on capital has been *negative*.

OID: And, interestingly, their spurts in store count look as though they've consistently occurred immediately after they've been able to issue stock.

Rodriguez: Wall Street has basically financed all of Best Buy's growth. And when they were introducing their Concept 3 store — which is their big one — the stock was around $14. I'd seen it back in Minneapolis and I talked to them about it. And I had serious reservations about whether the box was going to work.

Well, Wall Street financed them with tons of capital. And Best Buy's stock went from $17 to around $40 or 41. And they were able to issue more and more stock and some debt and that sort of thing. Now the stock's at $19 and there are a lot more reservations about its prospects.

And those reservations look very well founded to me. Very few dollars are staying in the store. They're just moving merchandise without managing to keep any profit. A perfect example is their software area. They're selling many of their music CDs at a net loss as a traffic builder to get people in the store. And I just don't think that's a good long-term strategy.

OID: And you believe that Best Buy may soon begin to pay more attention to profitability.

Rodriguez: That's right. And even more to the point, if they change, I would argue that almost any change that they make would have a positive impact on The Good Guys.

OID: In other words, they're as bad as they can be right now.

Rodriguez: Exactly. I think it's about as bad as it can get.

OID: Talk about viewing the glass as half full...

Rodriguez: There were even rumors recently about Best Buy being acquired by Sears. And my guess is that Sears would probably operate it with more of an eye towards profitability than Best Buy has in the past. So there were rumors to that effect floating around, although I have no idea how true they are.

OID: You heard the rumor or you called Sears yourself?

Rodriguez: No comment.

OID: As I suspected...

Rodriguez: It's not 100% Best Buy's entry, however, because I did think that The Good Guys would be somewhat better insulated from any fallout because of a much richer SKU count, its higher price point SKU and vendors that Best Buy just doesn't have. For example, The Good Guys will run about 4,500 SKUs, whereas a Best Buy might only run about 2,500 in the hard goods area — even though it's a larger box.

For example, in large-screen TVs, a Best Buy might have four or five models to choose from. On the other hand, a Good Guys might have more like 21 to 25.

OID: Wow.

Rodriguez: So they're both broader and deeper — broader meaning that they have a wider selection of manufacturers and deeper meaning that they have a wider cross section of models to choose from within each manufacturers' line.

A perfect example is that one of the larger sellers in the large-screen area is Mitsubishi. And they won't sell to a Best Buy.

OID: But they do sell to Circuit City?

Rodriguez: Circuit City and The Good Guys.

OID: Why don't they sell to Best Buy?

Rodriguez: I'm not sure. But it could be because Best Buy generally has a problem moving the consumer up to a more enriched product brand because some of the richer electronic goods need explanation. And the type of salesperson they have doesn't provide that as a usual and customary service.

OID: Best Buy staffs up with New Yorkers?!

Rodriguez: They don't have as many salespeople as The Good Guys — particularly on a per square foot basis. And the ones they do have typically aren't as well trained.

A NEW CONCEPT: THE WOW! STORE. AND SO FAR, AT LEAST, IT MAY BE A WOW!

OID: Yet, notwithstanding everything that's been said about Best Buy, I see its ROE has actually been higher than The Good Guys' ROE for the last several years.

Rodriguez: Given The Good Guys' high exposure to the California economy, that should come as no surprise. Prior to 1993, their returns were actually *very* good.

I'm very impressed with companies that can earn money in just really down-and-out lousy environments.

OID: Actually, I'm just impressed with companies that can earn money — period.

Rodriguez: I also like the fact that [The Good Guys Chairman] Bob Gunst was willing to put their expansion on hold when he saw the extent of the California recession in the early 1990s, And he admits he wasn't sure how it would impact them.

However, now that he's gone through the experience of Best Buy's entry and expansion in California and he

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feels like his home court is protected and his cash flows and the opportunities are there, he feels like it's time to restart their expansion.

OID: Whether they're earning decent returns already or not.

Rodriguez: The time to accelerate your expansion is when your competitor is unable or unlikely to respond. Therefore, The Good Guys is expanding outside California. They just recently moved up into the Pacific Northwest. Plus, they're experimenting with a new concept store that just opened last August in Las Vegas...

OID: Save the negatives for last.

Rodriguez: I don't view it as a *negative.* Far from it. I visited it in the last few weeks. It's called The Wow! Store.

OID: Clever name.

Rodriguez: And it *is* kind of a Wow! store. It's a unique concept in that the store encompasses two independent companies: Tower Records and The Good Guys. Tower Records specializes in music CDs, software and books. And it just so happens that the president of Tower — Russell Solomon — is on the board of The Good Guys.

OID: I suppose you're grateful he wasn't a dentist...

Rodriguez: So they combined these two companies that have strengths and put them together into a store. And when you walk into a Wow! Store, you can literally see everything from the front door. You have a panoramic view of everything. And let's say that you pick up some music CDs in the Tower Records' section. You can go over to The Good Guys' section to look at stereo headphones or something like that and be cashed out by a Good Guys salesperson. Conversely, you can pick up some headphones at The Good Guys and then get cashed out at the Tower Records' section. Then, at the end of the day, all of those transactions get separated.

OID: Fascinating.

Rodriguez: There hasn't been a successful retailer yet who's merged hard goods with what I'd call soft goods — or software.

OID: Although both Best Buy and The Good Guys seem to both be trying — each in their own way.

Rodriguez: They just may be the first to pull it off. One store does not a trend make. They'll be opening a second store in the Long Beach area here in September. And over the next two years, they plan to roll out approximately ten of these Wow! stores.

They take a lot more square footage. And given that they're working with two different companies, they have to coordinate each other's capital budgets, cash flows, etc.

OID: What's their experience been so far?

Rodriguez: When I talked with the manager of the one Wow! Store that they have up and running today, he said, "It's a 'wow'!"

OID: Naturally.

Rodriguez: I hate to use that, but it's true. Actually, there's one manager for the Tower Records section and another for The Good Guys section. And this guy was responsible for opening and managing the combined store. And he must have done a good job because Good Guys Chairman Bob Gunst told me he was just promoted to head the Pacific Northwest region.

OID: Certainly sounds like a good sign.

Rodriguez: Absolutely. So there is movement.

A BLOCKBUSTER PRODUCT IS OVERDUE, BUT SEVERAL ARE ON THE HORIZON.

Rodriguez: Also, it's been several years since we've seen any big electronic home runs — whether it's a VCR or a video camera or whatever. And when some of these major product areas come onstream, they tend to drive other areas of electronic retailing. So we've been missing that.

The second thing that's hurt the business, I believe, is that the hypergrowth of PCs in the last two years has taken part of the consumers' dollar from what they would normally have spent on electronic goods and moved it into the PC area. And that's driven down profit margins — because the gross profit margin on PCs is considerably less than that of other electronic goods.

OID: The Good Guys sells computers, too?

Rodriguez: Yeah. And the negative impact that PCs have had on profit margins the last few months has been quite severe. In fact, I was talking to Bob Gunst about it. And remember when we talked about how your first markdown is your best one?

OID: I do.

Rodriguez: Well, they were doing that on their PCs. And he says that the new computers they were putting in the stores were actually selling for less than the closeout price on their old units. So they had to blow those out. And that hurt margins considerably.

Incidentally, their PCs are typically sold to first-time purchasers who find that type of a store less threatening than going into a dedicated computer store.

So there's been a negative impact on margins because of that and, probably, because of the consumers' allocation of their dollars.

OID: The commie bastards.

Rodriguez: However, going forward, looking out over the course of the next three to five years, several potential new product offerings could positively impact the electronics environment in a material way. One of those could be digital video — DVD — which is coming onstream within the next eight months and could supplant the VCR, although it will take time to evolve into the marketplace. Another is TVs with substantially improved quality.

OID: Digital television?

Rodriguez: Digital television. And as the consumer

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gets more computer friendly, there's the likelihood that more and more of these electronic goods will get connected in their houses and interlinked. I think we're on the verge of something like that. I can attest to that because I'm working on something like that in my own home.

OID: You and Bill Gates.
But what you're saying is that consumers will soon be wanting computer-compatible appliances.

Rodriguez: Electronic goods, etc. Plus, the industry's been consolidating. Eight to ten years ago, there were probably 15 or 20 different public companies in this area. Now we're down to only *five*.

And the two largest are Circuit City — which has done a wonderful job nationwide — and Best Buy about which, I believe, there remain serious questions. But then comes The Good Guys.

CIRCUIT CITY HAS EXECUTED BETTER,
BUT I LIKE THE GOOD GUYS' STRATEGY JUST FINE.

OID: Incidentally, I believe it was George Michaelis who first introduced us to Circuit City in 1991.

Rodriguez: Actually, he and I were accumulating it at exactly the same time. We both started buying it totally independent of one another. And neither of us knew that the other was buying it until one day we met up in the trading department.

OID: You can carry this confidentiality thing too far, you know...

Rodriguez: Circuit City has split 2 for 1 since then. However, on the pre-split stock, we started in at $13 per share and scaled all the way down to the bottom — which was around $9-1/2 — and just started buying the hell out of it.

OID: Actually, it was $9. But who's counting.

Rodriguez: We bought a lot of stock and made a really nice return on it.

OID: Where did you sell it? I see that it got up to $34 in 1993 — which would have been $68 pre-split.

Rodriguez: I sold in the low $30s on a pre-split basis. And I left a lot of money on the table. George sold some and also repurchased some and held it. And Source still owns some today. It's been quite a roller coaster ride.

OID: Maybe so. But with a 25%+ compound in sales and earnings for the past ten years and long beyond, it's been a mighty rewarding one, too.

Rodriguez: No question about that.

OID: You mentioned that Circuit City has done a wonderful job. I gather that you're comfortable that The Good Guys can hold up competitively.

Rodriguez: To be honest, I originally thought that The Good Guys was a somewhat better company. However, Circuit City really did far better operationally than I would have thought three years ago.

So I've been wrong about Circuit City. And maybe I'll be wrong about The Good Guys, too. Maybe they've lost their edge and their knack for the business. But at current price levels, there appears to be a considerable margin of safety.

OID: I get the impression that The Good Guys has a lot more operating leverage than Circuit City.

Rodriguez: I think that's right.

OID: And you mentioned that The Good Guys stocks a lot more SKUs than Best Buy. Do they also stock more than Circuit City?

Rodriguez: They do. Circuit City's SKU count is considerably higher than Best Buy. But Circuit City has SKU areas that The Good Guys doesn't have. For example, they have a large component allocated to hard goods such as refrigerators, washing machines and that type of thing.

OID: That doesn't sound very focused.

Rodriguez: Maybe not. However, it does attract another consumer into the store. And maybe that balances things out a little more. Circuit City has also been offering its own finance card. So there may be an element of financial spread in their income which helps to stabilize returns, but also exposes them to elements of credit risk.

OID: All of which makes The Good Guys sound like a more focused play on rising standards of living, higher discretionary income, etc.

Rodriguez: It's certainly a more *leveraged* play.

OID: And, as I recall, they've generally had better inventory turnover than either Best Buy or Circuit City — although it looks like Best Buy has closed that gap in the last three or four years — albeit apparently at the expense of their margins.

Rodriguez: Yeah. The Good Guys has been pretty consistent on inventory turns at 6 to 6-1/2 or thereabouts.

OID: And even higher, it appears, pre-1988.

THANKS TO THEIR KEEN ANALYTICAL INSIGHT,
SHARE REPURCHASES HAVE BEGUN.

OID: But given all of that, what accounts for the absence of insider buying or any shrinkage in shares outstanding?

Rodriguez: I was wondering if you were going to ask that question. I called up Bob Gunst about three weeks ago. There was a large block of stock — 350,000 shares — available with the stock trading around $7-3/8. And I debated with myself, "The company should buy that block — or at least a portion of it. Well, before I suggest that, *I* better buy it." So I bought 350,000 shares at $7-3/8.

And as soon as I bought it, I called up Bob and said, "I just bought in 350,000 shares. There may be more stock out there. Let me run down a few things with you: Given your capital expenditure budget for the coming year, it sure looks like you're gonna generate positive cash flow."

He said, "That's correct."

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I said, "You have no debt on your balance sheet — funded debt."

"Correct."

I said, "With your stock at these levels, tell me why you shouldn't be buying in your stock. Why shouldn't you be buying in your stock from stupid, fearful, ill-informed investors?"

OID: Just because their stock cratered doesn't mean that I necessarily own it. It may be a good indication, mind you. But...

Rodriguez: So he says, "We *should*." So I say, "Then why aren't you?" And he says, "Because we don't have a board resolution yet. And one member of the board has been very much against stock buybacks for a long time."

And I said, "Yeah. But isn't he moving off the board?"

He says, "Correct."

And I say, "Bob, based on my calculations, it looks to me like you could *easily* fund a buyback of 500,000 shares at say $9 per share. That would be $4.5 million — which wouldn't be any kind of a real dent in your cash flow even if the environment were to turn worse due to a recession or your profitability were to otherwise get eroded. You'd still have flexibility on your capital expenditure plan. It wouldn't create a real stress on your balance sheet. And yet the stock is really depressed down in here."

So he says, "Your arguments are all well founded and we'll take them under advisement."

OID: Which, usually, very loosely translated means, "Get lost."

Rodriguez: But not in this case. One week later, they issue a press release. They announce they'll buy back 500,000 shares of stock and that they've purchased stock within the last few weeks. How much, I don't know. That will be disclosed when their quarterly results are released.

OID: I find it amusing that they authorized the precise number of shares you suggested.

Rodriguez: Actually, I saw the announcement. And he called me as it was coming over the tape and said, "Through our keen analytical insight and all, we've seen fit to duly purchase back half a million shares."

OID: That's funny.

Rodriguez: So they are buying back their stock. And if their cash flows continue the same or better than at present and given their current capital expenditure plans, if they complete the 500,000 share repurchase that's been authorized and their stock is still sitting here below $10, I'd guess that they'd come back and buy *more* stock.

OID: I get the impression that you have an influence on your managements.

Rodriguez: Not really. I just point out the obvious.

OID: Never underestimate the importance of seeing the obvious.

THE GOOD GUYS IS ONE OF THE SURVIVORS.
SO THEY MUST BE DOING SOMETHING RIGHT.

OID: But why has The Good Guys taken such a big hit in the last few months? There's often a good reason...

Rodriguez: Because people are realizing that their profitability is under pressure.

OID: And, therefore, bad comparisons are on the way.

Rodriguez: Exactly — and, therefore, that their margins won't be expanding in the near term.

So I'm expecting their earnings to decline — that they'll earn something in the 80-90¢ range this year. And, of course, I hope I'm wrong. But that's what I'm expecting.

OID: Despite California's apparently improving economic prospects.

Rodriguez: Let's just say that I think I have more potential for good surprises than bad ones.

OID: Whether management agrees or not. Didn't their founder just bail out?

Rodriguez: I understand that their founder was involved with a radio station in San Francisco. And he'd been selling stock to fund it and other personal interests since the early '90s — and not necessarily at the top. So he just left the company. And I don't think you can conclude anything from that aside from the fact that his interests are now elsewhere.

OID: How would you assess normalized net profit margins, earnings and returns for The Good Guys?

Rodriguez: I wish I knew. In fact, I think Bob Gunst would like to know, too.

OID: It looks like they had net profit margins of 2%+ and ROEs of 14-21% from 1987 to 1991.

Rodriguez: I'm hoping that they can get back to that level. When your operating profit goes from $45-50 per square foot down to $25, it doesn't take a lot of change to have a huge impact on your bottom line. So this is a very leveraged play in terms of its operating profitability.

OID: What could turn The Good Guys into a mistake?

Rodriguez: One would be expanding too rapidly. Another would be if California stays in the dumps economically for a long, long time.

OID: Or Best Buy doesn't change, gets access to huge amounts of capital and sets up shop on every corner.

Rodriguez: That might do it too. Also, because it's leveraged as much as it is on the operating side, I want to make sure that it's not leveraged on the financial side.

OID: Because there's enough risk as it is.

Rodriguez: Yeah.

OID: How much are the interests of The Good Guys' management aligned with those of shareholders?

Rodriguez: Bob Gunst has purchased some stock on his own. Plus, he has options. All told, he controls about 370,000 shares — or 2.7% of the outstanding shares. And

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recently a couple of other insiders began buying shares.

OID: How did Bob Gunst become chairman?

Rodriguez: He was their CFO/COO. So when Ron Unkefer phased out about five years ago, he took over the reins.

OID: So that another risk might be that...

Rodriguez: The glory days are a function of Unkefer and the poor days a function of Gunst? Almost anything is possible. However, it doesn't look that way to me. Bob seems like a very levelheaded executive. He's always been cautious and mindful of his downside — which makes me more comfortable than I would be otherwise.

However, there isn't any question that from an operational/management standpoint, it does look like Circuit City has executed better. On the other hand, look at how many other retail consumer electronics chains have gone bankrupt. So Bob Gunst and The Good Guys must be doing *something* right.

OID: They certainly look like it. Even during the last five years, they've still managed to grow sales and cash flow per share 19.5% and 15.0% per year, respectively, although earnings have lagged a bit at 11.5%.

Rodriguez: You've got it. So here are a couple of companies in pretty difficult environments. We'll see where they go. But both of them have common attributes that we've looked for in other retailers and other companies in general.

NEVER UNDERESTIMATE THE IMPORTANCE
(OR VALUE) OF BEING ONE OF THE SURVIVORS.

OID: I gather that MacFrugal's moat is size and goodwill. But where is The Good Guys' moat?

Rodriguez: Buffett talks about companies with moats. However, there are actually very few of them out there. And if you do find one today, they tend to be egregiously overpriced. He may love Coca-Cola. However, I have a serious problem with its valuation.

And many moats that people think companies have turn out not to be there when they're most needed.

OID: As one of our contributors observes, you don't know they're there until they've really been tested.

Rodriguez: I don't believe The Good Guys has a moat. But, again, they must be doing something right because they're one of the survivors. And if you can be in a knockdown, drag-out fight and still be standing when it's over when the next cycle hits, you'll be one of those who reaps the profits.

If we were sitting here back in 1983 talking about Green Tree — which was just on the verge of going public through Smith Barney — they would have been a profitable company. However, you'd have also seen a lot of competitors in the financing of manufactured housing. And that was the case in the 1970s.

Lo and behold, along comes the agricultural recession, the industrial recession and the energy recession — actually make that depression because it was so bad. And all of those things hit so hard that they virtually wiped out everyone who was a manufactured housing financier. But Green Tree was still left standing. So when the industry hit a 29-year low in 1990, Green Tree was still around. And when the cycle turned, they just coined money by expanding their market share.

OID: Which, I gather, helps explain why revenues have quintupled in the last five years.

Rodriguez: But here we are today — six years later. And several companies are identifying this area as one ripe for attack. Even a couple of the second tier troops from Green Tree have left the company, gone to New Orleans and set up a small company in this area. So people are coming back in and there probably will be some pressures.

But Green Tree has a moat because they have so much liquidity in their asset-backed securitizations.

OID: And as you describe in the case of NIKE, Reebok and MacFrugal's, the moat is to a very large degree size-based.

Rodriguez: That's right. Size is often a moat. But is it a permanent moat? No.

And, most important, they were all left standing. I just really believe that if you can be in a lousy business environment and be one of the survivors and that environment shows any type of improvement in terms of volume and/or margins, you're there to catch the profit.

OID: To the survivors go the spoils.

Rodriguez: Exactly. It's like going through a terrible stock market. Many people were completely decimated on the downside in '74 and so psychologically damaged that they couldn't bring themselves to invest in '75, '76 and '77. However, those who were left standing and were able to maintain their psychological wherewithal were able to basically coin money on the other side.

I think that situation's analogous to many businesses. Too many times, people get all caught up in thinking, "Oh, this company is so great." or "That company is so great." I'm just not smart enough to figure some of those things out.

OID: As always, feel free to call anytime.

Rodriguez: I just want to know whether I'm with a company that's going to be left standing after the donnybrook. And if they are, we probably have a better than even chance to be financially successful. But it takes a hell of a lot of time and patience. And there's no way that you can forecast when it's going to occur.

OID: You noticed.

And I understand exactly what you mean.

CORPORATE RETURNS ARE UNSUSTAINABLY HIGH.
SO P/Es MAY BE HIGHER THAN THEY APPEAR.

OID: So, do you have any other fantastic companies

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likely to double or quadruple in the next year or so?

Rodriguez: Very funny. No. Sadly, The Good Guys and MacFrugal's are the exception. Again, the last time we spoke, there were a lot more fish in the barrel to catch. Finding investment ideas today is extremely challenging.

OID: And I thought you did an excellent job of explaining why in your latest letter — especially with respect to corporate profitability being so high.

Rodriguez: Did you read George's last letter?

OID: I did. And it was actually very similar to yours. Who plagiarized whom?

Rodriguez: I wrote my most conservative letter in years last September. And, coincidentally, so did George. And neither of us knew what the other was going to write. Nor did we discuss the subject. However, we had the same general ideas about the stock market going forward in terms of expecting rates of return on stocks to migrate to something more like 7-8% rather than the double-digit returns that people have come to expect.

Therefore, if long-term Treasuries hit 7% or more, asset allocation models will kick in and say to sell stocks and buy bonds. So it wouldn't take much of a rise in interest rates to cause us to experience some fairly decent downside price action — say 500 to 700 points.

OID: And the odds of bonds rising above 7%?

Rodriguez: I think it's reasonably probable.

OID: Meaning?

Rodriguez: Percentage-wise? I'd say it's certainly 40% or more — whether it seems that way today or not.

OID: Could you summarize your concerns about P/Es?

Rodriguez: Sure. In a nutshell, we've suggested that P/E ratios are deceptive. They're not all that far above their historical long-term average of 15. However, because corporate profitability is unsustainably high, a return to more normal ROEs for American business would imply much lower earnings and, thus, much higher P/E ratios.

OID: So that based on normalized profits, at least, stocks may be much more expensive than they appear.

Rodriguez: Exactly. Furthermore, current valuations seem to discount a higher level of profitability and growth than appear likely to us in the next several years.

Also, most of the benefits of massive corporate restructuring and high levels of productivity growth for American business are behind them. Therefore, major increases in profit margins are very unlikely going forward.

OID: Especially alongside a stronger dollar.

Rodriguez: That's right. And if you assume 2-1/2% inflation and 2-1/2% real GDP growth — which is a relatively optimistic scenario for stocks — you wind up with the likelihood of long-term profit growth approximating the 5% nominal GDP growth. So if we're in a lower inflation environment, it's hard to see how faster growth can occur. On the other hand, if you believe faster economic growth will lead to faster growth in profits, that probably has negative implications for inflation, interest rates and P/Es.

OID: Certainly for perceptual reasons if nothing else.

Rodriguez: Meanwhile, with profit margins close to peak levels, earnings are bound to be more volatile. And some of the valuation measures we regularly monitor show a diminished margin of safety. For example, the current market value of all stocks relative to nominal GDP and relative to those companies' replacement value is at its highest level since the 1960s.

And I recently saw some of Leuthold's work. And what he's saying is very much how I feel. Leuthold looks at the stock market on a normalized basis according to various measures — earnings, cash flow, price-to-book, yields, etc.

And he concludes that for stock prices just to get back to *1987* levels would require a 9% decline. To get back to the *top quartile* of all historical valuation levels experienced since 1926 would require a 19% decline.

OID: If you're trying to scare me, you're doing a pretty good job.

Rodriguez: And in my gut, what he says feels right. So we're concerned. When various stock market indices are setting new highs, it's time to begin thinking about what can go wrong.

WE DON'T TAKE SELLING LIGHTLY. FAR FROM IT.
BUT SOMETIMES IT'S THE RIGHT THING TO DO.

OID: Buffett says that he and Munger try to be greedy when others are fearful and vice versa.

Rodriguez: Exactly. And people are paying my price. For example, both NIKE and Quick & Reilly have recently set all-time highs. And both still have a ways to go. But when people really want these things bad enough, you have to accommodate 'em. And so that's what I'm doing.

OID: It must be tough to let some of these go when you've owned something as long as you've owned NIKE — especially when your cost basis is 2-3¢ on the $1.

Rodriguez: It really is. I almost want 'em to go *down* so I *can't* sell 'em and they stay in the portfolio. In a way, it's like losing a very old friend. Plus, it's very much on my mind that if I *do* liquidate some of these, what can I replace 'em with? And I don't have a good answer there.

So I've been trimming our sails and raising liquidity. And I'm basically hoping that a higher and higher market won't turn us into a money market fund.

OID: When you sell a holding without a replacement in mind or in sight, to what degree is that a function of the stock market versus the fundamentals of the company and/or the stock?

Rodriguez: It's *always* the fundamentals.

OID: Do you take income tax factors into account?

Rodriguez: NIKE's been in our portfolios for nearly 12 years. So I think we've avoided a fair amount of taxes during that time — although, frankly, I think more about the fundamentals of each company than I do about taxes.

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However, given that I'm one of the larger shareholders of FPA Capital, taxes definitely do enter my mind. A tax deferred dollar is a dollar to my shareholders' advantage. And, incidentally, in my personal portfolio, I've had exactly *one* short-term gain during the last 25 years.

OID: Wow. That sounds very much like mine — only, I suspect, for different reasons...

Rodriguez: The tax hurdle of a short-term gain is *such* a heavy exit premium that it forces me to ignore short-term blips in stock prices. I've never understood managers who buy something at $20 and sell it at $24 and buy it back at $22. Net net, what have they accomplished for their shareholders? Nothing — other, perhaps, than to create a pretax return for themselves.

OID: And make their brokers very happy.

Rodriguez: That's right. So yes, I do consider it.

OID: Roughly what percentage of your gains would you estimate have been long-term historically?

Rodriguez: The most short-term gains we've ever had were about 2% — i.e., 98% long-term and 2% short-term.

OID: So you don't take selling lightly.

Rodriguez: Certainly not. Prior to the last two years, my highest cash level would have only been 7-8% — which we hit after the 1988 acquisition of Western Federal Savings by Bill Simon.

However, unfortunately, during the last eight months, prevailing market conditions have forced me to carry the largest cash levels in my accounts that I've had since I began managing money in '74. I'm in my most conservative stance in my personal portfolio in 25 years. And my mutual fund, with right around 22% in cash, is at its highest cash level — except for a very brief period last year when it got to around 30% — since I began managing it in 1984.

OID: And I imagine that played a part in your decision to close FPA Capital to new shareholders.

Rodriguez: That's right. Also, it seemed to be on the verge of getting a lot of recognition. And that would have accelerated our growth. I just didn't want to go down that road because I believed that the shareholders we'd get in that circumstance would be LIFO shareholders — Last In First Out. And I thought it was more important to protect my existing shareholders.

I have a very solid shareholder corps. And being one of the larger individual shareholders of the fund myself, I suppose I have a bias and a conflict of interest.

OID: A conflict?

Rodriguez: If I didn't own a fair amount of the fund, then my economic remuneration would be more tied to my management fees. But by owning a big chunk of the fund — and with all the stocks I own personally being stocks owned in the fund — fund investment performance and my personal net worth are extremely closely related. And that probably played a part in focusing my mind on returns rather than asset growth.

I DON'T KNOW THE FUTURE OF HEALTH CARE,
BUT I DO KNOW THERE'LL BE MORE DIRTY SHEETS.

OID: How much of your high cash levels are a function of concern about what the future may hold versus simply being unable to find bargains?

Rodriguez: For me, cash is *always* the residual of investment opportunities. If we find attractively priced securities, we purchase them irrespective of what we think the market will do.

OID: Super — because I noticed that some of your holdings have declined a bit since September 30th.

Rodriguez: That's right. I've had great success in finding things that can go down.

OID: I can certainly relate.

Rodriguez: In fact, I wish that *more* of them did. When we feel like we've done our homework and that we have a competitive advantage, we just keep on buying and buying and buying — viewing it not as a problem, but as an opportunity. They're what I like to call "increasing profit opportunities".

People ask me, "What's your time frame?" And I don't have a clue. I've never been able to forecast time frames. I've always found it quite interesting that when I was on the corporate side that I'd be in cost of capital and capital allocation committee meetings and that those strategic investments that happened to be favored by the principal people such as the CEO would always achieve returns that exceeded the hurdle rate.

OID: Funny how that happens. And Buffett's talked about that more than once.

[Editor's note: See Buffett's comments at Berkshire's 1995 annual meeting in our August 19th, 1995 edition.]

Rodriguez: Yet when I looked back five years later, rarely did any of them work out. So I'm highly suspect of scenario and time frame forecasting. I just figure that if I take care of my downside, the upside will take care of itself.

And if I can place myself in enough different areas where I have these potential bounces, it's amazing how over time so many of them keep working out. But I can't forecast the time frame.

But people keep trying to do that in the stock market — especially on the brokerage side when they incentivize their analysts to pick stocks that are going to outperform the market in the next 6-12 months. That's just *total* lunacy.

OID: Investment-wise, if not business-wise.

Rodriguez: For example, I don't know when Angelica [AGL/NYSE] will *ever* become a good stock. I've been in it for two-and-a-half years. And it's been going no place fast.

OID: It's easy to see why. It's gone from earning an ROE in the mid-to-high teens in the early '80s to a single-digit level since 1992.

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Rodriguez: That's right. On the other hand, they have a very good market position.

OID: Might we trouble you to define "very good"?
Rodriguez: Share is very difficult to know because the healthcare linen service market is so fragmented.

OID: You can round it off to the nearest 1/10th of 1%. We'll move the decimal point later.
Rodriguez: I'd guess that they have a market share somewhere between 10% and 20%. But, again, it is an extremely fragmented industry.

OID: And aside from Angelica, it's ma and pa?
Rodriguez: It's ma and pa.

OID: And no Ma and Pa Walton on the horizon.
Rodriguez: That's right.

OID: So that they probably have market share gains ahead of them for years to come.
Rodriguez: Exactly. And the demographics of the business are absolutely fabulous. I don't know which way health care's going to go in this country — how it's going to be provided, who's going to provide it, etc. However, I do know that people will get older, that they'll go to hospitals, convalescent care facilities and all of that and that there'll be more dirty clothing, dirty sheets and so forth.

OID: It's certainly hard to argue with you there.
Rodriguez: And in their ongoing effort to become more efficient, hospitals are reviewing their in-house laundries. They're expensive to operate. So outsourcing of services in the hospital area is just starting to take hold.

Quite honestly, it's taking much longer than either Angelica's management or I would ever have expected. But the trend's there. And nothing's going to stop it — because outsourcing is quicker, safer and more cost effective.

OID: We'll send you an advertising rate chart.
Rodriguez: And this company is right in the way of all of that. It's my chickenhearted way of participating in the health care arena. This is a backdoor play on the aging of the American population and the increasing incidence of people using hospitals, nursing care facilities or whatever. It's my dirty linen play.

LEADING MARKET SHARE + GREAT DEMOGRAPHICS
+ HUGE OPERATING LEVERAGE = LOTS OF POTENTIAL.

OID: Thanks for airing your dirty linen play in public.
Rodriguez: Angelica was a darling on Wall Street in the early '90s. And its stock got up around $39 per share. It was thought they'd earn something around $3 and that it'd be a 15-20 P/E stock because of the aging population. But that kind of price was too rich for me.

But then along comes '93. And with the attack on health care by the Clintons, pricing starts to change, the pressure on reimbursement rates accelerates and hospitals start really clamping down on suppliers in an effort to reduce their expenses.

OID: And, of course, it's not like the revolution wasn't already in progress — with HMOs, PPOs, etc.
Rodriguez: The pressure was from a variety of places.

OID: All of which led to a margin squeeze at Angelica.
Rodriguez: You've got it. Also, there was a shift in the health care industry from reusables to disposables — in everything from surgical care packets to different types of linen. Now it's starting to shift back towards reusables because of problems with landfills, etc.

OID: Interesting.
Rodriguez: But, today, of course, Angelica is still generating substandard returns on equity.

OID: Single-digit ROEs for the last four years, I see.
Rodriguez: They've had some competition come in — like at the Kaiser facility where they lost a couple of major accounts in 1993 through lowball bids. What typically happens is that during a recession, laundry facilities that launder table cloths and so forth for restaurants see their volumes go down. Therefore, they start looking around for ways to keep their plants running.

OID: Because unused capacity is lost forever — similar to unoccupied seats in the airline business. And, therefore, they have a short-term incentive to keep the capacity utilized at almost any price.
Rodriguez: Exactly. Therefore, they cross over to the hospital area and bid on some of that business. However, they're going from laundering a product with no significant contamination issues to one with very real disposal issues. And, as a result, many times they bid incorrectly.

Therefore, in the cases of two of the accounts that they lost in '93, it looks like they're on the verge of gaining one or both back.

However, pricing has eroded so badly in the meantime that prior volume increases haven't helped. For example, their most recent annual report shows Textile Services — which is their hospital care area — reporting a drop in operating earnings from $28.3 million to $17.1 million between FY1992 and FY1996. [Angelica's fiscal year ends January 31st.] And that drop occurred despite the fact that Angelica's Textile Services revenues actually grew — from $230 million to $254 million during that same time. So Angelica's operating margins declined all the way from 12.2% to 6.7%.

OID: By nearly half.
Rodriguez: That's right. So that area's been the primary culprit in their earnings contraction.

OID: Roughly a 90¢ per share swing after tax.
Rodriguez: It's a huge number.

OID: But was that 12.2% operating margin typical?
Rodriguez: I think it was fairly typical. In fact, that wasn't even the peak. They haven't been at peak earning power since 1982. And, not so surprisingly, that was when

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the stock hit its highs.

OID: I see that. If I'm reading my Value Line correctly, Angelica earned $1.36 per share in 1983 and sold at an average stock price of nearly $27 — which was nearly 2.8 times its average book value that year.

Rodriguez: They were both much more profitable and much steadier in their profitability in the early '80s. In fact, their ROE was higher than that of the S&P.

OID: Indeed. It looks like they earned more than 18% on beginning of year equity in 1981, 1982 and 1983.

Rodriguez: Even from 1986-1992, Angelica's overall gross profit margin ran between 29.5% and 30.5%; whereas last year, it was 26.2%. So there's three points of gross margin reduction...

OID: Actually more like 3.8%. But who's counting.

Rodriguez: And on $487 million, that's a big number.

OID: Roughly $1.25 per share after tax, I think.

But that would still only bring them up to $2.33 and a return on equity of about 11%.

Rodriguez: Which would still be subpar returns.

However, they do throw off considerable cash. To give you some idea, before deducting the restructuring charge, it's selling at only about 4.8 times EBITDA.

OID: That sounds cheap, all right.

Rodriguez: I'd say so. And mind you, those are on depressed earnings. It wouldn't surprise me at all for a business like Angelica to sell for 7-8 times EBITDA — and not *depressed* EBITDA either.

Depreciation alone is running close to $2 per share. So, here again, there's a fair amount of operating leverage. So any kind of improvement at all in pricing could have a big impact on their bottom line.

OID: Sure sounds like it.

Rodriguez: Incidentally, they're also one of the larger manufacturers of uniforms — be it for health care, restaurant or hospitality. So when you see companies — whether it's McDonald's or hotels — wearing uniforms, they come to an Angelica-type company to *buy* them.

OID: You certainly can't accuse 'em of being focused.

Rodriguez: And they've had problems in that area.

OID: How shocking.

Rodriguez: On the other hand, a very good operation buried in the company — that could wind up going public one of these days — is their Life Retail area. They're the largest retailer of hospital medical uniforms in the country. And that little unit is growing quite nicely — both in nominal sales and comp store sales. They're able to acquire mom-and-pop stores — one to two units at a time. As these people decide to exit the business, they take 'em in and get greater and greater economies of scale.

OID: Interesting.

Rodriguez: So, on the one hand, as hospitals have cut down on providing uniforms to their employees — uniforms that would have stayed in the hospital and gotten washed by an Angelica — the hospitals and other health care facilities have pushed some of the uniform buying decision back onto their employees. And those employees go over and shop at a Life Retail store. So while they've lost something on the laundry side, they've gained something on the uniform side through the retail operation.

OID: And by doing all of them, they perhaps can be sure that they won't earn high returns on any of them.

Rodriguez: Actually, I'm still hoping that they *will*. They were actually starting to get there right when the Clinton Health Care Plan hit in 1992-93.

[Editor's note: True enough. We estimate that Angelica's beginning of year ROE was 12.8% in 1991.]

MANAGEMENT KNOWS WHAT THEY HAVE TO DO AND THEY'RE DOING IT. BUT THE JURY'S STILL OUT.

OID: Do you have any sense of what's "normal" here return-wise — "di-worse-ification" aside?

Rodriguez: As their margins show, falling prices have hit them squarely between the eyes. And with the industry in so much flux, forecasting pricing is out of the question. Therefore, there's no way of knowing whether they'll get their pricing back or not.

That's why they have to take expenses out of the operation very aggressively — by closing plants, etc. — which is exactly what they're doing. And it's up to CEO Larry Young to figure out how to get them back up to a more respectable ROE. And the $64,000 question becomes whether he'll be able to pull it off.

OID: And the answer?

How long has Young been running the show? And how would you rate him as a manager?

Rodriguez: He's been president and COO of Angelica since '88 and CEO since '89. And he's been with them for about 23 years. So he's been there in both good times and not-so-good ones. And I think one of his greatest strengths is his enthusiasm for the linen business. He gets excited over dirty sheets.

OID: If we weren't rated PG, we couldn't pass that up.

But what about the CEO's weaknesses?

Rodriguez: Given the changes that were occurring in the industry, he probably should have acted sooner to restructure both their manufacturing and laundry areas. But he's going at it with a vengeance today.

OID: But Angelica's margin contraction and problems basically began under his watch.

Rodriguez: That's right. It started in the late '80s and has accelerated in the '90s. But in the last month or two, he's taken over executive and operating responsibility of their manufacturing operation. He's looking at closing excess plants and getting back to a more efficient operation.

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That's something I've been awaiting for more than a year. And they're finally *doing* it.

OID: Is he up to the challenge?

Rodriguez: When things are really tough and you're in the middle of a turnaround, it's always tough to assess. But he's really focused on the task at hand. And now that he's stepped in to address the problems — especially in the manufacturing area — it's certainly obvious who stands to get the credit and/or the blame.

OID: So he's highly motivated to solve the problem.

Rodriguez: Exactly. And in the textile services area, they're also rationalizing and reducing their laundries. They've recognized that they're not going to get back as much of the pricing as they thought and that they, therefore, have to take it out of their costs.

And they've also just recently drawn a line in the sand on pricing. Hereafter, if business is unprofitable, they say they're going to let the competition have it.

OID: Sounds rational to me.

Rodriguez: And who knows? Maybe that marks the beginning of a return to rational pricing.

Meanwhile, their strategy is to continue to expand and increase market penetration in hospitals — in many cases, operating the hospital's laundry. And that seems logical because once they have the customer, it becomes a strategic relationship because Angelica's a known quantity. And there's nobody I see who's going to take that business away from them other than the laundry-type companies who come in and get a contract during a recession to keep their plant busy and then wind up losing their shirts and exiting the business when their contracts expire.

OID: Sounds like property and casualty insurance.

Rodriguez: So they're in a transition phase. But will they be successful? I don't know.

ANGELICA'S NOT LIKELY TO BE A GRAND SLAM,
BUT I'M NOT SWINGING FOR THE FENCES.

OID: Might you give us some idea of what kind of normalized earning power and returns you see here?

Rodriguez: Potentially, Angelica could earn $3 plus and achieve a return on equity in the 15% area.

OID: Although, unlike Green Tree, NIKE and Reebok, there's no history — or, at least, recent history — of this company having earned high returns.

Rodriguez: You're absolutely right. There's not. Angelica is highly unlikely to be a grand slam. If it works, I'd expect it to be no more than a base hit to a double.

But I have a totally different posture today than I did in 1989. I don't see tremendous opportunities today to buy 10-baggers and 20-baggers. Stock prices have taken that alternative away.

So if it's not there, I look around for things that will keep me in the game and protect me — at least somewhat. I just don't want to get blown away in the next down cycle.

Again, it's paying an annual dividend of 96¢. So on my average cost of about $22, I'm receiving a 4% yield.

OID: Actually closer to 4.4%, but who's counting — and nearly 4-1/2% on today's $21-3/8 price.

Rodriguez: And its stock hasn't exactly run away in this hyperactive, overactive stock market. It's not exactly on the #1 hit list for stock market enthusiasm. So it's probably not terribly over-owned in momentum accounts. And people who do own it have owned it for some time and know it. So I don't see tremendous downside risk here.

OID: Talk about famous last words...

Rodriguez: And I know Larry Young is working like hell to get profitability up. And as hospitals increasingly outsource, he expects Angelica's business to improve. I don't know if or when he'll be successful. However, again, I'm being paid a nice yield while I wait to find out.

OID: And may I ask the range you've paid?

Rodriguez: I've been accumulating Angelica between $25 and $20. And again, my average cost today is right around $22. So given its current price, I'm underwater.

OID: Those are our favorites.

Rodriguez: And they probably won't earn much more than $1.70 this year. So in all likelihood, the stock will languish here — at least for now.

OID: Only if you can't get our subscribers excited...

Rodriguez: On the other hand, over the next five to ten years and beyond, this huge demographic shift is going to continue. And our aging population will be utilizing health care facilities in growing numbers. Additionally, the hospitals are closing down their laundry facilities — which is also in Angelica's favor.

Meanwhile, their competition is having problems. And Angelica is a survivor. So if they can survive and get through to the other side, then I believe Wall Street will see better profitability, come waltzing in and get excited over the stock again.

DIAGNOSTIC RETRIEVAL WENT TO HELL AND BACK.
BUT IT'S PROBABLY A BETTER BARGAIN TODAY.

Rodriguez: But I know my time horizons are considerably longer than those of the average investor.

OID: You look beyond the next quarter?!

Rodriguez: I told you about Coherent back in 1989. Well, I only had to wait seven years to get paid off. And all of the returns came within a period of about four months. And then it turned into a hell of a compound rate of return. I think we paid $8-9 per share for Coherent from 1987 to about 1992 and walked away with $27 per share in 1995.

And I sold too soon again. Today, it's up around $54. And their earnings are pretty much what I expected. Their stock has just gotten a P/E expansion as their shareholder

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base has increasingly become growth/momentum people. And that's who I generally sell to.

OID: That's what Bill Sams tells us, too.

Rodriguez: And speaking of things taking a long time to come around, I still own Diagnostic Retrieval [DRS/AMEX]. It's been the worst performer of those we discussed. It turned into a far more difficult situation than I ever expected. In fact, it's probably a more attractive bargain today than it was before.

OID: Given the benefit of hindsight, I sure hope so.

Rodriguez: As you may recall, they're a leader in providing antisubmarine warfare equipment for surface ships and helicopters. In 1989, we'd been downsizing the military for four years. That was no secret on Wall Street. As a result, Diagnostic Retrieval's stock had declined from $18 to $7 — when we spoke.

And then all hell broke loose. Things got far worse in the defense area — with Diagnostic Retrieval getting caught by problems with military funding and the politics associated therewith. I won't go into the details because I don't want to precipitate any future problems. But it almost bankrupted the company.

OID: Don't look at me. It might have happened even if we hadn't spoken with you.

Rodriguez: The stock got as low as $1-1/8. And we were their largest creditor. We shrewdly got into the bonds at 80% of par and rode them down to 56% of par — where we bought a lot more. Many of my friends own the bonds in the 60s, incidentally. And Mark Newman, who was CFO, did some real crisis management. They came within an *eyelash* of going under.

At the time, we talked about ways to go and what should be done. I owned about 18% of the company. So I had a serious interest in it. However, more importantly, the management controlled around 40% of the stock — and didn't have a diversified portfolio like us. So they really worked on it.

OID: Funny how that tends to aid one's concentration.

Rodriguez: However, there was a falling out within senior management — between the CEO and cofounder, Mark Newman's dad and the other cofounder, David Gross. There was a rather challenging period when there was lots of uncertainty about who was going to support whom and who would be the jockey there. My feeling after meeting with the company's division heads was that the loyalty and support for Mark was considerably higher than it was for the existing team. And I liked his recovery plan best.

So it got into a hostile situation. And because of the particular circumstances, we couldn't vote our shares. However, we could express our opinion on who would best be able to effect a successful recovery. And with that, David Gross — who was the chief technical officer and technically the chief operating officer — sold a big portion of his shares back to the company at $4 or $4-1/8.

Then, Mark moved from CFO to president and COO and eventually took the title of CEO. And he's mounted an absolutely tremendous turnaround — to the point that today they have all-time record backlogs and are on the verge of achieving all-time record profitability.

OID: So some turnarounds do work.

Rodriguez: And they recently floated a $25 million convertible deal. With the proceeds, they retired about half of an existing issue at par. So we've been smiling for several years now — collecting a nice coupon and receiving a healthy capital gain. And, incidentally, we did provide additional capital to the company on this latest deal — which occurred about six months ago.

And Diagnostic Retrieval's stock price is back up from $1-1/8 to $8.

OID: And you're no longer underwater.

Rodriguez: Finally. We work hard for the money.

HIGHER RETURNS TODAY AND MORE TO COME — BEFORE ALLOWING FOR POTENTIAL ACQUISITIONS.

Rodriguez: And we're looking for good things from the company. They're now earning respectable returns on capital and equity. We expect them to earn about 65¢ per share for the fiscal year ending March 31st, 1996. So with a book of $4.16 at the beginning of this fiscal year and $4.56 today, they'll be earning an ROE of around 15%.

Meanwhile, they still have considerable room for margin expansion. Their operating margins are up around 7-1/2% today. And I expect them to be more like 10-11% within the next 12-18 months.

OID: What about the outlook for revenue?

Rodriguez: That's much tougher to guess because he's in the process of pursuing a couple of acquisitions. So I'm thinking more in terms of the margin element.

OID: We'll bite. Assuming stable revenue, what would the operating margin increases you're expecting imply for earnings?

Rodriguez: Between $.90 and $1.00 per share.

OID: And very respectable returns on equity.

Rodriguez: Correct. So it's been a real long-term workout.

OID: When we spoke in '89, you said that a big chunk of their assets was in cash — $40 million — and that they had 5.7 million shares outstanding and revenues of about $80 million. What's the story today?

Rodriguez: At September 30th, they had $21 million in cash and 5.7 million shares still outstanding. And sales for the fiscal year ending March 1996 should be something over $100 million.

But they're just starting to tell their story to investors. For the first time in six years, Mark did an investment presentation. So that process is just starting.

It's kind of an unknown situation today. To make it a big stock probably requires one more leg to the company — which, if executed correctly, could move it from being a hat-sized stock to being more of a young to mid-teenager.

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OID: Price-wise.

Rodriguez: That's right. Another thing we like about Diagnostic Retrieval is the significant arbitrage between the price of its stock and that of small, private companies.

OID: Really!?

Rodriguez: Really. He picked up one acquisition where I accused him of paying too much — because his payback was roughly six months.

OID: Six months!?

Rodriguez: Some of them just don't have access to public markets. And he's also shown that he's willing to walk away from a deal when the price isn't right.

I keep telling him, "Remember. This is probably your only shot at being CEO of anything. Make it a good one. And remember: Invest in haste. Repent in leisure."

OID: Great line. But I strongly resemble that remark.

Rodriguez: More important than any coaching I might do, a lot of reasonably smart individuals who are investors in Diagnostic Retrieval are pulling for them — including Mike Lauer, who used to be one of the top defense analysts on Wall Street, and Palisades Capital founder Marty Berman.

And Mark wants to make this thing work because this is his shot. He has options and stock himself. So our interests are similar. And in order to enjoy them, he has to make money — and this is his vehicle. It doesn't hurt to have someone who's hungry.

LONG-LIVED, COST-PLUS CONTRACTS
TO PROVIDE CRITICAL EQUIPMENT.

OID: Did you add to your position when it cratered?

Rodriguez: Oh, yeah. George thought I was crazy. And at the time, he was probably right. I averaged down at $5, $4, $3 and $2. My lowest purchase price was probably $1-1/4. And once I'd bought as much as I could, I bought a chunk of stock for myself personally.

OID: Congratulations, again. And yet it doesn't look like a large position in FPA Capital Fund.

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Rodriguez: No, it can't be. When I got involved with this, FPA Capital was an $82 million fund.

OID: And this company only had $2-4 million of float when it was near the bottom.

Rodriguez: That's right.

OID: Based on your comments about prospective margin expansion, likely returns on equity and the availability of attractive acquisitions, why aren't you buying more today?

Rodriguez: The same reason. Given the volume of assets that I'm currently managing, I wouldn't be able to go after a Diagnostic Retrieval Systems today. Plus, I own so much of the company that I *can't* add any more. And I want more liquidity in the stock — which, as I mentioned, is being addressed right now.

But for all of the reasons you've mentioned, there's a lot more upside here than downside. And one thing I haven't mentioned is that a lot of projects that were in the design phase back in 1989 are now moving into the production phase. And that's where they earn the really good money.

And, finally, if the turn continues and the stock languishes here, this company would be an ideal acquisition target...

OID: For a larger defense company.

Rodriguez: Correct. We've been approached in the past about selling our position. I have a pretty good idea who it was, but I'd prefer not to say. But you'd know it. And with the stock at $3-3/4, the price discussion was between $6 and $6.50. And that didn't look too shabby relative to the stock price at that time. However, when we looked at the company and its prospects, we just concluded that it wasn't good enough. We thought that we should get a double-digit price. And with some patience, I think we can get there.

OID: But won't you always be subject to considerations involving politics, budget matters, etc.? What keeps them from being knocked out of the water by budget cutbacks down the road?

Rodriguez: One of the things we've always liked about this company is that they supply critical components for the U.S. Navy in the areas of antisubmarine warfare and aerial identification by surface ships. Plus, there's been a follow-on program. And a lot of pain and suffering went into it. Had they gone under, it could have been very harmful to the Navy and this program.

OID: So the Navy helped them survive.

Rodriguez: That's right. Or, at least, they backed off. Of course, the Navy *caused* some of the problems, too.

However, once a company gets a program that's this significant, there's a built-in moat.

OID: And they tend to be long-lived.

Rodriguez: *Very* long-lived. Plus, as I mentioned, their backlog is at record levels. So I don't worry too much about that issue. And speaking of risks, one difference between the company today and in 1989 is that the bulk of their contracts then were fixed-price contracts. And we

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learned the hard way how difficult the Defense Department became with fixed-price contracts. Today, 80-90% of their contracts are cost plus.

OID: Which eliminates a huge source of risk.
Rodriguez: Exactly.

THEY'RE EXPANDING THEIR OFFERINGS
— BOTH MILITARILY AND COMMERCIALLY.

OID: Does anyone have a better mousetrap today? And even if they don't, what's to keep someone from knocking them out of the water by developing one?
Rodriguez: Diagnostic seems to have a pretty good mousetrap. They're sure starting to buy it. And there's the opportunity to sell these products overseas to our Allies.

OID: And there's nobody to the best of your knowledge who does it as well or better?
Rodriguez: Not at present. They've outdistanced and outflanked larger companies such as Hughes on some of their products. And they've teamed with other companies that would like to have Diagnostic Retrieval as a partner.

OID: How can they compete with larger companies when their R&D budget is so much smaller?
Rodriguez: They're in smaller programs.

OID: A niche strategy.
Rodriguez: That's right. In the same way that Diagnostic is too small for me to buy today, their niches are too small for their big competitors.

Also, they are diversifying into aeronautical mission recording equipment. In the past, they've brought the data from helicopters to surface ships. Now they're taking that capability to other areas — such as fixed-wing aircraft. And that's starting to diversify the company platform-wise and function-wise.

They're also moving into nondefense areas like engineering — producing data rendering devices, optics and so forth — to the point where it's up to about 20% of their total business today.

OID: Di-worse-ification?
Rodriguez: I don't think so. They're doing exciting things with data storage. For example, they made an acquisition of Ahead Technology — which reconditions and improves the heads that go into tape storage systems. And with what they were working on previously for the military, they were able to merge the acquisition with their existing operation and create an even more significant entity.

And they're teaming right now with one of their suppliers in the data storage area. It's not been publicly announced who it is, but it's a large Japanese company. So they're not only getting leverage out of their defense relationships, but also from their relationships in commercial data storage.

They seem to be carefully picking their niches. And all of the commercial operations they've added or expanded into are profitable.

OID: That's pretty amazing. You make it sound like they're well managed.
Rodriguez: That's for them to prove. The jury's still out. Certainly, they're much better managed today because they're now focused on bottom line profitability. The heads of the company previously were engineers. Today, they're business people. The most successful company in the defense industry is Loral Corp. — which is headed by non-engineer Bernie Schwartz. And that lesson hasn't been lost on Mark.

On a scale of 1 to 10, they were probably a 2 or 3 before. And, today, I can comfortably say that they're a 5. But before I give them credit for anything higher than that, I need to see results.

OID: What's the biggest risk here?
Rodriguez: Because they're in an acquisition phase, the biggest risk is overpaying or buying the wrong company. And that is a risk.

OID: How significant do you think it is?
Rodriguez: Today, it's not very high — because the memory of how close they came to bankruptcy is still extremely fresh in their minds. I'd worry about that more after five years or so of success if their stock's at $25 and they're being wined and dined on Wall Street.

MY MOST CONTROVERSIAL HOLDING TODAY
IS ALSO MY LARGEST PURCHASE EVER.

Rodriguez: The most controversial of my holdings today in my opinion would have to be Reebok [RBK/NYSE]. It's already the largest initial purchase that I've ever made in FPA Capital Fund. And I've put between 5% and 10% of my personal net worth into it.

OID: And as someone who's been a NIKE shareholder continuously since 1984, you're no babe in the woods when it comes to understanding Reebok's competition.
Rodriguez: It's funny you mention that — because back in February with Reebok around $26 per share and NIKE at $65 or $70, I asked someone at NIKE, "Would you care to make a wager about whose stock doubles first? And, of course, since NIKE's the one with the momentum, what *odds* will you give me?" And he said, "*No way.*"

So I said, "How about *even* money?" And he still said, "No way. A year ago, I'd have made that bet. Today, I won't." I found his remarks fascinating.

OID: That makes two of us.
Your 1989 comments were somewhat interesting, too. As you pounded the table about NIKE, you observed: "NIKE hit the wall and was able to make it through and become a stronger company for it.... [But Reebok] hasn't been tested yet."
Rodriguez: That's right. And this is their period. They've been in the right areas for a long time. They really

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did segment and identify the women's market while NIKE focused on the men's market.

OID: Some suggest that NIKE was asleep at the wheel when they let Reebok capture the women's market.

Rodriguez: Yeah, you might say that — although they're certainly no longer asleep today.

I've always felt like there were questions about Reebok because on numerous occasions they've had their compass move off in a different direction. They've been sidetracked by acquisitions and lost focus on their core markets.

OID: You don't think the acquisition of Boston Whaler was focused!?

Rodriguez: I never understood that one. I mean it was a *yacht* company, for God's sake!

I also had reservations about the prices they paid. A perfect example was Avia. It was scheduled to come public right before Reebok acquired it. And Reebok actually paid $1-1/2 to $2 above the top end of what the pricing was going to be for the IPO. I couldn't believe it. And sure enough, they've never gotten a return on that investment. The market share was never achieved. The growth never quite occurred.

Now they've announced that they're selling Avia — which is the correct thing to do, I think — so that they can get their focus back on their core product line.

OID: Never underestimate the power of focusing.

Rodriguez: To be fair, NIKE also tried something in a different product line in the women's market called i.e. And it never took off either. But at least they didn't pay hundreds of millions of dollars for the privilege of doing it. So Reebok has diluted its returns by doing things like that.

However, this business is so incredibly profitable and throws off so much cash that it can *take* a lot of mistakes.

OID: And as has been pointed out to us by several contributors, it requires almost no capital aside from what's required to fund inventory requirements.

Rodriguez: Exactly. They outsource manufacturing. These are marketing companies. Very little in the way of assets is involved. So they throw off a *lot* of cash.

THE #2 SPOT IN A COZY OLIGOPOLY
AIN'T NECESSARILY ALL BAD.

Rodriguez: Therefore, the key has always been who could get to be among the top companies because the barrier to entry — what Buffett refers to as the moat — is really the ability to capture the market share of space in the retailers' point of sale and to protect it by advertising.

OID: In order to — as he describes — retain the space in the consumer's mind.

Rodriguez: Exactly. And as bad as Reebok's been, they still have a 19-20% share of the athletic shoe market versus 40% for NIKE. Lagging far behind is Fila with 5-6% — up from 3% two years ago — and Adidas with maybe 3-4%.

OID: And internationally?

Rodriguez: They're somewhat closer. But it's still in a state of flux.

OID: Some suggest that NIKE and Reebok have tended to stay relatively close share-wise, but that Reebok has lost contact, as it were — that the race is over and that NIKE's won.

Rodriguez: For today, NIKE *has* won. However, have they won it for the next 10 years or 20 years? I don't think anyone knows —although the odds are very good that NIKE will maintain its number one status for years to come.

OID: Especially, I imagine, since they have the resources to lock up the key endorsements.

Rodriguez: That's right. A company builds up more and more momentum until it becomes a self-perpetuating protection. But it's also important to remember that the consumer tends to be a bit variable in his or her taste and regularly gets tired of a particular look. If everyone's wearing the same brand, consumers look around for something else — for a degree of individuality. They want to fit in with the crowd, but not *too* much. They also want their individual identity. There's a dichotomy, if you will — a never-ending battle. And where that dichotomy plays out in the future, no one knows.

OID: When we spoke in 1989, one of the things you said was: "I love situations where I can get involved with a market leader that is at the trough of a cycle and that's still making money. I've just found out over time that buying situations with those elements present has been a very good way to earn high rates of return."

Rodriguez: Absolutely. It's fairly simplistic. But identifying companies with market leadership positions in industries that are temporarily out of favor invariably works time and time again.

OID: It sounds like a wonderful formula.

Rodriguez: I've been amazed that it's worked so well over the last couple of decades. If it's so simple, why isn't *everybody* doing it? But even as I say that, between the cup and the lip, there's a lot of room to slip.

OID: When you say, "a market leader", do you mean #1 or #2 or do you mean #1 only?

Rodriguez: Either. And I view that statement as being terribly appropriate in this case because both NIKE and Reebok are market leaders. It's just that Reebok is #2. Is it critical to be #1 in a market? No. In most cases, it's perfectly OK to be #1 or #2.

OID: So why is today's 40% to 20% market share split grounds for panic?

Rodriguez: They've generally always been fairly close in terms of revenues and market shares. Obviously, these past two years have just been huge for NIKE. Two years ago, they probably had a market share of 32-33% vs. 28-29% for Reebok.

And NIKE's market share gains have come right out of Reebok's hide. Plus, a couple of other players have gotten

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stronger at Reebok's expense. So much of the market share shift the past two years has been everyone else's gains and Reebok's losses. And the question is whether Reebok's market share erosion will continue.

OID: And the answer?

Rodriguez: We'll just have to wait and see. We won't know the answer for at least another year.

A COMPLETE REDESIGN FOR REEBOK — FROM CORPORATE SYMBOL TO AIR TECHNOLOGY.

Rodriguez: And that has to do with the fact that Reebok's going through a redesign phase. NIKE's swoosh has been around since about 1970. But when Reebok was growing up in the 1980s and really being successful, when you saw the name Reebok, what else would you see? It was the Union Jack — because it evolved out of a company with a British base.

Well, if you're going to be marketing worldwide, there are a number of places in the world where the Union Jack isn't looked upon favorably from an historical context. Therefore, they've developed and have been promoting a new "corporate identity symbol" — which is their vector. And it's becoming extremely well known.

Incidentally, NIKE shrunk its swoosh — which enabled them to change the design of their shoe. Well, Reebok's going to do exactly the same thing on some of their newer shoes.

OID: Still, doesn't NIKE enjoy an incredible advantage simply by virtue of the fact that they, in effect, have a patent on running on air?

Rodriguez: NIKE and Reebok each have their "technology" in terms of cushioning systems. And each has a different way of managing air, if you will. In the case of Reebok, they have their DMX technology of managing the flow of air within the shoe.

OID: We've been told that NIKE is the only one that really has air underneath the shoe — that Reebok's air simply surrounds the foot and puts it to sleep...

Rodriguez: It's true that the consumer has bought into the NIKE air. But Reebok's new walking shoes move air fore and aft under your foot so that when you step on your heel, it pushes air into your foreshoe and vice versa.

And they have a soon-to-be introduced court shoe that will also move air side-to-side because of the way that athletes move in court sports.

OID: Fascinating.

Rodriguez: There are actually little bladders moving the air around and directing it in a controlled manner underneath the foot. The initial usage was in one of their walking shoes. And that shoe was a complete sellout. Now they're broadening the line and extending its usage to other shoes they're introducing in late May.

They're undergoing a complete redesign of their line. But, of course, all of the other shoe companies are, too. So we'll just have to wait and see what happens. Compared to competitors' products, Reebok's products don't look bad. But I hate to make investment decisions based on my personal opinion about a product.

OID: Whatever Peter Lynch may say...

Rodriguez: That's right — because I may be right about the product's relative merits, but the consumer may not like it anyway. Therefore, I don't hang much weight on my opinion of products.

AN *EXTREMELY* IMPORTANT POINT — SHOE RETAILERS ARE PULLING FOR REEBOK.

Rodriguez: Incidentally, the life cycle of shoes has gotten a lot shorter. Today, the average design life is only around 6-9 months. So to be competitive, athletic shoe companies have to achieve rapid turnaround of the design, move the shoe out, market it and then start all over again.

And it takes a lot of infrastructure to handle the design, management and acquisition of material resources and then distribution. So the more rapid the cycle becomes, the more difficult it gets for smaller companies to compete.

OID: That makes sense. However, several months ago, the manager of a large New York shoe operation told me that all of Reebok's brands have very high customer return rates as defective merchandise — and that NIKE's don't.

Rodriguez: We always hear those types of things about every manufacturer. However, I'm not aware of Reebok having any manufacturing problems.

OID: Maybe this is how those rumors get started.

Rodriguez: If you're a retailer, how much space are you going to allocate to the upstarts? With retailers cutting back on their SKUs and the number of vendors they use, they naturally want to go with the stronger ones. Well, obviously, in the case of athletic shoes, retailers have expanded their exposure to NIKE because of the strength and popularity of the brand.

But is a retailer going to allow 90% of their sales to come from one manufacturer? The retail channel doesn't want to be dependent on a single supplier.

OID: And Reebok is the only other player big enough to assume that role today.

Rodriguez: Exactly. Can Fila play that role today? Not likely. They have a very narrow product line. Granted, they're going to try and broaden it. And we'll see whether they'll be successful. But many athletic shoe companies have had single hot products, seen their market shares shoot up and then seen them fade just as quickly.

OID: Like L.A. Gear.

Rodriguez: Exactly. L.A. Gear was a hyper case — both up and down. It was a hula hoop company.

Fila admittedly does look like it has a very good shot. It looks like they have a broader attack underway and, therefore, that they have a good shot of cementing a position as a solid number three. And maybe Adidas

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comes on from its number four position. It's been resurrected almost from the dead by the venture capital people who LBO'd it back about five years ago.

So there's inherent support for Reebok. Shoe retailers *want* Reebok to succeed — there's no question about it — because only a strong alternative supplier like Reebok can keep NIKE honest in terms of pricing, sourcing, etc.

OID: That sounds like a very important point.

Rodriguez: I believe that it's *extremely* important. But if Reebok isn't well on the way to solving its problems a year from now, we can probably conclude that they have a serious problem that they may *never* be able to solve.

But it seems like the elements of strength are there. The market share is there. The cash flow's *obviously* there. They seem to be refocusing on their core business — which is the Reebok brand. And they're continuing to use the discipline of buying in their stock as a hurdle rate or yardstick, if you will, when they think about acquisitions.

OID: Which is a mighty tough hurdle at today's price.

Rodriguez: I'd say so.

AT LEAST 95% OF EVERYTHING NEGATIVE
THAT *COULD* BE SAID ALREADY *HAS* BEEN.

Rodriguez: Plus, let's face it. A lot of people are out hunting for a certain scalp. [Reebok CEO] Paul Fireman obviously led a team that did a number of things right. Now they're having a real tough time.

But looking at the company in terms of their designers, their design labs, etc., there's more than one person there.

OID: How would you assess second-line management at Reebok?

Rodriguez: When somebody gets to #2 in a business, even though they're losing market share, I think you have to conclude that they're better than average — because they've gotten there ahead of everybody else. The people who I meet at Reebok strike me as solid. However, that's just my gut instinct and my impression. Will they execute? As I said earlier, I won't know for at least another year. We can sit here and speculate. But when a stock is down, investors believe management's I.Q. is subterranean. And when it's up, investors believe management's brilliant.

OID: Absolutely.

Rodriguez: Paul may have used too pyramidal a management structure where too much decision-making was concentrated in one person. But, of course, it's easy to make that observation today. You could have said the same thing about [NIKE CEO] Phil Knight at times. Today, everyone seems to agree that he's the spiritual head of NIKE. However, it wasn't all that many years ago — only several, in fact — that investors were criticizing him for missing the women's market. And for a period of time, NIKE's offerings fell out of favor in the basketball market.

OID: So he hasn't been perfect either.

Rodriguez: That's right. Some people suggest that Fireman's been too dictatorial and that the result has been some problems. But he's actually gone on record saying that if the situation hasn't turned by the spring season next year, he won't be there.

OID: So you're not worried about Reebok's problems not having his full attention.

Rodriguez: Exactly. The pressures are there. Plus, I look at a stock market that's done modestly well since '91...

OID: Understatement noted.

Rodriguez: And then I look at Reebok which has effectively gone no place fast. So I think there's a lot of margin for error here. It wouldn't surprise me to see Reebok retest its lows in the low to mid-$20s because they're likely to report less than spectacular earnings in the next quarter or two. And I say that because they're still in a transitional period. But nobody's good enough to pick the exact bottom...

But at $29, Reebok's stock is close to the lows that it hit back in late '93 and mid-'92. So I view Reebok as a way to buy a good consumer name without paying a huge price. Reebok's current market cap is only about $1.9 billion. Meanwhile, they'll do about $3 billion in sales.

OID: So it's cheap relative to sales.

Rodriguez: For a company with that kind of consumer franchise? Absolutely. And there's no question in my mind that at least 95% of everything negative that *could* be said about Reebok already *has* been said.

OID: In fact, I think people may even be getting tired of saying negative things about it. But what you're saying is that all of the negatives are in the price...

Rodriguez: Exactly. And then I look at NIKE and ask myself, "What other words are there in the dictionary to describe how fabulous NIKE has done." All you have to do is look at all of the brokerage reports and see how effusive they are. So here's NIKE selling at around 6 times book and over 2 times revenue and something like 25 times trailing 12-month earnings.

And maybe NIKE's valuation is justified. But I've sold my shares. Unfortunately, I sold 60-65% of my position during the first few months of this year at an average price of about $70-71 per share. And it's currently at $87-1/2. So I've been very shrewd again in my selling.

OID: Yeah. I hear those 80- and 90-baggers are rough. My heart goes out to you...

Rodriguez: So for the reasons I've described, I am concerned about Reebok's future. However, more than balancing that concern, however, is its valuation. After all, it's selling at around 60% of revenue.

And I just don't see their franchise totally collapsing. It's been hit hard in the last couple of years. But has it been permanently impaired? It's too soon to say. Even if they were able to maintain their 20% market share and they continued to generate the cash that they do today and buy in stock and nothing else changed, I'd guess that over a 5-year time frame Reebok's stock price would probably be higher than it is today.

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OID: We'll bite. How high?

Rodriguez: Maybe 12 times $4 to $4.50 in earnings.

OID: So your status quo scenario is $48 to $54. May we ask you what you've paid?

Rodriguez: I started buying it around $33. And I think I've paid as much as $33-1/2 and as little as $25. My average cost is approximately $30. So I've gotten in at a pretty good price level considering that it's now at $29.

OID: Still, you don't sound nearly as emphatic about Reebok as you did about NIKE.

Rodriguez: By 1989, NIKE had already turned the corner. But in 1984 — which is when I first got into NIKE — it was a very different story. At that time, there wasn't a single recommendation of NIKE on Wall Street.

OID: So you'd have been similarly sanguine about NIKE in 1984?

Rodriguez: NIKE was what I refer to as "home run plus one" because in a very short period — a period of only four or five weeks — major negative articles had come out on it in *The Wall Street Journal, Barron's, Fortune, Forbes* and *Business Week*. There was just *so* much negativity. Split-adjusted, NIKE had gone public in October of 1982 right around $10, proceeded to go to a high of about $28 a share and then collapsed — all the way down to about $6.

I started getting interested in NIKE at around $8-1/2. So I took my position and bought more at $7 and $6. And then I watched it trade for a long time between $8 and $10 and then $10 and $14. It was extremely frustrating.

[Editor's note: We estimate that the preceding cost figures are before three 2-for-1 splits — so that Rodriguez's actual split-adjusted cost was right around $1 per share.]

But the common element between NIKE then and Reebok today is that there were a lot of negatives. The retailer saw NIKE getting overwhelmed by Reebok in a number of areas and they were rooting for NIKE to come back. But there were a lot of reservations about whether they could.

BECAUSE THE INDUSTRY IS NOW MORE MATURE,
THERE'S LESS RISK AND LESS REWARD.

Rodriguez: But remember that it was much earlier in the game then. In fact, I believe that NIKE could have been put away at that time.

OID: By Reebok?

Rodriguez: And others. There were a number of smaller companies out there — including Hyde Athletic. In 1984, NIKE's total revenue was only about $900 million. They're around $6 billion today. At that time, the industry was still very much in its infancy.

Today, NIKE and Reebok are quite large relative to their competition. They have what I call "girth" — which makes it much less likely that they can be put away. On the other hand, the likelihood of earning the same kind of extraordinary returns is considerably less today, as well. In fact, I'd view it as virtually impossible.

OID: Because their huge market share gains are mostly behind them.

Rodriguez: Right — and because the industry is far more mature than it was. But that doesn't mean it won't be a reasonably attractive investment. If Reebok does manage to get its act together, it wouldn't surprise me for its share price to double over the next two to four years.

And while, that may not sound exciting to you, relative to my assessment of the prospects of the overall stock market, I find those returns *quite* exciting. I believe Reebok offers substantially more upside potential and considerably more downside protection than the market.

OID: And the scenario that would get you to a double?

Rodriguez: The consumer starts to like the renewed Reebok product line, retailers start to order more product and their future orders start to turn up.

OID: And how likely is that?

Rodriguez: I think it's reasonably *likely*. But one of the biggest athletic shoe retailers out there is Foot Locker. And Foot Locker and Reebok have been at odds for awhile — although Reebok has been doing considerable work to repair that line of distribution. And from what I've heard, Foot Locker is amenable. But some of its buyers want to see their newer product lines before they make a commitment to expanding Reebok's share of their overall open-to-buy.

So the first chance we'll probably have to get an inkling of a turn will be in July to September of this year. So I'm knocking on wood, I have my fingers crossed and I've put a chunk of my own money into Reebok personally.

OID: Are you still buying it?

Rodriguez: I haven't bought more for FPA Capital since December because, again, it's the largest purchase I've ever made for it. But if Reebok were to go lower and I felt the same way I do today, I wouldn't be at all opposed to buying more still.

And to give you some idea, I have a new account that just came in recently that owned some Reebok already. And we not only didn't sell it, but we're actually open to buying some more. So I guess I'm thickheaded. We'll see. When you're in one of these, you never know how right you're going to be. It's always easier in hindsight.

RAWLINGS: FIGGIE WAS A MOTIVATED SELLER —
WHICH MADE US A MORE MOTIVATED BUYER.

OID: And the story on Rawlings?

Rodriguez: Rawlings [RAWL/NASDAQ] is one of the few IPOs that I've purchased during my 13 years at FPA.

OID: There's no need to apologize to us. It's your shareholders who had to live with...

Rodriguez: Actually, the others worked pretty well.

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Rawlings was intriguing to me because it was a subsidiary of Figgie — which was in violation of its debt covenants with its banks about two years ago. So they had to raise cash, pay down debt, etc.

And if I'm going to buy an IPO, I like to buy it from somebody who's being forced to sell during a time frame that is not of their choosing.

OID: A motivated seller.

Rodriguez: Exactly. That increases the odds that I can get a successful investment. So Figgie was going to sell the company. And they went out in late '93 to get some bids for the entire operation.

And in early '94, the IPO market was hotter than a pistol. So rather than sell Rawlings in its entirety, the management of Figgie thought they could get a better price if they went the IPO route. So they filed to do an IPO in late January/early February — which just happened to more or less coincide with the peak in the IPO market.

OID: Doesn't sound like a bad time frame so far.

Rodriguez: Unfortunately for Figgie, the SEC was all backed up and couldn't review it. And they finally got authorization to do their IPO in mid-June. But they'd promised their banks that they'd have this cash by the end of June or the first week of July. So they were hard pressed timing-wise. And in June '94, the small cap stocks were taking a pretty good-sized hit on the downside.

OID: That explains it.

Rodriguez: Dillon Read had originally filed the deal at $15 to $17. I looked at it and said, "If it were cheaper, I could be interested." So they came back to me and said, "What would you pay?" And that's probably an indication that there's not a lot of demand.

So I looked at it. And I'd been checking around and gotten indications that it looked as though Figgie had received bids for the entire company in the $11-12 range. So I said, "Between $11 and $12, I'd probably take down some stock." And lo and behold, it was priced at $12. So we took down a piece.

OID: Hindsight is sometimes 20/20. But why would you offer 100% of the price that they'd been offered instead of something less?

Rodriguez: I felt it was under distressed conditions and that the strategic buyers were trying to take advantage of the situation.

OID: So you didn't feel like that was a full price.

Rodriguez: Exactly. I looked at that price and thought, "This gives me an idea that if I'm wrong about this, maybe my downside isn't all that great — because there are interested buyers at a price close to what I'm paying." Whether I was correct, I don't know. The game isn't finished yet.

BAD BREAKS AND BAD CONTROLS
LEAD TO BAD RESULTS.

Rodriguez: Anyway, Rawlings' stock did well — it went up to around $14-1/2. However, the baseball strike occurred. And we thought, "Gee, this strike is only going to last for a short period of time. No one is crazy enough to stop the World Series."

OID: For the first time in the entire history of professional baseball — no less.

Rodriguez: Exactly. So the baseball strike hit, disrupted their selling cycle, and decimated everything. So they couldn't get their normal sell-through for little league play, etc.

OID: In terms of endorsement values, attention to baseball, etc.?

Rodriguez: Yes. And there was collateral damage, too — because one area from which they've derived very good benefit in the past has been the sale of memorabilia. Well, if the players aren't playing, where's the memorabilia?

OID: No baseball, no memories.

Rodriguez: Exactly. And even more painful, an unprecedented number of batting records were set to be challenged or broken when the season was interrupted. And all of those things came to an end along with the memorabilia sales that would have followed. And that killed demand. Meanwhile, Rawlings' management was overly optimistic about what might happen. As a result, they misjudged demand.

OID: Along with just about everybody else, I presume.

Rodriguez: Rawlings could have done much better. When I went into it, I wasn't sure whether they had good financial controls. However, Harry Figgie [Figgie's CEO] was a control freak about almost everything within Figgie. He'd have data down to the absolute minutiae. And he wanted to review it all the time. So I thought, "Well, if he's that type of person, he'd have invested in Rawlings' systems, etc. So they probably have decent systems."

Well, it looks like they *didn't* have such good systems. And their CFO wasn't as good as they should have had. And that caused some management misjudgments in forecasting what their business would do.

OID: So management wouldn't get high marks.

Rodriguez: No. In fact, I think I'd be hard pressed to even give 'em a "C".

OID: Although I know you're a tough grader.

Rodriguez: In all fairness, they've had everything go wrong the past two years — some of it beyond the scope of management's capability. Who, after all, could have foreseen the first cancellation of a World Series in the history of baseball. So I'm not going to criticize 'em for that.

OID: Predicting human folly is particularly difficult — one reason why our publishing schedule...

Rodriguez: But they did shoot themselves in the foot in other ways. They could have been more effective.

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OID: Primarily in the area of controls — to avoid unnecessary inventory buildup.

Rodriguez: Exactly. But how much of it was the environment and how much of it was their own fault? That's nearly impossible for an outsider to ascertain.

TWO BIG ASSETS: THE RAWLINGS NAME AND PRODUCTS WITH MINIMAL STYLE CONTENT.

OID: I presume that there are some positives here.

Rodriguez: One thing you can say for this company is that they have an extremely well known name in the consumer products area. In fact, the Rawlings name is among the top ten names in the athletic products area.

And they're looking to leverage their name by broadening their product line. However, it's too early to tell how successful any of those efforts are likely to be.

Today, the key to this company is baseball. If we have a good season this year, then that will help sell through the inventory that has backed up in the retail chain because of all the disruption. They have two prime selling periods. The first is from August to October during which about 70% of their product is ordered by their customers — customers meaning the retail chains.

Then there's a fill-in period from February to April. So the first time that we could see a normal cycle isn't until February 1997. And then the major reorder won't occur until September 1997.

OID: Why are you ruling out the August to October '96 selling period — because they still have the overhang?

Rodriguez: Exactly. And I'm being pessimistic because I just don't know how quickly the excess inventory is going to be sold off. That would be pure unadulterated guesswork at this stage of the game.

OID: It's customary for our contributors to postulate about imponderables with authority...

Rodriguez: But one good thing about their product is that there isn't a large style content to it. You could put the '95 Rawlings leather glove beside the '96 model and see no difference — because there is little or no difference. The only time merchandise gets dated is when the signature is from someone who's no longer playing in the league. And, if so, then they might have to sell 'em to MacFrugal's.

So they really haven't had a shot at normal business operations. And it looks like this coming year will be the first shot they'll have at that since they've come public.

OID: I didn't realize that they'd revamped baseball's management structure...

Rodriguez: Whether or not shareholders derive the benefit of that, I don't know. When this company was shown around in late '93 through March of '94, anybody who looked at Rawlings had to sign a two-year standstill agreement saying that if they looked at it and didn't buy it, they couldn't get involved with the company for two years. Well, those standstill agreements start expiring in April and May.

OID: Fascinating.

Rodriguez: So with the stock at $9-1/4, it wouldn't surprise me if sometime in the next twelve months that another company might not take a look at buying them. Plus, they'd derive the benefit of not having suffered through two years of the baseball cycle. They could make the wager that it's finally returning to normal...

OID: You left out pretty please with sugar on top.

Rodriguez: And I think they'd be right. The odds of another shutdown are virtually nil — because both sides realize that they nearly committed suicide the last time. So the predictability of potential earning power going forward is probably higher than it has been.

RAWLINGS' NORMALIZED EARNINGS?
YOU TELL ME. THERE'S NEVER BEEN NORMAL.

OID: Sounds like an intriguing idea. But could you run us through its fundamentals?

Rodriguez: The fundamentals are all over the board. If you're asking me what they can earn, I'm not really sure — because their margins and expenses have changed so dramatically over the last two years that it's almost a case of, "Will the real gross profit margin please stand up?"

They've typically operated with a gross margin of about 33%. And that's now running at about 30%. So they've lost about three points of gross margin that comes straight out of the bottom line.

OID: Pretax, of course.

Rodriguez: That's right. Also, when the revenue came in light, they couldn't cut their overhead fast enough. A little thing like the World Series not occurring can catch the best of us by surprise. Therefore, the extra SG&A probably cost 'em another 80 or so basis points. And between the top line and the bottom line, they've probably lost close to 400 basis points on their operating profit line.

And since they've been saddled with greater inventories due to these extraordinary circumstances, that means that they've had to fund their working capital at a higher level. So interest expense has been higher than normal. It seems like everything that *could* go wrong *has*.

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OID: And the result earnings-wise?

Rodriguez: Their fiscal year ends August 31st. And when they went public, they were talking in terms of $1.20 per share in FY1995 and $1.45 in FY1996. But they only earned 60¢ in FY95. So they only missed it by 60¢. And their revenues also came in $15-16 million light because of all the problems that they had.

This year, we're hoping they can earn something in the neighborhood of 70-80¢ per share. And what they do *next* year is pure guesswork. But why shouldn't they earn something closer to 85-90¢ per share? I'm not even thinking in terms of a three-digit number. But they're just now starting to come out and get a chance to earn what they thought they'd be able to earn two years ago.

OID: When was their last normal year?

Rodriguez: There hasn't *been* a normal year. And I say that because when they were part of Figgie, everybody operated on its schedule. And Figgie's books closed in December — which is in the middle of Rawlings' working capital cycle. That, needless to say, made absolutely no sense whatsoever.

So when they went public, they did a stub period for 1994 for eight months and then started a pro forma year ending in August of 1994. Therefore, August of 1995 was their first real fiscal year. And it included the problems of the baseball strike and the first World Series cancellation in history. So when I say that there hasn't been a normal year, that's literally the case.

But in the past, they had about a 33% gross profit margin, an operating margin in the neighborhood of 9-10% and net profit margins in the 4-1/2% to 5% range.

OID: And their historical sales?

Rodriguez: Again, there's no normal. But for the year ended August of 1995, they reported revenues of $144,141,000. There are 7,652,000 shares outstanding.

OID: And no substantial options outstanding?

Rodriguez: Not really. The last available data shows 165,000 options outstanding — all with an exercise price of $12. This management isn't egregiously overpaid.

So dividing their $144,141,000 in FY1995 sales by their 7,652,000 shares outstanding gives them revenues per share of $18.83. So let's round that to $19.

Quite frankly, they were expecting sales of more like $160 million when they went public. This year, they're looking for a "more normal" period — or $150-odd million. And I haven't even tried to come up with an estimate yet for 1997. But hope springs eternal...

OID: And their book value?

Rodriguez: Today, their book value is around $4.30 per share. But that's low because they upstreamed cash to Figgie in order to buy their freedom.

OID: Everything that wasn't nailed down plus the assumption of debt.

Rodriguez: That's right.

OID: So that if they were to earn 70-80¢ — which is kind of what you're guesstimating for FY1996 — they'd be earning something close to a 16% ROE.

Rodriguez: That's right.

OID: And here's still another case of a market leader earning money at or near the trough of its cycle.

Rodriguez: You've got it.

OID: And if I'm doing the figures right, it looks to me like they earned close to 16% on equity in a year in which virtually everything that could go wrong did.

Rodriguez: That's right. But, again, Rawlings' equity is temporarily depressed because of how they came public. So what is the real equity? This company's debt is too high today — although they can sustain the debt because the cash flow is there. But I'd like to see their balance sheet improve materially.

When they came public, we thought their leverage would be coming down. Unfortunately, it's been going up instead. And it was already more leveraged than I would have liked to begin with. But with it coming public at the trough of the small cap cycle in '94 and with it being sold by a motivated seller, I really thought we were extracting a real value here. If they'd executed and come through with earnings of $1.20-1.40, we'd be talking about an $18-20 stock. And with those kinds of earnings numbers, its balance sheet would look totally different.

OID: Debt would be lower and interest coverage would be much, much higher.

Rodriguez: Exactly. Unfortunately, it didn't happen that way for a number of reasons. Will it happen in the future? The same elements are there as they were in 1994. However, [Rawlings Chairman] Carl Shields and company will have to demonstrate it.

Carl realized that he didn't have the right players on his team. And he reorganized his senior management and let several executives go. And those executives included a broad cross-section of people. He reorganized the financial area, brought in a new MIS person and terminated the vice president of manufacturing so that his assistant now reports to the COO. And he eliminated a customer service person because they had too many people in there.

They added a human resources person because they felt like they had to improve that area. They replaced their CFO. And they brought in a new controller. However, other than that, everything's the same.

OID: And how would you assess the moves and the talent that they added?

Rodriguez: It hasn't been long enough. All of those changes occurred between June and August of last year.

THERE'S NOTHING WRONG WITH THE FRANCHISE.
THE PROBLEM HAS BEEN IN THE EXECUTION.

OID: How much fantasy and how much reality do you believe were in their original pro forma projections — not in predicting the future, but in estimating normalized earning power?

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Rodriguez: I think that there was a degree of fantasy there. But I believe management believed its projections.

OID: Similar to "bi-monthly, more or less", I guess.

Rodriguez: I considered it a reasonable speculation. Obviously, in retrospect, I've been 100% dead wrong. On the other hand, any number of entities would love to have Rawling's brand name. There isn't anything wrong with it. It's a problem with execution. And that's a fixable item.

OID: That's certainly what we keep telling ourselves.

Rodriguez: There isn't any question in my mind that Rawlings' senior management — particularly Carl Shields — is feeling the heat. In fact, Carl asked me, "Do you think we're exposed to a hostile acquisition?"

And I told him, "There's not any question in my mind that you are."

OID: No kidding.

Rodriguez: Incidentally, this was at a public/private meeting. In other words, there were analysts present. And I was at their corporate offices last August — and we were talking about it. And he said, "I guess we *are* exposed. But we need time to get our plan executed."

And I told him, "Well, Carl, I've been known to support managements and vote against hostile takeovers. I've even taken 30-40% share price declines when I felt like a bid price was inadequate and against my clients' long-term interests. So I am willing to side with management when they've demonstrated that they're working on my behalf and they've put themselves at risk along those lines."

He said, "OK. But what does that mean?"

And I told him, "It means that you have to open up your damn checkbook and start buying stock personally. Put yourself on the line. If you think the stock is so cheap here, go out and borrow against your home and buy a chunk of stock for yourself."

OID: And has he?

Rodriguez: He bought some, but not a large amount. So I said, "You can tell me a lot of things. However, I learned a long time ago that actions expressed in dollars convey a lot more information than verbiage."

OID: Ain't it the truth.

Rodriguez: So he knows that we control a little less than 10% of the company, that I'll do what's in my clients' interest and that I'll take a long-term view. But he's on a very short leash. He knows that he needs to execute this year to demonstrate that he's getting control of his marketing, his distribution and his expenses.

RAWLINGS' CORE ELEMENTS ARE STILL THERE: I.E., ITS GOODWILL AND ITS MARKET SHARE

Rodriguez: And this company isn't capital intensive. The only plant they have is the one down in Costa Rica where they manufacture their baseballs and some apparel. And they're thinking about expanding it next year. However, they want to make sure they have the proper volumes first.

OID: Sounds prudent.

Rodriguez: In Costa Rica, it's a cottage industry in the truest sense of the word. They farm it out to people who manufacture the baseballs in their homes.

Then, their other products — their baseball gloves and so forth — are manufactured in the Far East on a contract basis. So they're very much like NIKE or Reebok in some ways — they don't have a lot of manufacturing overhead to deal with. They're more of a designer/sourcer.

OID: What kind of market share do they have in their respective niches?

Rodriguez: The latest market share figures I have handy are from the original offering prospectus. But it hasn't changed very much. They're #1 in baseballs and gloves with a market share of approximately 32% and 34%, respectively. They're #2 in footballs with a market share of 25%. And they were #3 in basketballs with an 11% share.

OID: Sounds mighty impressive.

Rodriguez: It is. It's not that they're not recognized. Quite simply, they just didn't execute. And on top of that, they had the macro problems. So the problem has been a function of the external environment as well as internal miscues of the management.

OID: And they didn't suffer any deterioration in their market share?

Rodriguez: That's right. There hasn't really been any market share erosion in any of their key categories. In fact, they just recently got a new order for basketballs. One of their key customers is Wal-Mart. And they're on EDI with all of their major customers.

OID: Electronic data interchange?

Rodriguez: You've got it. So, for example, they just announced that they took an order away from Wilson. And they now have a 1 million basketball order with Wal-Mart — which is 9% of all domestically sold basketballs.

OID: Whatever the margins might be.

Rodriguez: The margins are in the low 20% range. Their initial shipment was approximately 300,000 balls. Wal-Mart says they've already sold approximately 240,000 of them. And in mid-April, I understand that they shipped another 600,000 balls.

So their market share has suddenly gone from about 11% to more like 20%. If they were losing market share, they wouldn't be getting some of these kinds of things. So the core elements of the company are still there.

OID: Particularly name and market share.

Rodriguez: Exactly. They're still there.

OID: How do their sales and earnings break down between the domestic and international segments?

Rodriguez: International sales represent about 11% of their total revenues. However, inside their revenue base is an item called licensing — which is their licensing profit. And they have a joint venture with Asics of Japan. And

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Asics' revenue doesn't get counted in Rawlings' top line. They just net it out as a net profit that just flows through.

OID: In effect, as a gross royalty.

Rodriguez: Exactly. And licensing revenue accounts for approximately 7% of their total revenues. So it wouldn't surprise me if half of that is international. Then, if you were to gross things up, their international sales might represent something like 30-35% of their sales.

OID: And profits?

Rodriguez: We don't see those numbers.

OID: Do you think that their overseas business is less profitable than their domestic business or more so?

Rodriguez: It's probably somewhat more profitable in the sense that their licensing revenue doesn't require the same kind of marketing and administrative infrastructure that's required in the U.S. They're just netting it out.

If you were to gross it up, its international profitability would probably be about the same or even a little bit less because of expenses associated with operating overseas. Distribution in Japan is more expensive than it is here.

SO RAWLINGS HAS TREMENDOUS BRAND EQUITY.
BUT IF NIKE DECIDED TO PLAY, IT COULD GET ROUGH.

OID: And their key competitors?

Rodriguez: Wilson was #2 in gloves at that time at around 17%. Mazzuno would have been #3 at about 9%. And #1 in basketball was Spalding — who has the license for the NBA — and then Wilson.

OID: Aren't NIKE and/or Reebok trying to move into the sports equipment area?

Rodriguez: They are. And that's a real, real threat.

OID: And one of our contributors has pointed out that "What NIKE wants, NIKE gets." Historically, whenever they've targeted a market, they've taken it.

Rodriguez: Not true. If that were true, they'd have been successful with their shoe line, "i.e." — which was their foray into the women's shoe market. And it was an abject failure. NIKE has never really demonstrated the ability to market multiple brands. You could argue that Reebok hasn't been successful at it either — because they were trying to market both the Reebok brand and the Avia brand and now are in the process of spinning it off.

However, when NIKE acquired Canstar, they acquired the Bauer brand of roller hockey skates.

[Editor's note: And, we understand, $75 million worth of sales of hockey skates, sticks and other equipment.]

Rodriguez: And NIKE's designing a roller hockey skates that would carry the NIKE brand name. So they're in the process of trying to implement a multi-brand strategy in the hockey area. If they're successful doing that, it might give NIKE further confidence that they can pursue a multibrand strategy in a different product area.

OID: How can Rawlings or anyone else stand up to the onslaught of endorsements from the pantheon of stars and teams that NIKE can produce?

Rodriguez: If they go out and do the same thing with the appropriate people in baseball, they *could* be successful. But don't forget that Rawlings has the NCAA for basketball and the leagues in professional baseball.

NIKE is certainly the 800-pound gorilla. And it is conceivable that they could decide to come after Rawlings. That is a legitimate risk. But that risk was there when I first got into the stock. And it's been in the back of my mind the entire time that NIKE could decide to target this area and try to roll over Rawlings as they've rolled over other competitors.

But if NIKE is successful with its multibrand strategy, rather than trying to roll over Rawlings, they might say, "Gee, there's such tremendous brand equity in this name. Why try to roll over it? Why not just acquire it? And we'll just take Rawlings through the NIKE distribution system. We'll just NIKE-ize them with our efficiencies and modern management techniques."

OID: And a little Zen for good measure.

Rodriguez: And a little Zen. That's also a possibility. Conceivably even another sporting equipment company such as an Anthony Industries might have an interest in them.

OID: So it isn't clear to you just how vulnerable Rawlings is or isn't.

Rodriguez: Correct. NIKE would have to knock off a leading market share company. And can they do it? Well, they entered Germany. And they've been in a donnybrook with Adidas.

OID: They haven't just knocked 'em off.

Rodriguez: That's right. Could they knock off Rawlings? I don't know. Rawlings has such tremendous brand equity in baseball gloves that it's just hard for me to imagine NIKE even *trying*.

OID: Is there much in the way of a technology moat?

Rodriguez: They're as complicated to make as shoes. But they're different factories. NIKE could knock off Rawlings in basketball. And, maybe if NIKE succeeds in roller hockey skates, then they could probably do NHL equipment. And they *are*. They're doing NHL *outer*wear.

But Rawlings is focusing on the protective gear area — the underwear, if you will. And they're very well known in that area. They're the leader in providing protective gear in the baseball arena. So they're taking some of their protective gear capability there and transferring it back over into hockey — which they had experience with many years ago.

RAWLINGS UNDER FIGGIE HAD ITS CONSTRAINTS
INCLUDING SWINGING DOOR-STYLE MANAGEMENT.

Rodriguez: In fact, several years ago, Rawlings was the leading hockey glove — in the pros and the amateurs. But they exited that market — although they're reentering it.

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They have about 20 players in the NHL using their hockey gloves now. So they're starting to rebuild their identity. But they're just moving into the distribution channels with those products. So it probably won't begin contributing much to their business for a year or two.

OID: Sounds promising.

Rodriguez: Yes. Plus, they're looking at some other opportunities to expand the Rawlings name.

OID: But for God's sake, why did they exit a market where they were the leader?!

Rodriguez: That's a very good question. One of the earlier COOs of Rawlings — while they were under the Figgie banner — decided to have them exit that area.

To give you some perspective, from '89 or '90 through '93 during the time Rawlings was owned by Figgie, its management suite was a virtual swinging door. I think they went through something like 12 senior operating officers in a period of around three years. It was just amazing. I doubt that even the secretaries could remember who was coming and going.

OID: What accounted for that?

Rodriguez: Figgie was not exactly the easiest person in the world to work for. He operated at such a lunatic fringe level that capital expenditures over $5,000 had to be approved by corporate — and by him personally. This was not exactly a sanely managed operation. And you can understand how under those kinds of circumstances that a lot of turnover could occur.

OID: How people would go where they might be treated like adults.

Rodriguez: Exactly. And so you can draw your own conclusions about the people who elected to stay behind. I've often wondered about that.

And when Rawlings wanted to expand internationally, Figgie said, "Fine. We have great distribution systems in Europe." However, how many people play baseball there? No one.

OID: Picky, picky, picky...

Rodriguez: Baseball is played in the Far East and South America. And Figgie wouldn't let Rawlings expand into those areas.

TODAY, RAWLINGS IS IN THE GARAGE.
HOPEFULLY, THEY'LL GET THE ENGINE RUNNING.

Rodriguez: So they're just now starting to do that. They have a representative down in Miami who's working on penetrating the South American market. How successful he'll be, we'll find out over the next couple of years. But because of their history, he's starting from a very low base.

OID: And yet, all of that apparently hasn't led to market share deterioration. Perhaps, that's grounds for optimism about their franchise and their future.

Rodriguez: I believe it is.

OID: And since sports is supposedly one of the things that travels best internationally, I imagine that their potential for international growth is quite attractive.

Rodriguez: I believe so.

OID: And for a #1 player with a 30%+ market share in a branded product business, a 5% net profit margin sounds somewhat on the low side of normal — at least before interest.

Rodriguez: Yes. It does to me, too. And when I bought it, I thought they were going to go through a deleveraging process. But it never occurred. And the combination of lower revenues and the failure to deleverage all worked their magic in terms of profitability contraction.

So I agree that you could conceivably expect those kinds of figures with their market shares. However, I'm just not counting on it. I'm keeping my expectations very, very low. This is my Missouri stock. They're going to have to show me.

OID: Aside from NIKE, what could turn Rawlings into a mistake?

Rodriguez: Management could turn it into a mistake by expanding into a product area where they don't have expertise — particularly if it's much more capital intensive. That combination — financial leverage and capital intensity — can easily spell disaster.

But, again, if I turn out wrong long-term, I think my most likely scenario is that I come out earning no return on my $12 cost, but that I get my money back.

And if we do have any kind of normalcy in the next 15 months, my guess would be that Rawlings' earning power moves up, people start looking at the following year, analysts start talking about what a "model" should be for the company and then they start forecasting some growth. In effect, the stock market machine starts working for you.

OID: A pretty good description of what happens.

Rodriguez: But right now Rawlings is in the garage. And we're not sure the engine is running. If we can get it going, get it down the street and get a little more gas in it, we go from a car that's not worth a hell of a lot because it isn't working to one that's on the road. And depending on how well it runs, the price goes up from there.

[Editor's note: For whatever it might be worth, in the first month of baseball, hitters appear to be on a tear again — reportedly setting an all-time record pace in home runs.]

I'D BE PERFECTLY HAPPY TO OWN ARROW FOREVER
AND JUST GROW ALONG WITH ITS EARNINGS.

OID: And Arrow Electronics?

Rodriguez: Arrow Electronics is the largest electronics distributor in the world. They have slightly over 20% of the market. Avnet is #2 with only slightly less — something close to 19%.

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I first encountered them when they acquired Anthem Electronics — which was another electronics distributor and one of our holdings at the time. I looked at them and thought, "Hmm! I like what I see. They've really transformed themselves. So I'll just hold on to it. That way, we won't have to pay a capital gains tax."

And when Arrow came down in December and January — from a high near $60 to $35 — I increased my stake by 75%. I started buying more right around $44 and averaged down at $42, $38, $37, and $35. Today, it's recovered to about $50.

OID: And the most you've paid?

Rodriguez: I believe that we've paid up to $46 in the Fund and up to $48 for an account that recently joined us. And when you consider that Arrow could earn close to $4.75 this year and have earning power of $6 or more within 18 months, I don't think it's overpriced at all. In fact, I think it's probably pretty cheap.

And I'd be thrilled if it were to stay reasonably priced so I could own it forever. I'd be perfectly happy to hold it for a long, long time, have it trade at the same valuation and just grow with its earnings. What's wrong with that?

OID: From the perspective of shareholder or broker?

Rodriguez: If it never gets egregiously overvalued, I'd never have to sell it and take a capital gain. Plus, I'd never have to build up a reservoir of new knowledge about another company.

OID: Bite your tongue.

Rodriguez: That's the ideal situation.

OID: But why this company?

Rodriguez: I view Arrow and the distributors I own generally as my chickenhearted way of playing technology. I view them as a mutual fund of electronics companies. It's a low risk way of participating in the growth of electronics without having to bet on a particular technology. It lets me hedge my risk.

Incidentally, the electronics distribution business is a really neat business.

OID: How so?

Rodriguez: Because they can return merchandise or get credit for it based on its actual cost. And that's been the standard for the industry for many years. They have to have it that way because of the nature of the inventory — which is eroding in price all the time. Furthermore, it has a highly diversified customer base.

OID: So that you get much of the technology gain without all of the pain.

Rodriguez: Exactly. Of course, they aren't immune to the economic cycle or the electronic cycle. And I say that because I think it's quite possible there will be an impact there. However, if that doesn't happen, then this stock should carry a considerably higher price.

OID: How do you figure?

Rodriguez: I view 10-1/2 times this year's earnings for the leader in international electronics distribution — especially when they're earning the returns that they are and have the call option that they do on the growth of technology — as a very *inexpensive* price.

Again, I'm just hoping that it *stays* that way.

RECENT 20%/YEAR GROWTH WON'T CONTINUE.
BUT LOW-TO-MID TEENS WOULD BE JUST FINE.

OID: It's very hard to get a handle on this company from its page in Value Line. It looks like they've been actively acquiring other distributors and increasing their own shares outstanding since 1991.

Rodriguez: That's right.

OID: It looks like whatever they've been doing has been working.

Rodriguez: They've been active in acquisitions. And they've also been active in improving their profitability. The last five years have been the best five years of their corporate history.

During the 1980s, this was basically a leveraged company with mediocre returns. And I could have said that about the entire electronics distribution industry. Really only one company had high returns on capital, generated nice free cash flow and was unleveraged. And that was Anthem Electronics. Anthem was earning considerably better margins and returns on capital.

OID: Which is the case with Arrow today.

Rodriguez: That's right. But that wasn't lost on the rest of the industry. They started looking at what Anthem was doing and improved themselves.

Also, the larger electronics manufacturers realized that they couldn't service some smaller customers. And, therefore, they began "partnering" with the distributors. And, finally, the industry has consolidated. Thus, those factors have changed the overall level of profitability within the industry.

OID: Where's the moat?

Rodriguez: Customers don't want to work with umpteen different distributors. It becomes too complex. And that's happening in lots of industries. We even hear that in the money management business.

So larger distributors are getting a bigger piece of the pie. Plus, distribution's expanding into the international arena. And manufacturers are increasingly seeking to consolidate their distribution and avoid dealing with a different cast of characters in every country. So what was going on in the United States is also gradually starting to evolve internationally, too — although it's still very much in its early stages. And Arrow stands to be a prime beneficiary.

OID: According to Value Line figures, it looks like its book was up 25% per year in the past five years and that its revenues were up about 22% per year for the last four years.

Rodriguez: Like I said, it's been the best five years in

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Arrow Electronics' history.

OID: And I see that their sales and earnings per share were up 18% and 22%, respectively, during the first quarter. What's that about? And is it sustainable?

Rodriguez: I don't think so. The electronics area itself is growing at a double-digit rate. But it's probably growing at something in the low-to-mid-teens, not 20%. Therefore, I'll be perfectly happy if they just manage to grow sales and earnings at something in the low teens.

OID: That doesn't sound very exciting.

Rodriguez: I don't believe Arrow is a home run stock. As I've said, I don't see any of those today. The market's taken those away. But if Arrow is able to compound its sales and earnings anywhere in the 10-15% range during the next five years, my guess is that its stock will outperform the stock market handsomely.

OID: Which may not be saying much, of course.

Rodriguez: Exactly. I'm telling my clients not to expect stocks to earn much more than 8% per year from today's levels. I'm not expecting Arrow to provide me with a 20-30% per year compound rate of return.

OID: If you don't tell anybody, I won't.

Rodriguez: To find companies with that kind of prospective return today is very, very unlikely. I'd guess that returns of 13-15% per year from today's stock prices would put me in the top quartile — if not higher.

And I hope I'm wrong — because I like 20% per year better. But I just see so much optimism out there today. Therefore, one of the most important things I'm doing today is trying to lower our clients' expectations.

I DON'T THINK I'M ANY SMARTER TODAY — JUST MUCH MORE POPULAR.

OID: And how large is FPA Capital today?

Rodriguez: About $400 million. But that's not the only money I run. My total equities today are right around $1.1 billion.

OID: Are you accepting individual accounts?

Rodriguez: No. Steve Romick and Eric Ende *are* accepting new accounts. But with only a single exception, I haven't accepted new money — either within FPA Capital or as separate accounts — since November of 1994.

As you know, size and rapid growth are a lethal combination against superior investment performance.

OID: Something I struggle with every day...

Rodriguez: Therefore, during the last two years, I not only turned away more money than I'm managing today, but I turned away more than the cumulative dollars represented by prospective clients to whom we made presentations for the last 13 years.

OID: And they say living well is the best revenge...

Rodriguez: It's just unbelievable. I don't consider myself any different today than where I was five years ago when I had poorer investment performance. At various points in time, you look more brilliant or more stupid.

Of course, luck has something to do with it — as does the nature of the market and a host of other things. But I've always believed that if we put ourselves in enough depressed investment areas, the blind squirrel would eventually find the acorn and that we'd come out with a pretty decent compound rate of return.

OID: Of course, that's what we thought...

Rodriguez: When I had my worst quarter since 1974 — which was the third quarter of 1990 when I was down 31% — my I.Q. was subterranean. I sent out a special letter to my shareholders laying out why it was an opportunity, not the debacle everyone was proclaiming.

To remind you of just how bad it got, an associate and I went to the East Coast to talk to the consulting community and anyone who'd listen about investing in small cap stocks. It was like throwing a party where nobody came. One consultant even told me, "I know you're right. But none of our clients will be ready to go for at least two years."

OID: Sounds familiar...

Rodriguez: So I wrote the special shareholder letter. And I argued why small cap stocks were particularly cheap and why that situation was unlikely to continue for long.

As a result, I believe, we had virtually *no* redemptions. In fact, we had *contributions*. Several organizations read it and said, "You're absolutely right" — and put *in* money.

OID: Wow.

Rodriguez: So adversity is good. It tests the mettle not only of the individual, but also of the organization. And with George's passing, we have a challenge. But today, it's business as usual. We're looking at stocks, bonds and other potential investments. And we're meeting with clients.

I truly believe that George planted a lot of good seeds that are growing up into fine, strong trees. The enterprise he began will continue forward. And aside from his family, I think that would be the best possible tribute to George.

OID: That and regular contributions to OID by you and your associates. Thanks for some super ideas and valuable insights — both past and present.

— OID

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from page 1)

overall partnership, net returns to the limited partners and those of the *Ibbotson* Small Cap Index. (Return figures provided by Ravenswood and *Ibbotson*.)

Year	Ravenswood Overall Return	Ravenswood Limited Partners	Small Cap Return
1983	+21.5%	+17.2%	+39.7%
1984	+ 1.4	+ 1.1	- 6.7
1985	+21.8	+17.5	+24.7
1986	+21.8	+17.4	+ 6.9
1987	+ 3.7	+ 2.9	- 9.3
1988	+40.6	+32.5	+22.9
1989	+19.6	+15.7	+10.2
1990	-10.0	-10.0	-21.6
1991	+17.6	+16.3[1]	+44.6
1992	+36.6	+29.3	+23.3
1993	+30.5	+24.4	+21.0
1994	+ 7.9	+ 6.4	+ 3.1
1995	+50.1	+40.0	+34.5
1983-95	+19.1%	+15.4%	+13.2%

[1]Net return is greater than 80% of gross return as limited partners received an allocation of 100% of return until prior year's loss was recouped.

If there seems to be more than a little bit in common between Robotti today and Tweedy, Browne historically, there's a very good reason why. As a young accountant, Robotti saw the importance of TBK Partners' success in helping to start up their money management operation.

So he decided to "steal" its model — i.e., earn a living as a broker and set up and run a partnership on the side. But Robotti didn't stop there. He took two more pages from Tweedy's book by specializing in obscure "inactives" and even making a market in many of them to facilitate their purchase.

Therefore, when one of our contributors told us that some of the most interesting opportunities out there today were among the micro-caps — and, shortly afterwards, one of Robotti's associates informed us that they just happened to be finding particularly compelling ideas at that point — we, of course, had no choice but to give him a call.

As the following excerpts will no doubt make clear, we were glad we did. They were distilled from a series of conversations with Robotti. We hope that you find the ideas as intriguing and the insights as interesting as we do.

WE JUST STOLE THE MODELS WE KNEW — FROM BROKER TO PARTNERSHIP, ETC.

OID: I understand that your primary activity isn't money management, but brokerage?

Bob Robotti: That's right. When we started the firm in '83, we just stole the models that we knew. After all, there's no such thing as an original idea.

OID: You sound like Charlie Munger.

Robotti: I was in public accounting for four years.

OID: Which explains your winning personality...

Robotti: I was with the firm of Pustorino, Puglisi and Company, P.C. — which happens to audit Tweedy, Browne and has audited TBK Partners forever.

OID: And I understand that one of your associates is Joe E. Reilly?

Robotti: That's right. As you know, his father — Joe R. Reilly — was one of Tweedy's founders. The firm was Tweedy, Browne and Reilly before it became Tweedy, Browne and Knapp. He retired in the mid-'60s. And it's probably thanks to him that I got into this business.

OID: Fortunately, you can take it out on Joe.

Robotti: I joined Pustorino, Puglisi right out of school. And Joe was retired. He used to come into our office every day around noon or 1:00. And he'd stay until 7:00 at least managing his own investments and so forth. But by 6:30, everyone else would be gone. So the two of us would chat about investing — which is obviously a lot more interesting than auditing, checking, verifying and crossfooting.

OID: You'll certainly get no argument from me...

Robotti: So he and I became pretty good friends. And that's how I got interested in this business. Actually, he was instrumental in starting our firm, our partnership and a lot of the things we've done over the years.

So, anyway, I started auditing Tweedy in '75 and continued doing so through '79. And, as you know, their genesis was in brokerage.

OID: Nobody's perfect. After all, we publish...

Robotti: They were a broker-dealer for many years. And at some point, they said, "Gee. We own these things personally. We know that we make a lot of money in 'em. Why don't we start a partnership that invests in 'em?"

And I saw that what really led to a lot of their success was starting up the money management operation through the success of TBK Partners.

OID: I don't think you'd get any argument from them.

Robotti: Anyway, upon leaving the accounting firm, I joined Mario Gabelli. I was CFO and a shareholder in his firm from '80 to '83. And, of course, Gabelli was also primarily a broker when he started in '77. Then he started managing money. When I joined him, he was managing $8 million. By the time I left in '83, he was up to $88 million. And that's where he made all of his money, too — through the track record he built on the money management side.

So those were the models I knew best.

OID: And just imagine where you'd be today if your firm had audited a somewhat different clientele...

Robotti: So when we started up the brokerage firm, we decided that we'd find good ideas and try to sell 'em. We were really looking for investments for our own capital. But the best way to leverage that was to start a partnership, buy our ideas in there and, over time, be successful.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

OID: You make it all sound so easy....

Robotti: And since we had relatively little capital, the brokerage activity would help pay the bills and provide us a living. But we haven't been all that successful business-wise on the brokerage side. And, frankly, we haven't been all that successful raising money for the partnership either. Despite a pretty good record and the fact that Ravenswood's been around since '83, it's only a $10 million partnership.

OID: Certainly, $10 million in 13 years won't qualify you for the money manager marketing hall of fame.

Robotti: But what the heck. I'm only 42. We've been running Ravenswood for 13 years. So I've *been* around. However, I think we've got many years ahead of us, too. So I'm not in any hurry.

WHY HAS OUR PERFORMANCE IMPROVED?
EXPERIENCE HAS LED US TO FACTOR IN MGM'T.

OID: And Joe Reilly's role today?

Robotti: Today, Joe's main involvement is managing his family's capital. Joe and his siblings have a family partnership that owns a lot of inactive securities. That's because when his father retired from Tweedy, he was a one-third partner and got one-third of every security Tweedy owned. So he still owns a huge amalgamation of small stocks. And it offers a plethora of opportunity.

OID: And, no doubt, an abundance of reading material.

Robotti: He's always sifting through reports digging up things that we ought to look at. He's also a shareholder and an employee of Robotti & Co. and has money in Ravenswood — besides managing his own money.

OID: I see Ravenswood has two general partners...

Robotti: That's right. The other general partner is a full-time partner in a CPA firm.

OID: Remind me to miss your annual meeting. How do you two allocate responsibilities?

Robotti: We don't. We just agree before we buy something.

OID: Do you manage any discretionary accounts?

Robotti: Just one.

OID: Why do you have only one separate account and so little — relatively speaking — under management?

Robotti: I can't get anybody to give me their money.

(continued in next column)

OID: Not because of any lack of candor I gather.

Robotti: We're managing $10 million in Ravenswood and about $1 million in the individual account. However, the individual account isn't nearly as representative — both because the history is shorter and because the client has his nuances and whims. And Ravenswood's significantly bigger and has a 13-year audited track record.

OID: The first three years of Ravenswood's existence appear to have been your worst ones performance-wise — at least relatively. Do you have any idea why?

Robotti: No. I'm not really very good about knowing performance statistics and knowing whether I'm underperforming or outperforming this or that index — because, frankly, I don't give those things much thought. I'm too busy trying to find cheap stocks with our capital.

But it does seem like our performance has improved over the years. And that probably has to do with experience. I think I'm a better investor than I was 10 years ago. And 10 years from now, I'll undoubtedly know more than I do today. And I hope I'll be a better investor then.

OID: How exactly has your approach changed with the passage of time? It certainly doesn't look like you're buying bigger cap issues.

Robotti: I imagine we're a little more aggressive today when we have a conviction on something. And that just comes from gaining experience and knowing what attributes make an idea not only cheap, but timely, etc.

One way that we've improved, I think, is that we used to do a lot more statistical investing when the numbers made something look cheap. But over time, one of the things we've realized is that a 50¢ dollar isn't cheap if it doesn't appreciate or if it *depreciates*. So today we look a little more at who's running a company, how smart they are, what their attitude is about making money for themselves and other shareholders and their record for building value.

HOW CAN WE BE FINDING BARGAINS TODAY?
EVENTS HAPPEN — WHATEVER THE ENVIRONMENT.

OID: One of our contributors recently told us that the micro cap area is one of the few segments of today's stock market still offering a fair number of bargains.

Robotti: I don't know about the relative attractiveness of our niche versus other segments. However, I don't think I'm having much more difficulty finding things to buy than I have during the last ten years. We're about 106% invested today...

OID: Via margin debt?

Robotti: That's right. That's pretty standard for us. We've generally been 105% to 110% invested in the past. And we're finding a reasonable number of good ideas today — certainly enough to keep us fully invested.

OID: With reluctance or excitement?

Robotti: We're definitely excited about some of the things that we're finding today. No question about it.

OID: Before I beg you to tell us about some of those,

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let me ask you how that can be the case with stocks having advanced so much in the last year or so?

Robotti: The pool of capital we have is small enough that we always have more ideas than we have capital.

OID: I can certainly relate there.

Robotti: But we're just stock pickers. That's really all we are. There's no market timing or asset allocation involved. When we find stocks we think are cheap, we buy 'em. And if we find that we're borrowing a little money, then we look through our portfolio and figure out what we can sell so that we can buy the next thing we like more.

That process usually forces us to sell some holdings that we might not sell otherwise. But there's no timing or portfolio strategy involved, although I wish I could say there was.

OID: Why would you like to say there was?

Robotti: Because it would sound more intelligent. But I think the timing of some of the tiny things we buy probably relates more to the vagaries of when we stumble across them than anything else and not so much where the overall market is trading.

For example, we look at spin-offs and restructurings — which have much less to do with bull markets. Most of our investments are just undesirables that are always being thrown off and created. I think those corporate events happen pretty much without regard to where equity markets are.

OID: However, wouldn't corporate events tend to be oriented towards raising money in expensive markets and more towards buybacks, etc. in cheaper ones? Aren't investors typically swimming against the tide in either case?

Robotti: I guess so. Maybe they're harder to find in a bull market. But situations with no following are always being created — and that creates opportunities.

SUPERIOR HAS A COMBINED RATIO BELOW 100.
YET IT'S SELLING AT LESS THAN 60% OF BOOK.

OID: For example...

Robotti: For example, we're buying a stock that up until the last month or two was in the Pink Sheets. Today, it's on NASDAQ. But its stock still hasn't done anything because it still hasn't gotten any attention.

OID: And it should?

Robotti: You tell me. Superior National [SNTL/NASDAQ] is a California property and casualty insurer that specializes in workers' compensation insurance. It's a solid company with proven management that writes insurance at a combined ratio below 100.

OID: A rare and wonderful ability of a few insurers because it means that they're not only effectively borrowing funds from policyholders at zero cost, but that they're not even repaying all of the principal.

Robotti: Exactly. And yet Superior National's stock is selling significantly below its peers. It's selling at only $5-1/4 despite having a fully diluted book of over $9 per share — $9.22 as of December 31st. So, in effect, Superior's selling at less than 60% of book.

OID: Wow. It certainly has our attention.
But is that a hard book?

Robotti: Except for deferred acquisition costs — which are reasonable. After all, the most significant item is commissions paid to brokers for originating business. And these are only one-year policies that get expensed and replaced by the next year's deferred acquisition costs — within one year at most. So I'm comfortable with them.

OID: Then what's the catch?

Robotti: None that I'm aware of. But as a result of open rating and a lot of the changes that have occurred in California the last five years, no one in the industry is really making a lot of money because it's incredibly competitively priced today. So Superior didn't report a lot of earnings last year — both because of industry conditions and because they're disciplined and aren't writing business until the market gives them the right opportunities.

OID: That certainly doesn't sound like a catch.

Robotti: Not to me. I think it's a solid company that has a very good long-term earnings outlook — in part because of its disciplined approach.

THE SCRAP HEAP IS NORMALLY WHERE WE LOOK.
AND THAT'S WHERE SUPERIOR NATIONAL IS TODAY.

OID: Before we call our broker, might we trouble you to tell us a little more about it?

Robotti: There are 3.4 million shares outstanding. However, that's only 70% of their fully diluted shares. There are also warrants for another 1.5 million shares that are held by an investment group who loaned money to the company in 1991 to help get it through difficult times.

OID: So this company's been through rough times.

Robotti: The scrap heap is *normally* where we look — because so many times things do get thrown out. Additionally, when things have been bad long enough, those situations have either improved or disappeared. And when they've improved, people tend not to give them credit. They've fallen out of the limelight. So people aren't attracted to them like they once were.

OID: For some very powerful psychological reasons, people seem to want to affiliate with "winners" and avoid "losers" — literally at almost any price.

Robotti: One real plus of being contrarian investors.

OID: Also, our brains tend to extrapolate trends into the future no matter how unsustainable they may be. So that sounds like an excellent place to look.

Robotti: Which is why a lot of the stuff we find is

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post-bankruptcy, post-difficulty or in the *middle* of difficulty.

OID: Vastly preferable to my pre-difficulty approach. But back to Superior National...

Robotti: We've done a reasonable amount of property and casualty insurance investing. Actually, my father owns a "storefront" insurance brokerage. His business was downstairs and we lived upstairs. And I used to work with him part-time. Therefore, understanding the business led to understanding the accounting — although it's pretty complicated, frankly. So we like the property casualty business because we think we know something about it.

OID: It's within your circle of competence.

Robotti: We think so. Furthermore, we like some of its important attributes. And I'd be happy to explain what I mean by that in a minute.

WE LIKE CALIFORNIA WORKERS' COMP COMPANIES — BASED ON LOGIC AS WELL AS EXPERIENCE.

Robotti: However, first, I should point out that the workers' comp insurance business in California is different than it is in the rest of the country.

OID: As are most things, I gather...

Robotti: But in the case of workers' comp insurance, it's actually different in a lot of ways that are *positive*.

Workers' compensation business in California develops much quicker than it does in the rest of the U.S. — where it's normally a long-tailed line. The process of identifying claims and setting up reserves occurs faster in California. Therefore, it's actually not that long-tailed.

OID: Because of the reforms that California enacted in the wake of the terrible problems of recent years.

Robotti: Even before that. They've always taken the attitude: "Let's get the process underway." So long before anyone else, they shortened the process so that the parties could more rapidly agree on a settlement and get it going.

OID: How do they do that?

Robotti: They just limit the length of time following an incident after which you can place a claim. Therefore, the line develops very quickly.

If you have a long-tail line, one of the things that can be difficult to do is estimate future losses and, therefore, accurately estimate book. But because there's shorter development in California, you can have more comfort in reserve estimates and whether they're accurately stated. And if they're not, you find out sooner rather than later. So it's easier to get comfort with book value.

OID: Gotcha.

Robotti: Another reason why we're comfortable with Superior National is our experience with Unicare Financial — which was another workers' comp company in California that we followed in the early '90s. When the industry had its increasing claims experience in '91 because California's economy went into the tank, Unicare's stock went from the high $20s — or nearly 2 times book where everybody *loved* it — to $12 when its book was $16.

Plus, the Leatherby family — who started the business and ran it — owned a third of the company. And we like that because they're not going to lie to themselves about reserves. At least that's not a very intelligent move.

OID: Although that's never stopped us...

Robotti: And they bought in stock at $12 with it selling at less than book. So that gave us comfort, too — because you don't buy in stock if you own a third of the company and you know you've underreserved.

The market in '91 was unusual — it was a new time — because it'd been so long since they'd had a recession in California that people didn't anticipate how much of an increase there'd be in workers' comp claims. So Unicare actually stopped buying in stock after starting to buy it at $12 because the times were so tough that they wanted to first make sure that they could stay in business. So it got down to $8. And we bought quite a lot of it down there.

And we singled out Unicare because of one of their attributes we like best — an extremely low expense ratio. It was down around 17%.

OID: And the industry average?

Robotti: For the average workers' comp company in California, it was probably in the mid-20s.

OID: So Unicare had a fairly substantial advantage.

Robotti: That's right. So we figured that no matter how bad business got, they had a cost advantage based on their lower expense ratio — and they'd be a survivor. This cost advantage related to the type of business they wrote. They tended to focus on writing much larger risks. And the costs associated with writing those larger risks were much less.

So that was their niche. It was risks they understood. And we were comfortable that they knew how to price it. So by writing exclusively to a single niche, Unicare truly had something that differentiated it.

OID: Was it a free market in terms of what insurers quoted?

Robotti: There was a minimum rate, but no maximum — with pretty wide variability in terms of what they'd charge.

OID: And did the market tend to be above that minimum or did it tend to hug it?

Robotti: It was above it.

OID: So that the expense ratio would have been an advantage not only in terms of profitability, but also in terms of competing for business.

Robotti: We think so. Well, ultimately Unicare got bought out by Wellpoint for $28 a share — which was roughly 2 times book — about 1-1/2 years later. And by that time, the market had stabilized, the legislative reforms had come through along with an industry-wide crackdown on fraud, and losses had come down significantly. So it had once again become a profitable line to write.

So we've been through a full cycle in workers' comp insurance in California.

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(cont'd from preceding page)

A HIGH QUALITY BOARD/SHAREHOLDER GROUP INSTALLS A HIGH QUALITY MANAGEMENT TEAM.

Robotti: And then we came across Superior National. So I thought, "OK, I kind of understand that. And, therefore, maybe I can get some additional comfort in terms of reserves and that their book value is accurately stated because I know that the tail develops kind of quickly."

And then I looked at its other attributes — one of which was that in '91, they raised capital in the form of debt with warrants attached from a group called III, a predecessor to Insurance Partners. Do you know who they are?

OID: Let's leave my ignorance out of this...

Robotti: It's an investment group with a number of people who used to be at Salomon.

OID: I'd usually crack a joke right about now. However, my wallet hurts too much to laugh...

Robotti: The financial backers included the Bishop Estate, Marsh and McLennan, J.P. Morgan and Centre Re. They provided the capital for this fund with a five-year life to invest in insurance companies.

OID: Gotcha.

Robotti: And today the successor entity, which is maybe a little over a year old, is called Insurance Partners. They changed some of the money people, but they still have the same core operating people.

It's a very incestuous relationship. Insurance Partners shares space with Zurich Re down at Chase Plaza. And Chase — which does quite a bit of innovative lending to the insurance business — is another of its backers. Similarly, Zurich Insurance, which is managed by an alumnus of Berkshire's National Indemnity, controls Centre Re — which is also an investor in Insurance Partners.

OID: I imagine you're giving us all of this background for a reason...

Robotti: Because Insurance Partners' predecessor loaned Superior money, took back warrants, arranged for Centre Re to enter into reinsurance quotas, brought in new management and put five or six of their people on its board. Those were warrants to buy 1.5 million shares at $4 and $5 per share — which would give them 30% ownership.

OID: So that you know they're particularly interested in the success and well-being of this company.

Robotti: That's certainly the way it looks to me. Furthermore, one of those reinsurance agreements provides for quota sharing. And that gives me additional comfort — because if they're sharing business, they're probably comfortable with the risks Superior's writing.

OID: Sounds logical.

Robotti: We also like the management team and their incentive structure. Some of the capital was provided by management in return for warrants and debt — which is a structure that Insurance Partners likes to set up so that management also has money at risk and, therefore, is committed to the project's success and, equally important, to avoiding its failure.

OID: Because they stand to share not only the gain, but also the pain.

Robotti: You've got it. And CFO J. Chris Seaman — who's been there since '91 — is a really competent guy. Also, Superior brought in a new president and CEO — Bill Gentz — in mid-'94. He used to run the workers' comp business for Zenith National which is known to be well run by its highly regarded chairman Stanley Zax — although he's somewhat of a personality in his own right.

OID: Who isn't? Present company excepted, of course.

Robotti: And we know Zax would never put up with anyone who wasn't highly competent, who couldn't deliver and who wasn't a good nuts and bolts operator. So Gentz comes from a very disciplined, successful background. He has lots of experience. And he knows this area very well.

So we feel *really* good about the appointment of Gentz. And the quality of Superior National's management team is another attribute that we really like.

PRIOR MGM'T WAS MISPRICING ITS PRODUCTS — WHICH IS THE MOST COMMON P&C PROBLEM.

OID: Notwithstanding everything you've said, in order for them to need the capital infusion in the first place, they must have been through some very rough times. What's the story there?

Robotti: The people who started Superior in the mid-'80s were refugees from Mission Insurance — the entity Marty Whitman controls which is known as Danielson Holding today. But most of that management left in '89 — with the balance leaving in '91. So the people at Superior have only been there four or five years or less. So they aren't the ones who caused the problem.

But under their prior management, they were inadequately reserved. They wrote a *lot* of their policies — particularly their contractors' general liability business — at significant losses, although they curtailed that line in '89 and finished writing it altogether in '91.

OID: And what happened to the former management?

Robotti: They were forced out — because the board realized they had a big underwriting problem. And I imagine that regulators played some role, too.

However, now their problems have been well identified and reserved for.

OID: The next best thing to not making the mistake.

Robotti: So their prior management was mispricing their products — which is the most prevalent problem in the property and casualty insurance business.

In my mind, that's what differentiates the property and casualty insurance business from the life insurance business. I rarely invest in life companies. And I don't understand the life business as well. The way I think about it is that the life business is an asset business, not a liability

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business — because the principle risk in life investing is asset risk, not liability risk. In other words, loss reserving is a relatively straightforward calculation.

Therefore, life insurance companies tend to price off of what they think they can earn on their assets during the policy's duration.

OID: Gotcha.

Robotti: I also think the vast majority of life insurance companies are *lousy* businesses because you have to price your product to be relatively competitive. And there's always some lunatic out there who swears he's going to get a 200 basis point higher return than the average without taking additional risk. And, of course, invariably, three years later, you find out that he incurred *significantly* greater risk to get those 200 basis points.

Then he has huge asset writedowns and can't cover his liabilities. They chase return which leads them to invest in bad assets — which then leads them into problems. And even if you're a good company, you still have to price against the bad ones who always think they're going to get returns that are better than average.

OID: A version of Gresham's Law, as Buffett observes, wherein the bad insurers drive out the good ones — at least in the short run.

Robotti: Exactly. I couldn't have said it better. On the other hand, in property and casualty insurance, there's much more of an art to understanding and pricing risks and accurately stating liabilities — all of which go hand in hand. So as a rule, property and casualty companies go out of business because of bad *liabilities* — life companies go out because of bad *assets*.

OID: Interesting.

Robotti: And it's a lot harder to understand how to price a product when there is quite a variation in terms of what losses are going to be and if you do have losses, what you'll have to pay. So there's much more value added by good underwriters in property and casualty insurance than there is in life insurance.

Therefore, the variability of returns is much greater and good companies are going to significantly outperform.

OID: And bad companies are going to significantly underperform and get into trouble much more often.

Robotti: Exactly. And that's exactly what happened to Superior National under prior management.

AND THEY'RE MISPRICING PRODUCT TODAY — WHICH THEY'LL LEARN SOONER THAN LATER.

Robotti: And that's also what's been happening since California's workers' comp market went to open rating on January 1, 1995. Rates have come down significantly — in large part because losses came down significantly following the changes in the law that occurred in '93 or thereabouts. Market dynamics changed dramatically. But insurers got way too aggressive and cut their rates far too much.

That's a phenomenon that recurs again and again. Insurance invariably goes through these cycles.

OID: Although they sometimes seem to last forever.

Robotti: But since the tail on workers' comp is shorter, it's not going to be very long before companies begin to realize they were writing business at completely inadequate rates and the market begins to correct itself. And since those rates date back to January 1st, 1995, we're already 15 months into the corrective process.

OID: That's certainly looking on the bright side.

Robotti: I don't believe so. I'd think that sometime this year, workers' comp companies will realize that the rates at which they've been writing business don't make sense. And there are a lot of reasons why. First, loss patterns have been changing because of the new laws. But insurers have been overestimating how good those changes are going to be — i.e., how much they're going to cut losses.

Also, very large companies are writing large policies and trying to grow their book of business — including players like Wellpoint who, again, bought Unicare. Their rationale is along the lines of: "We've got a cost advantage because we're an HMO and can put our workers' comp claims through our network and thereby be more cost efficient." Or they have some other similar, synergistic corporate logic that's just not going to hold. Therefore, these players will eventually start reporting big losses.

OID: Unless they're right — in which case it could be Superior National that starts reporting the losses.

Robotti: That's not going to happen. HMO acquirers have a limited knowledge of this business. We think they don't realize the impact of their aggressive pricing. And we believe the HMOs will discover that sooner, not later.

Meanwhile, well regarded worker's comp companies are writing *less* business. For example, Superior wrote *significantly* less business in '95 than it did in '94. They're in effect saying: "We're going to be disciplined. We're not going to write insurance at a rate that doesn't make sense. We'll simply contract our volume and wait for the market to get more rational and for pricing to improve."

And yet Superior still made money in '95. It was only 11¢. But that was no small feat in that environment.

THE IMPORTANCE OF UNDERWRITING IN CALIFORNIA IS SUBSTANTIALLY GREATER THAN IT USED TO BE.

OID: Does Superior National pursue a niche strategy?

Robotti: The predominant risk that they used to underwrite was medium-sized businesses. But during the last year or two especially, they've written more smaller lines. And they've done that for two reasons:

First, from '91 to '94, they had a test project with a state association where they put in a computer program to see whether they could administer smaller accounts on a cost-effective basis. They terminated their agreement with that association in '94, but they kept writing more small-line business. So they had three years to test software that enabled them to communicate directly with brokers. And they believe that they've become more efficient in processing

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that business than they used to be — and more efficient than most of their competitors, too.

OID: Interesting.

Robotti: And in '95, Superior stepped up the amount of small account business they wrote because there's been less price competition for smaller accounts. One of the reasons why is that one of the companies that specializes in the large account segment is Unicare — who, again, was bought by Wellpoint. And they, along with other HMO-affiliated workers' comp insurers, want to gain market share.

And there are plenty of insurers who say that they're disciplined and won't write business at irrational prices — which is true of most to some degree. But even though some of the larger companies would prefer not to write some of that business, they feel like they have to in order to maintain a presence in the market.

OID: Although, in effect, they may do a better job of maintaining their presence than their capital...

Robotti: Bingo. Before California implemented its open rating system, they had a minimum rate law. You didn't have to worry as much about the risks you were assuming. The issue became how much business you could write. Underwriting wasn't as important.

But this new law gives insurers tremendous flexibility and lets them price almost anywhere they want. And, therefore, they also have to be a better underwriter and understand the risks they're writing — because over time, there's going to be even greater differentiation between the good companies and the not-so-good ones.

OID: A shakeout, if you will.

Robotti: Exactly. So the value-added potential of the underwriting function is far greater today than it used to be.

ONCE YOU PUT TOGETHER THE PUZZLE,
IT REVEALS A VERY PRETTY PICTURE.

OID: And the abilities of Superior National's management become particularly important.

Robotti: Exactly. And I don't think that you can fully appreciate how good these guys are just by looking at the numbers.

OID: You have to read the press releases, too?

Robotti: A lot of it comes from meeting the people and understanding the pieces of the puzzle — who the capital came from, that there's significant board involvement from shareholders and warrant holders, that they're very knowledgeable, that there's value added they can bring to the table and that they have already.

For example, access to people like Centre Re Chairman Steven Gluckman brings expertise to Superior National that you wouldn't normally get in a company with only $43 million of capital.

And they have a computer system they call SWAMI that they *swear* by. The people at Centre Re say, "We've never seen anything as good as this before."

OID: Sung to the music of SWAMI River, no doubt...

Robotti: Seriously. And the Insurance Partners folks — very knowledgeable insurance professionals who see a lot of companies — say the same thing.

OID: Although I gather they have as many reasons as they have warrants to paint a pretty picture.

Robotti: I believe the story — although it's being tested now — about the things their computer can do, what kind of information they have, how responsive it is and how it lets them know much sooner than they would otherwise whether they're losing money on a line or not.

OID: That sounds like quite a story, all right.

Robotti: And I believe their management response and information system — especially with underwriting having become so much more important in California — differentiates them from most of their competitors.

OID: That's very hard for me to imagine in a company selling at only 60% of book.

Robotti: But there are other attributes we like, too. For example, it was only last year that they got a rating from A.M. Best. That was true in the '80s because they hadn't been in business *long* enough. And once they'd been in business *long* enough, their numbers weren't *good* enough. Therefore, they were never rated until last year.

And since they're writing small-to-medium-sized lines, one of the concerns is inevitably: "How are they rated?" Brokers have to be more concerned when they're selling to small-to-mid-sized companies because if they place business with a weak insurer, they have exposure. So Superior's ability to sell to its primary market was hampered because they didn't have a Best rating. But now they've gotten one.

OID: What rating did they get?

Robotti: They got a B+. But they point out that it isn't really the B+ rating that's significant. They've also received a financial strength rating of VII. You need $50 million in capital in order to attain a VII rating. And it means that they can play in the majors — maybe in the basement, but at least they're in the big leagues. Of course, only time will tell what position they'll *finish* in.

So now they have great people. They continue to improve the process. And Gentz has a lot of contacts in the field that can bring in new accounts through brokers now that it's a rated company. So when Superior got its Best rating, they probably automatically got some more business.

MANAGEMENT HAS NO INCENTIVE TO *HIDE* TROUBLE.
IN FACT, THEY HAVE REASONS TO *UNDERSTATE*.

OID: What's the catch here? The market's saying that this company is garbage and you're saying it's gold. How can there be such a total disconnect? And, more importantly, what could turn it into a mistake?

Robotti: We find that inefficiency in virtually all stocks we buy. As for what can make it a mistake — a discontinued line they wrote back in the early '80s has developed negatively all along. They added $15 million

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pretax to their reserves for it last year — with part of the reason why being that there was a decision in California which increased the obligation of insurers — even when they weren't the insurer at the time the incident occurred. In effect, it extended the exposure period. So that's been a negative development.

OID: No kidding. And $15 million is $4 per share.

Robotti: It's a big number. And to give you an idea of just how negatively reserves have developed, at the end of 1990, they estimated that the losses were going to be $56 million. Today, they estimate that loss reserves should have been $126 million. In other words, they were $70 million deficient on a $56 million reserve.

OID: I've heard worse. In fact, I've owned worse.

However, two or three more reserve strengthenings of that size and they'd be history...

Robotti: We don't think that risk exists today. But there could certainly be more negative developments regarding insurance company obligations in California.

In any case, their historical experience reflects the results of business the prior management put on the books. So we don't think that those results are a very good proxy for the risk that the company faces today.

OID: Maybe on new business. However, as regards the existing book...

Robotti: Here's why we think it's remote that they'll have the same kind of reserve development going forward. Today, they have five or six years of loss experience — years in which they've litigated claims and paid out losses. Therefore, they have a much better sense of what their future claims experience is likely to be than either they or prior management could have had before.

OID: Gotcha.

Robotti: And there's a different management in there who didn't write the business and, therefore, doesn't have any incentive to sweep problems that they didn't create under the carpet and say, "It isn't as bad as you think."

OID: Quite the contrary. I imagine there's actually an incentive to write off as much as they can to make themselves look as good as possible going forward — as long as it doesn't impair their ability to function.

Robotti: That's very true. From the outside looking in, it's difficult to know exactly what's going on. But it looks to me like they're reserving very conservatively.

I get the sense that they've decided, "Hey. Nobody's going to give us credit for good earnings this year anyway. So let's whack some extra reserves on there to address any possible deficiencies — because if we lose money this year, it's not so bad. We're very comfortable going forward. At some point, we could even start to bring money back *out* of reserves. That way, our earnings will look even *more* attractive and we'll have an excellent growth rate in a market in which people will be very excited about our business."

OID: A la Wells Fargo, if you will — in terms of outcome, if not intent.

Robotti: That's right. They might be thinking, "The holders of our warrants put in money on a five-year plan. That partnership's been liquidated. We've distributed the warrants. They've cashed out of every other investment they've made. So these people are looking for an exit. And their exit is that we eventually have to sell this company — whether it's to the public or to someone else in its entirety."

"To do that in a market where people get excited about the business' profitability because pricing's improved and we have very good earnings — not only because of the current environment, but also because we know we've conservatively stated our results historically — gives us a beautiful trend line. And that's worth a couple of points when we cash out."

OID: That certainly wouldn't be altogether irrational.

Robotti: Nope. And only time will tell. However, my personal sense is that their reserve addition has put this problem in the past.

GENTZ HAS A LONG AND IMPRESSIVE HISTORY
OF PROFITABLE UNDERWRITING AT ZENITH.

OID: How did Gentz's reserving develop at Zenith?

Robotti: Actually, I don't know. However, I'll tell you what I *think* it was.

OID: Guesses are allowed, if rarely admitted...

Robotti: It probably developed very irregularly — because what we've had the last five years are unprecedented highs *and* unprecedented lows. In '90 and '91, when the California downturn hit and people were getting laid off, they filed workers' comp claims in droves. Unemployment is a fixed amount of money for 26 weeks or whatever it is and then you're cut off. But workers' comp can be *forever*. There's *no limit* to how much you can get. So there's a lot more money to be made by filing a workers' comp claim.

OID: As a recipient or a plaintiff's attorney, I gather.

Robotti: Exactly. And all they needed in California to qualify for the gravy train was to show 10% of the claim was related to stress from the job.

OID: And who wouldn't qualify by that standard?

Robotti: Exactly. So there was a *huge* influx of claims — unforeseeable from prior history because there hadn't been that kind of economic distress and layoffs since the Great Depression.

And in those circumstances, it's hard for me to imagine that *anyone* was properly reserving for claims.

OID: And was Zenith concentrated in California?

Robotti: That's right. At that time, they *only* wrote their workers' comp line in California. Today, they write in Arizona, Texas and one or two other states, too — although their book remains predominantly in California.

But as regards the adequacy of Zenith's reserves historically, I suspect that its chairman, Stanley Zax, probably had more influence there than Gentz — probably

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(cont'd from preceding page)

significantly more. So it would say a lot more about Zax than it would about Gentz.

OID: With that in mind, what do the figures show?

Robotti: In Zenith's latest annual report, they report that net written premiums in the workers' comp line for the 19 years ended December 31, 1995 grew from $64 million to $197 million. And their combined ratio exceeded 100 in only six of those years: '84, '85, '86, '91, '92 and '95 — and it was only 100.7 in '91 and '92.

For the entire period, it averaged only 99.6.

OID: Very impressive.

Robotti: And Gentz was there for more than 15 years — although I'm not sure exactly how many of those years he headed the workers' comp area. But he was president of their operation for some time.

OID: Longer than he could fake it.

Robotti: Right.

OID: And the odds of Gentz achieving similar success at Superior National?

Robotti: I'd say that it's more likely than not.

[Editor's note: Incidentally, Superior's combined ratio was 97.6 in '95 vs. 107.2 for Zenith. And Zenith's 19-year record includes the 107.2 figure for '95 — again, by which time Gentz had already departed. Excluding '95, we estimate that the 18-year average would be closer to 99.2.]

AND GENTZ IS VOTING WITH HIS FEET
— OR, SHOULD WE SAY, HIS CAREER.

Robotti: Plus, I believe they *lured* Gentz away from Zenith. I suspect that he knew he'd always play #2 to Zax — and that he'd never really be in the limelight at Zenith. So they probably said, "Here's a company for you to run. We think that we've already put a lot of the pieces in place. You know the business. So come in as CEO. And as a board, we own a lot of stock, but we're not there day-to-day. So it's your show to run."

"And as part of your inducement, we're going to give

(continued in next column)

you options — because in relatively short order, there's a good chance that this company gets sold."

OID: Might you define "relatively short order" and tell us how you know that's so?

Robotti: Three to five years — because that's the intended life span of the Insurance Partners' vehicle. And so they probably said, "We're all looking to reap the benefit of our investment — which to date we haven't. We have warrants that strike around the market. So we'll probably sell the company."

"Also, whoever buys the business may need management. So you could wind up in a great place having made lots of money from your stock, too."

OID: Have you ever considered a career in recruiting?

Robotti: So that's the inducement because the warrant-holders want to realize their gains. Unless Gentz thought there were good possibilities, it's hard to imagine him making the move. He had a good situation already — because workers' comp is the core of Zenith's business.

OID: And he definitely wasn't fleeing any kind of personality conflict, etc.

Robotti: Well, again, Zax is a personality. So perhaps there may have been a little abrasiveness there. But the Superior board made him a very tempting offer. They set it up so that he could make plenty of money and have a really good chance of continuing to run it, too.

OID: And have insiders been buying?

Robotti: This management owns stock — through the warrants if nothing else — because I know certain members of management loaned money to the company and have warrants alongside the Insurance Partners group. And they own shares outright, too.

OID: So you believe management's interests are in alignment with yours.

Robotti: I do. And they did offer to buy back 10% of the company about a year ago at just under $4.

OID: That was my next question.
Was that offer made as a tender?

Robotti: No. One of the original incorporators was a life insurance company that had gotten taken over by the State of Arizona. So the State of Arizona was conducting a liquidation and had 1.3 million shares of the "old" stock — before adjusting for a 1 for 4 reverse split. So they, in effect, had 325,000 "new" shares. And the company made a bid to buy back those shares at just under $4 per share — which did give us some comfort.

OID: But their bid wasn't successful.

Robotti: No. We bought it along with someone else — for right at $4.

OID: An excellent reason.

Robotti: My average cost is something around $4.60. And I've paid between $4 and $5-1/4 or $5-1/2.

OID: So you've paid the current price.

Robotti: I have.

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(cont'd from preceding page)

OID: Are you still buying it today?

Robotti: I still nibble at it from time to time. But it's already a 10% position and my second largest holding.

ANOTHER INSURANCE PARTNERS COMPANY — THIS ONE AT A 30% DISCOUNT TO BOOK.

OID: Any more like that one around?

Robotti: Well, now that I've told you that I don't like life insurance companies, here's one I'm buying today — Transport Holdings [TLIC/NASDAQ].

OID: Never say never.

Robotti: Again, a key player is Insurance Partners. And it's also selling for a very nice discount to book. Transport Holdings' fully diluted book value is about $65. And its stock price today is around $42-1/2.

OID: You really know how to get a guy's attention. But may we ask your cost?

Robotti: Our average cost is something around $39. And we've paid between $36 and $42-1/2.

OID: Then tell us about it, please.

Robotti: The company was bought in the early '80s by American Can back when it was run by Jerry Tsai before it became Travelers. Transport was a spin-off from Travelers. It had two lines of life insurance: [1] long-term care and [2] supplemental health. Travelers spun it off last October with a 1 for 200 distribution to their shareholders.

OID: In other words, for each 200 shares of Travelers shareholders owned, they got one share of Transport.

Robotti: Exactly. They distributed 1.6 million shares to public shareholders of Travelers. And as part of its compensation, Travelers took back a straight preferred of $45.5 million with a redemption value of $46.9 million. It provides for a 12% cumulative return — although it doesn't require any payments whatsoever until September 2003.

OID: I'm with you so far, I think.

Robotti: And Insurance Partners also contributed $42 million of additional capital in return for a 10-year bond yielding 8.5% interest that's convertible into equity at $31.44 per share.

OID: Sounds familiar.

Robotti: Then, the two senior members of the management team — John Sharpe and Garland Lassater — contributed $1.5 million each to buy some of that convert. And, then, Travelers also bought some of those converts — $5 million worth, I believe. However, their converts carry a different strike price for conversion into Transport common — a 10% premium to its closing price of $40 on its first day of trading or $44.

OID: Gotcha.

Robotti: Here's how their equity capitalization looks:

[1] straight common of 1.59 million shares,

[2] potential new common of 1.52 million shares upon conversion of the $50 million of convertible bonds,

[3] options exercisable by management for the purchase of 200,000 new common shares at a strike price of $40 per share, and

[4] warrants exercisable by management for the purchase of 250,000 new common shares at a strike price of $55 per share.

Therefore, on a fully diluted basis, Transport has roughly 3.56 million shares outstanding.

OID: With the ownership breaking down how?

Robotti: Before the exercise of its options and warrants, management would own 3%, Travelers would own 5%, and Insurance Partners would own 42%. Afterwards, the ownership breakdown would be more like 15% for management, 2-3% for Travelers and 37% for Insurance Partners.

Initially, fully diluted book — assuming conversion of all options and warrants — was about $75 per share. And, meanwhile, Transport began trading at around $40.

OID: I thought you said book value was $65...

Robotti: Subsequently, Transport Holdings decided to sell its long-term care business — because it was a damaged insurance line in this company. Transport had lost that line's distribution. So new business imploded.

And they figured: "We're not going to be able to get a new source of effective distribution. So we'll sell the business and take the loss." So they sold it for $40 million and took a $20 million loss. And that loss lowered their fully diluted book to $64.38 as of December 31st, 1995.

OID: Still not too shabby for a $42-1/2 stock.

Robotti: Our thoughts exactly.

TRANSPORT'S GROWTH WILL COME FROM ACQUISITIONS — AND INSURANCE PARTNERS WILL HELP THERE.

Robotti: And they figure: "That gives us $40 million of cash to go out and make some add-on acquisitions — because we feel like we have an efficient, low-cost operation which includes servicing some business from Travelers."

OID: "Add-on acquisitions" being defined as...

Robotti: The add-on businesses they're looking for are in credit, accident, health, and straight life insurance where they really are underwriting — trying to determine how long potential insureds are likely to live or the probable incidence and cost of their health care expenses — not asset accumulation-type life insurance.

And we think that Transport's growth is going to come from these add-on acquisitions. So we view Transport as a growth play where the growth just isn't specified yet.

OID: I'll definitely have to remember that line...

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Robotti: We don't know how it plays out long term. But, this year, even though they're carrying around tons of excess cash and their earnings are extremely depressed, they'll still earn close to $5. So you can buy Transport today at 70% of book and 8-9 times depressed earnings.

OID: We definitely have to speak more often.
But how confident are you that management can successfully execute their add-on acquisition strategy?

Robotti: This management didn't demonstrate that ability at Travelers, but we think they have in the past. John Sharpe and Garland Lasater have been around. And I understand that they've built some good businesses and a pretty good operating record along the way.

OID: How good?

Robotti: I don't know. In large part, I'm relying on Insurance Partners and their belief in this management — because they're the ones who loaned this company money. So they clearly think these guys can run this company, make acquisitions and give them the returns that they're looking for. And they know who'd be a good manager of a life insurance company better than I do.

The Insurance Partners folks have also clearly shown that they have some ability in the acquisition area, too. They feel that they can add value in that area because besides the contributions of its own management, Transport will benefit from the deal flow that they see.

OID: Assuming they buy right, operate smart, etc.

Robotti: And we think that their hurdle rates in terms of what they're looking to earn as returns on their acquisitions going forward are high.

OID: That's certainly never helped us...

Robotti: The only business that they have left today is their supplemental health lines. But I don't think that they have an allegiance to be in that business or any other. I think they're more opportunity-driven or return-driven. And, again, they've made acquisitions before and have a low cost infrastructure in place. Therefore, for them to acquire something and generate good returns out of it seems pretty reasonable to us.

The only thing they're missing are loss carryforwards — which would make it a wonderful package.

OID: Have 'em give us a call.
But why would Insurance Partners do acquisitions through Transport Holdings rather than directly — as you've described them doing in the past?

Robotti: It's always possible that the next investment opportunity that comes along may have problems similar to those that Superior had. And, if so, Insurance Partners might lend it money and take back warrants along the lines of what their predecessor — III — did with Superior.

OID: But why would they do it via Transport at all instead of directly? If it's some very wonderful deal, why wouldn't they just buy 100% for themselves?

Robotti: Well, first, they have *cash* in Transport. Second, they have an infrastructure: There are people and systems and computers and so forth in place. So for them to put additional life insurance companies in this entity is a cost-efficient way of acquiring a life company.

TRANSPORT IS CHEAP FOR LOTS OF REASONS,
BUT INSURANCE PARTNERS ISN'T ONE OF THEM.

OID: But Insurance Partners controls both situations. And both are selling at large discounts to book value. Is your assessment of these guys much more positive than the prevailing view?

Robotti: I don't think so. The Insurance Partners people are clearly very sharp.

OID: What can you tell us about their paper trail? How did their original partnership do?

Robotti: I'm not sure.

OID: What then gives you so much confidence in them — aside from their ability to structure favorable deals where it's heads they win and tails you lose?

Robotti: I just think they're relatively smart. And they've accumulated capital from other people in the insurance business who are also knowledgeable. Frankly, a lot of my comfort is based on what they've done with Superior — where they've taken a problem company with severe challenges and turned it into a very well positioned, very well managed company with a very bright future. So I think they'll make a lot of money on the warrants.

But it's not like I'm just going out and buying *all* of their deals. For example, I'm passing on Highlands — which was a recent spin-off from Halliburton.

OID: May I ask why?

Robotti: I'm passing for a couple of reasons: First, I don't like the capital structure due to potential adjustments to the warrant strike price. And, second, although the manager Insurance Partners brought in from Progressive and the Lindner insurance companies to run Highlands is very highly regarded, his experience isn't as closely related as I'd like. Nonstandard auto insurance is *not* very underwriting-intensive, whereas the Highlands business is special risk, big risks and *very* underwriting-intensive.

Also, Highlands Capital's stock has a discount to book closer to 20% than the 35-40% discount we're taking advantage of with Superior and Transport.

OID: Then forget it.
But what, then, accounts for the deep discount?

Robotti: Several things: First, as I mentioned, Transport lost the distributor for its long-term care division. So they just sold it and took a $6 after-tax hit to their book. And one of the distributors in their primary remaining line — supplemental health — is writing less new business, too.

OID: That certainly doesn't sound very encouraging.

Robotti: No, it doesn't. But we think Transport did the right thing to part ways with their former distributor. A broker named Markman had distributed their long-term care product. And Markman said, "Listen. We're

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distributing your long-term care line. But we want to distribute a full complement of life products — including a universal life product. So why don't you manufacture those others and we'll distribute them through our system."

But Transport Holding said: "To manufacture a line isn't cost effective for us. We can't make money that way. We can't create product because our distribution system needs it. You'll have to sell someone *else's* product."

But Markman, in effect, said: "We'd really prefer to get all of our products from one insurer." So Frontier agreed to do it. Therefore, Markman's not writing any business for Transport. So the top line for that segment has declined significantly. And that tends to scare people.

OID: Absolutely. But how likely or unlikely is it that they can replace the lost distribution?

Robotti: Well, they recently said, "It looks like it's going to be very difficult to find a new distribution outlet. We don't know if we'll be able to find one or not. And, therefore, it's not obvious to us how to distribute our supplemental health line cost effectively. So that business will probably continue to decline."

OID: It's easy to see why the stock is cheap, all right.

Robotti: "Meanwhile", they say, "we're going to focus on acquiring businesses we understand that we can integrate into our system."

So it sounds like they're saying: "If distribution comes, it comes. And that's great if it does. But in the meantime, we're not holding our breath waiting."

BUT TRANSPORT DOES HAVE ONE BIG NEGATIVE:
THEY *HAVE* TO GO OUT AND DO SOMETHING.

OID: Whether they're holding their breath or not, what makes you think there aren't more write-offs where those came from? How real is their book?

Robotti: I think it's *very* real. The only asset I think could be soft is deferred acquisition costs. It's always possible they aren't being deferred and amortized properly. And there's always some risk of just how liabilities pay out and exactly what obligations they have under the policies they've already written.

OID: That sounds pretty open-ended.

Robotti: It really isn't. Supplemental health is a relatively straightforward kind of product — as opposed to the long-term care business where they *did* have to take additional reserves and write off some acquisition costs when they sold it.

In that case, their old policies said that they would pay 80% of the insured's costs. And ten years ago, when they wrote those policies, they didn't accurately determine what the costs would be. But they no longer write policies with open-ended benefits. So the long-term care business had inherently more risk of being inaccurately reserved than there is in the supplemental health line.

Therefore, with the long-term care business having been sold, their reserves are probably pretty accurately stated. And if that's the case, then their book is probably pretty accurate too.

OID: Is there any insider buying and/or selling?

Robotti: Not to my knowledge.

OID: What about share repurchases?

Robotti: There haven't been any.

OID: With the stock at a significant discount to book, why the heck not?

Robotti: That's a very good question. There may be some kind of prohibition against them repurchasing shares in their bonds. I don't know.

OID: Transport's 1995 10-K contains the following: "the financing agreements [for the convertible notes] restrict the Company's ability to make additional borrowings and to make acquisitions or divestitures."

Robotti: I don't know whether or not the sale of the long-term care business changes the formula so that they're no longer restricted. However, clearly, the intent here has always been for them to try to make acquisitions.

OID: What do you see as Transport's biggest negative?

Robotti: Transport doesn't have the same inherent growth opportunities as Superior. Therefore, it's shrinking its existing businesses, trying to turn around what's left and planning to use the company as a vehicle to grow.

OID: Because it has to.

Robotti: In a word, yes. Superior's core business is intact and good enough to be an attractive investment in and of itself. It's a very small player and, therefore, can write a lot more business and become a lot bigger without doing anything differently. Also, part of its success comes from focusing — understanding a niche and staying in it.

OID: Doesn't everybody's?

Robotti: So there's no *reason* for Superior to acquire other companies. Therefore, it's in a much better position. All it has to do is wait for a turn in the market.

OID: Don't underestimate the difficulty of doing that. Bill Ruane and Warren Buffett suggest that the ability to sit on one's hands is a rare and wonderful talent.

Robotti: I agree. And it's a position we *often* find our holdings in. But I don't think acquisitions are in the formula for Superior. And, meanwhile, the tremendous uncertainty in the workers' compensation insurance market in California is more than reflected in their stock price.

OID: On the other hand, the need for Transport to make acquisitions makes the skills of management and Insurance Partners even more key.

Robotti: Another reason why these stocks are cheap — and, probably, why Insurance Partners was able to come in and structure these deals in the first place — is that these companies had a history of problems. They weren't good, growing businesses that were already generating great returns. They were distressed properties that they could buy at a discount and turn around.

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And, again, given the new shareholder base and the calibre of managers that they're bringing in, we don't think that what these companies have done in the past is any indication of what they're likely to do going forward.

OID: Past underperformance is no guarantee of future duress.

Robotti: You've got it — although the stock prices of both seem to be discounting continuing underperformance. Finally, neither Superior National nor Transport have a sponsorship yet — Superior because of its troubled past and Transport because it was just spun off last September. And both have the ingredients that we consider to be one of the profiles of a potentially cheap stock: selling pressure and no sponsorship yet with significant insider ownership.

So very few investors even know about them yet. And few of those who do have confidence that they're for real. But they will.

HERE'S A DOLLAR AT A 30% DISCOUNT
THAT'S GROWING 20-25% PER YEAR.

OID: Any others?

Robotti: Lynch Corp. [LGL/AMEX].

OID: Gabelli's company? I thought that one had already run like crazy.

Robotti: It has.

OID: And you'd like to sell it to our subscribers.

Robotti: Nope. I still think it's a bargain.

OID: You're not saying that with much conviction. This isn't just a crumb to an old boss?

Robotti: I don't think so. We figure that it's worth over $100 per share — and it trades in the mid-$70s.

OID: As macho-type investors, we always look for discounts of 50% or more — preferably a lot more. Could you help us rationalize this one, too?

Robotti: In his latest letter to Lynch shareholders, Gabelli estimates pretax intrinsic value is *$150*.

OID: Now you're talking.

But is his $150 figure a reasonable estimate?

Robotti: I don't know. Like I said, we value Lynch at something over $100+ per share — $107 actually. And we're *very* comfortable with that figure.

OID: Why do you suppose there's such a big gap between your valuation and his?

Robotti: He has his assumptions and we have ours. The actual value is probably somewhere between the two. I don't have all of his assumptions. However, if you'd like, I'd be happy to walk you through my valuations.

OID: I thought you'd never ask.

Robotti: But, frankly, I'm not all that concerned if the value is $150 or if it's $100. More important to me is that he's compounded Lynch's value at 20-25% per year. What do you pay for something compounding at that rate?

OID: Rarely too much — if it continues.

Robotti: If the value is at least $107 today and you had some confidence that he'd continue to compound value at 22% per year for the next 10 years, then I think it would clearly be worth *more* than breakup value.

OID: Gabelli's stated objective is 25% per year or more compound growth in intrinsic value. But how exactly do you figure he's managed 20-25% historically?

Robotti: Gabelli took control of Lynch in December of '85. And at the time, he sent out a letter to shareholders saying, "We bought control. And we think this company is worth $12 to $15." And it wasn't that difficult a company to value at that time.

Therefore, if we're right about what it's worth today, he's compounded Lynch's value at 22% to 25% per year during that time.

OID: And if Gabelli's right about what it's worth today, he's compounded value even faster.

Robotti: That's right. In fact, in his latest letter to Lynch shareholders, he says that its pretax intrinsic value grew from $12 in December of 1985 to $150 in December of 1995.

OID: Which would imply compound annual growth of nearly 28-3/4% per year — although, needless to say, those returns were in the past.

Robotti: I'd argue that it's a lot better company today than it was when he took control of it — because there was nothing there at that time aside from Lynch Machinery and M-Tron. It was a corporate entity and that was about it.

Today, it's a much larger company with some very interesting dynamics.

OID: What do you mean by "interesting dynamics"?

Robotti: It's starting to do some interesting things. For example, it has those small telephone companies. Plus, it recently bought a small cable television system that overlaps with some of their telephone systems. So with the deregulation of telecommunications, they can compete in different markets.

And Gabelli's as knowledgeable as anyone out there about the whole telecommunications area including cable TV and many other services that could be provided through telephone companies. Therefore, I expect Lynch to be on the forefront of all of that.

OID: Are you sure this isn't payback?

Are there any conflicts you'd like to disclose — business interests, client relationships, old debts, relationships by marriage...

Robotti: We don't comment on whom our clients are or aren't. And as regards the other questions, the answers are no, no and no.

OID: Just checking.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

Robotti: So Lynch owns an interesting portfolio of other businesses today. Plus, it has critical mass. It didn't have either of those things when Gabelli first took it over. There's just a lot more going on today.

OID: Like bidding on spectrum at the PCS auctions?
Robotti: Exactly. And it looks like Gabelli is bullish on Lynch, too. He personally bought 10,400 shares at $60 per share in mid-March.

So, again, we think we're buying a company today at roughly two-thirds of its value or less whose intrinsic value is growing 20-25% a year.

IF GABELLI DIDN'T OVERPAY FOR THE TELCOS,
THEN LYNCH'S VALUE COULD BE $130+.

OID: Before we give him a laurel wreath, could you go through the math of your valuation with us briefly?
Robotti: Sure. First, Lynch owns 80-100% of seven telephone companies. However, I don't have the ownership and profitability for each of them broken out separately. So I value the package at 7 times trailing cash flow and come up with a gross valuation of $90 million.

Then I add their $18 million of cash to that gross figure and deduct the $55.8 million of debt that they have at the operating company level. And netting those figures out, I calculate that 100% of the telephone company equity is worth about $52.5 million. And because Lynch owns between 80% and 100% of each of these various telephone companies, I take 90% of that figure — which brings me to a valuation of $47.3 million for Lynch's interest.

OID: How confident are you that their interest is 90% or more value-wise on a weighted average basis?
Robotti: The big one where they don't own close to 100% is the one in Western New Mexico. And that's a relatively important telephone system for 'em. To give you some idea, at year end, Lynch reported ownership of a total of 15,586 access lines in their telephone companies. And 5,200 of those lines — or about one-third of their total lines owned — were in their Western New Mexico system. And they only own 80% of that one.

OID: But they tend to own close to 100% of the others?
Robotti: About 98%.

OID: So the average appears to be well over 80%?
Robotti: That's the way it looks to me. Of course, Western New Mexico could be a little more profitable than the others. But they don't break out profitability on a system-by-system basis.

OID: How does your valuation estimate compare to market transactions that have occurred recently?
Robotti: I'm not an expert on telephone companies, but I think my numbers are very reasonable. For example, in his latest letter to shareholders, Gabelli says that telephone companies sell for 7-9 times cash flow.

He also points out that Lynch has paid $81 million for the equity positions in their telephone companies. And, again, I'm valuing them at $47.3 million —which is significantly less than he paid.

OID: Over 40% less. But who's counting?
Robotti: That's right. So, in effect, I'm assuming that he has a loss on telephone companies that he's been buying over the last six or seven years.

OID: We can keep a secret if you can.
Robotti: If you value them at *9* times cash flow, that would add another $23 million — which is 2 times their 1995 cash flow of $12.9 million times our 90% allocation. But that would still only give them a value of $70 million.

OID: Which is still less than he paid. Interesting.
Robotti: But I have the telephone company debt at the operating level at its face value of $55.8 million. And the terms on some of that debt are *extremely* favorable. For example, $27+ million of that debt is rural utility service notes with a weighted average interest rate of 3%.

OID: That sounds extremely favorable, all right. And the average maturity?
Robotti: It doesn't say. It says "various installments to the year 2023". So the present value of that liability is probably significantly less than its face value — in which case the equity would be worth substantially more.

OID: Makes sense.
Robotti: So if you assume that the average maturity is halfway between today and 2023 and the market rate is closer to 8%, I figure that the discounted present value of that debt is around $14.6 million — or nearly $13 million less than Lynch carries it for on its balance sheet.

OID: And 90% of any such overstatement of liability — or $11.5 million — should be added to Lynch's value.
Robotti: Correct. And that's another $8 per share.

OID: And adding the $11.5 million to the $70 million value you arrived at using a 9 multiple, you arrive at an estimated equity value of $81.5 million — which would be right at Gabelli's historical cost.
Robotti: That's right. Also, Lynch's telephone companies have various investments in cellular franchises.

OID: That aren't generating cash flow yet?
Robotti: Correct. But I don't assign any value to them because, frankly, I don't know how to value POPs.

OID: Exactly what Robert Noel says. But since we're in investment publishing and know all, how many POPs are we talking about here?
Robotti: The letter accompanying the annual report says 49,000 POPs. But I'm not sure if they own them through one of the telephone systems in which they have an 80% interest, one they own outright or something in-between. And I don't know if 49,000 POPs is a lot or a few.

OID: And there's no need to engage in false precision.
Robotti: Exactly.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

OID: So let's just say they're worth another $4.19 per Lynch share — which brings us up to $135.19.

Robotti: Plus, Gabelli mentions that they also have the right to provide Direct Satellite TV to 10,000+ homes — for whatever that might be worth.

[Editor's note: Your editor knows less than nothing about valuing telephone companies. However, a very quick perusal through Value Line leaves us least confident about this segment's valuation — despite the fact that Robotti has given it a 40%+ haircut. The gross valuation per access line (apparently something around $5,500) is well above that of several publicly traded telephone companies (although Lynch's revenues and cash flow per access line appear to be substantially higher, too).]

AND IF MORGAN GROUP IS WORTH BOOK VALUE,
THEN ADD ANOTHER $3+ PER LYNCH SHARE.

OID: And the other pieces?

Robotti: Lynch owns shares of Morgan Group — which transports mobile homes and recreational vehicles from manufacturers to customers or dealer/distributors via a fleet of owner-operated trucks.

OID: Owner-operated meaning that the truck drivers own their own trucks.

Robotti: Right.

OID: So that Morgan acts as a clearinghouse of sorts?

Robotti: That's right. It's a central booking agent, clearinghouse and insurer. And they're trying to expand into certain related financial services — selling insurance and that kind of thing — to the fleet drivers.

Lynch owns 1.2 million shares of Morgan Group Class B and 150,000 shares of Morgan Class A — the latter of which they received when they recently restructured their preferred shares. And I assume that both classes are worth what their Class B shares are currently selling for — which is around $8-1/2.

OID: So that's $10.2 million for the Class B shares and $1.3 million for the Class A shares — or $11.5 million in all.

Robotti: That's right.

OID: Is that reasonable?

Robotti: Well, in his latest letter, Gabelli says this about Morgan: "Today, Lynch owns 1.35 million shares of Morgan which is traded on the American Stock Exchange. While its shares presently trade in the $8 range, we believe underlying value is at least twice that amount."

But he doesn't give any rationale or methodology to explain why he believes that.

[Editor's note: Gabelli doesn't, but we do: Interestingly, it looks like Morgan has a book value of $12±, sales of nearly $48 per share and is repurchasing shares. Also, they apparently have the same 25% per year compound growth target as Lynch. (But nobody's perfect.)

In 1995, they managed to grow sales 20% despite a reported 9% drop in recreational vehicle sales industry-wide — although profits were flat (at 80¢± per share) and sales growth has since slowed slightly, too (to just over 17%).]

OID: So if we split the difference in your estimates and valued Morgan at its $12 per share book value, that would add another $4-3/4 million — or slightly over $3 per Lynch share.

Robotti: That's right.

SPINNAKER MAY BE SELLING AT $82,
BUT WE CHOOSE TO VALUE IT AT $20.

OID: What's next?

Robotti: Lynch also owns 2-1/4 million shares of Spinnaker. And, incidentally, on a fully diluted basis, Lynch has about 1.4 million shares outstanding. So about 1.6 Spinnaker shares underlie each share of Lynch.

And Spinnaker is selling today at over $80 per share. So each share of Lynch owns roughly $128 of Spinnaker at its current stock price.

OID: Fascinating.

Robotti: However, in my calculation of Lynch's value, I assume that Spinnaker's only worth $20 per share.

OID: Just in case you hadn't noticed, it's customary to double the stock price, not cut it back by 75%...

Robotti: Yep. But it's the one with the puff in it potentially. It's the big unknown within Lynch. Therefore, we just give it a little haircut.

OID: Haircut?! That sounds more like a crewcut... What's your rationale?

Robotti: To explain that, I need to give you a little background. Spinnaker basically consists of two adhesives businesses that did about $225 million in sales last year.

The first piece was the business that Lynch bought from Kimberly Clark. It's called Brown-Bridge. And they develop, manufacture and market adhesive coated paper for a variety of uses. For example, they compete with Avery Denison and Bemis in labels. Plus, I believe that they're one of only two companies producing postage stamps for the U.S. Postal Service that you just peal and press.

OID: That you don't have to lick.

Robotti: Correct. It did about $75 million in sales last year. And Spinnaker laid out $36 million to buy it. However, they only paid $6 million of equity. So there's quite a bit of leverage.

OID: Slightly over 83%, but who's counting.

Robotti: The second piece of Spinnaker's adhesives business is Central Products — which they just bought. Central Products is the second largest U.S. manufacturer of carton sealing tape and the only company in the industry that can offer "one stop shopping" by providing a full line of water-activated and pressure-sensitive tapes.

Spinnaker bought Central Products for $80 million

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from Alco Standard and put *no* equity whatsoever into it. They borrowed $55 million — with Alco Standard taking back a note for the balance. However, they had problems refinancing the balance and completing the acquisition — which, again, they just managed to do recently, but not before generating a great deal of uncertainty — most of it generated by their auditors' qualified opinion.

OID: Qualified opinion?

Robotti: The auditors, in effect, said: "The financials look fine and dandy. We agree with 'em. But if they can't raise the financing to complete the acquisitions, then they may not be in business."

OID: Sounds like grounds for uncertainty, all right.

Robotti: And that's true. They couldn't at the time. However, Spinnaker says they had the financing in place originally, only that the lawyers hadn't completed the documentation. So they went back to the seller, told them that and said, "Would you give us two more weeks." And they said, "Sure. We'd be *happy* to."

OID: So there was less duress than met the eye.

Robotti: That's what Spinnaker says. Of course, I can't know for sure. But they subsequently announced that they'd put together a package with Lynch's help whereby Alco Standard is taking back paper. And Spinnaker's stock has soared ever since.

OID: But given all of that background, once again, why are you crewcutting Spinnaker's value by 75% in your estimate?

Robotti: Several reasons: First, because Spinnaker only bought Central Products recently — something like five or six months ago — it's tough to know what kind of earnings to expect. I haven't seen all of its numbers. So I don't know what the business will look like going forward. They bought the operation entirely with borrowed money.

OID: Let he who has not financed a business with credit cards cast the first stone.

Robotti: And, frankly, I'm still a little confused on it.

OID: So you're building in a margin of safety.

Robotti: I suppose that's right. However, Spinnaker is selling at a big multiple of EBITDA — a *big* number.

Second, Spinnaker's stock has skyrocketed from about $3 to $82 in about 22 months. And anytime a stock goes up 25 times that fast, you have to be a little nervous.

[Editor's note: And from $40± to $82 in the weeks between when we first spoke with Robotti and publication.]

Robotti: And, third, one of the notes Alco Standard took back was a $6 million note convertible into Spinnaker at $35 per share — which was less than the stock price at the time the note was finalized. And, needless to say, convertible notes are normally convertible at a premium.

OID: That's certainly true of those we've seen.

Robotti: So with Lynch willing to give back that note and accept dilution from the current market price, it looks to me like they're saying, "The $35 price is reasonable — whatever the market may be saying."

WOULD THE ~~LUNATIC~~ INVESTOR BUYING SPINNAKER PLEASE CALL ME. HAVE I GOT A DEAL FOR YOU....

OID: How do you arrive at your $20 per share valuation for Spinnaker?

Robotti: Including Central Product's 1995 sales, Spinnaker would have 1995 sales of $226 million. And together, they tell you that total EBITDA would have been $18.8 million in 1995.

And Spinnaker has about $102 million of debt. Therefore, I assume that there's $10 million of interest and $2 million of depreciation. So I calculate that they had $6.8 million of pretax income, pay $2.4 million of income taxes and are left with $4.4 million of after-tax earnings.

Then, dividing that $4.4 million of after-tax income by their 3.3 million shares outstanding gives them $1.33 of normalized earnings per share. And I assume a P/E of 15 on that $1.33. That's how I arrive at a $20 value.

OID: Any ideas, then, on why Spinnaker's stock has gone from $3 to $82 in the last 22 months?

Robotti: On a fully diluted basis, Lynch owns about two-thirds of Spinnaker. And management owns about 20%. So the float is only 12% of their outstanding shares — or less than half a million shares.

OID: That could certainly explain it.

And apparently, you're not the only skeptic about Spinnaker — because a $10 increase in Spinnaker should translate into a $16 increase in Lynch. And nothing of the sort seems to be happening.

Robotti: I don't know what other people think. But each share of Lynch does own 1.6 shares of Spinnaker.

OID: So either investors are very bad at math or there's huge skepticism about Spinnaker.

Robotti: The more appropriate question is what lunatic is buying Spinnaker at $82 when he can buy Lynch at $75 and get 1.6 shares of Spinnaker and everything else that Lynch owns for $7 less.

OID: Perhaps, instead of appraising the rest of Lynch at the $75 or so that you do, maybe he does the math and comes up with a negative number.

Robotti: Obviously, that's right. He must be coming up with Lynch's other net assets having a negative value equivalent to .6 shares of Spinnaker plus the additional $7 that he's paying — or a negative $56.

OID: Reasonable men may differ...

Robotti: If he reads this feature, I hope he'll give me a call so I can carve up Lynch shares and sell him my Spinnaker part. I'd let him short the rest of Lynch to me if he'd like. And I might even give him a buck or two for it.

OID: I'll give you a call after we go to press.

But, meanwhile, are you shorting Spinnaker?

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BOB ROBOTTI
(cont'd from preceding page)

Robotti: No. We don't do a lot of shorting — which, of course, has its own peculiarities. Again, Spinnaker has very little float. And I remember Ruane or Cunniff talking about how stocks often go from being very illogically priced to being *very, very* illogically priced. So I'm open to the idea that it can go *higher.*

And it *has.* Spinnaker's stock price defies the logic of where I think it should trade. But nobody's asked me what I think.

OID: Are you calling me a nobody?

Robotti: As regards shorting it, you probably *can't* — because the stock's not available. Who owns it margined? *Nobody.*

OID: There you go again...

ITS BUSINESSES & PROSPECTS AREN'T BAD.
I JUST DON'T WANT TO *COUNT* ON 'EM.

OID: You use last year's earnings in your analysis — which is certainly the prudent way to do it. However, since newsletter editors are under no such constraint, what do you see for Spinnaker in 1996 and beyond?

Robotti: Don't get me wrong. If things work out, there's clearly a lot of appreciation potential here — because this is a very leveraged investment. Plus, they're at $226 million of sales — and growing. And there are definite synergies between the two companies.

So there's probably plenty of room for improvement — which is obviously what they're banking on and which is why they made the acquisition and borrowed the money the way they did.

OID: You just don't want to count on it.

Robotti: That's right.

OID: What's reasonable to expect?

Robotti: Spinnaker management says the combined entity should achieve EBITDA margins of 10% or more. And that seems reasonable to me because these businesses have achieved 10% EBITDA margins historically. And management has talked about being able to achieve at least that kind of margin going forward. So if they can, they'd have $20 million of earnings.

Also, they should be able to achieve some economies from combining the operations because it was a sideline for both prior owners — Alco Standard and Kimberly Clark. So I suspect there *is* considerable room for improvement. And a 10% EBITDA margin on historical sales would be $22.6 million.

OID: How do you view the outlook for their future sales?

Robotti: Again, the fact that they're no longer a sideline business in a larger company probably bodes well. And it looks like Spinnaker grew Brown-Bridge's sales from $75 million when they bought it — which was back in 1994 — to $95 million or more last year.

OID: So you wouldn't be shocked if sales rose 10% from their historical pro-forma 1995 level in 1996?

Robotti: Not at all. In fact, I just saw that Avery Denison is having an excellent year. And I see no reason why Spinnaker shouldn't, too — although they do still face some challenges.

OID: Challenges?

Robotti: They're kind of walking a fine line. The fact that they weren't able to complete the Central Products financing has to be somewhat of a concern. They sent out a press release saying that they had the financing in place and that they ought to be able to close.

But if they managed to make Spinnaker a growth story, who knows — although we don't buy growth stories. Its valuation isn't to my taste. Plus, it's a more aggressive situation than we're normally involved with. So it's not one we'd go out and buy. But it's a good enough business.

OID: Why do you say that?

Robotti: I can't tell you all of the reasons why. However, prior to the Central Products acquisition, Spinnaker only had about $1 million of depreciation on its $110 million of sales. That's not much depreciation for that much in sales.

Therefore, I think it has some attractive attributes — limited capital requirements and the likelihood of achieving good returns on assets among them.

OID: Gotcha.

Robotti: Again, the combined entity has $226 million in sales and $100 million of debt. So 1 times sales would imply an equity value of $126 million. And dividing that $126 million by its 3.3 million fully diluted shares would suggest an intrinsic value of nearly $40 per share.

OID: More like $38. But who's counting.
And how would you characterize 1 times sales — aggressive, reasonable or something else?

Robotti: I think it's a reasonable valuation. There are a lot of investors who'd want to buy it at that valuation level.

OID: If the earnings start coming through.

Robotti: That's right.

THE LAST OF LYNCH'S PUBLIC AFFILIATES
— ITS 6% STAKE IN BROWN-BRIDGE.

OID: What's next?

Robotti: Then, Lynch also owns 6% of Brown-Bridge directly — which is the adhesive coated paper business that Spinnaker bought from Kimberly Clark.

OID: You're not just making this up to confuse me.

Robotti: No. I'm saving that for later. Brown-Bridge is 84% owned by Spinnaker, 6% owned by Lynch directly and 10% or so owned by management. So Lynch owns the controlling piece of Spinnaker which owns the controlling interest in Brown-Bridge. But it also owns a piece of Brown-Bridge directly.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

OID: I think I liked it better when you just said that Lynch also owns 6% of Brown-Bridge directly...

Robotti: And here's the way I value it. Brown-Bridge did $100 million in sales last year and earns $7.5 million after allowing for depreciation, but before taxes. And taxes on that are about a third — or $2-1/4 million.

OID: Aw, heck. Let's call it 40%.

Robotti: Fine. Taxes would be $3 million. And that would leave $4-1/2 million after-tax, but before interest. And then I give those after-tax earnings a multiple of 15. So that gives me a $67-1/2 million of gross business value. And then there's $20 million of debt. So netting that out would indicate $47-1/2 million of total equity value — so that Lynch's 6% interest would be worth $2.8 million.

However, they're not earning that right now. Therefore, I cut it back to $1-1/2 million.

OID: Sounds highly scientific...

Robotti: Again, the Spinnaker operations are the most tenuous — because these businesses really aren't making these earnings yet. And a multiple on EBITDA of say 6 times would only just about cover debt. So this one is really more on the come. And that's why when I'm valuing Lynch's interest in Spinnaker, I'm only using $20 when the market is saying $82.

OID: And cutting Brown-Bridge back by nearly 50% — after using last year's sales in your estimate.

Robotti: That's right. I'm just trying to come up with a reasonable valuation I can hang my hat on.

OID: Seems downright prudent to me.

Robotti: And, finally, part of Brown-Bridge's debt is $1 million owed to Lynch. Therefore, I estimate that the total value of Lynch's stake is $2.5 million.

And I know you'll be pleased to know we're done running through Lynch's public affiliates.

AND IF GABELLI AND BUFFETT ARE RIGHT,
WE'VE UNDERSTATED THE TV STATIONS BY $6/SHARE.

OID: I'd be ecstatic if you hadn't said "public". There are private holdings, too?

Robotti: They're much simpler. We're almost home. Lynch also owns interests in two network-affiliated TV stations. First, they own 20% of WHBF-TV in Quad Cities — whose area includes Davenport, Iowa and some surrounding towns. It's the older of Lynch's two stations. And its cash flow in 1995 was $3.1 million.

I give it a multiple of 10 and come up with an enterprise value of $31 million. But it also has $17 million of debt. So netting that out would give it an equity value of $14 million for 100% of the equity. And, therefore, I estimate that Lynch's 20% interest is worth $2.8 million.

OID: Gotcha.

Robotti: Then, besides Lynch's 20% equity interest, $2.7 million of WHBF's debt is owed to Lynch. So, here again, Lynch is a lender to WHBF in addition to owning a 20% equity interest.

OID: And their other TV station?

Robotti: They also own a network-affiliated TV station — WOI-TV — in Des Moines. So I take WOI's $3.3 million of cash flow and give it a multiple of 10 to come up with a gross value of $33 million. It has $12 million of debt. So I estimate that Lynch's 49% interest is worth $10.3 million.

And the WOI acquisition was *great*. At the time that they acquired it, it had a little over $1 million in cash flow. Lynch paid $14 million for it — $1 million as equity plus a $2 million loan from Lynch and $11 million of bank debt.

It had been run by Iowa State University. And in less than a year, they actually increased the station's cash flow all the way from $1.1 million to $3 million per year.

OID: Not bad.

Robotti: Gabelli mentions the 1992 acquisition in his latest shareholder letter. He says: "The total consideration ... was $14 million.... [We] initially borrowed $11 million.... We believe that our share of the station over and above our capital contribution is worth $20 million ... [which is] $15 per Lynch share."

OID: And you're valuing it at $10.3 million.

Robotti: That's right. Incidentally, in that same letter, Gabelli goes on to say: "We think properties like this station are worth 12 to 14 times cash flow."

OID: When he's selling or appraising, perhaps — but not when he's buying. Is 12 to 14 reasonable?

Robotti: Again, I'm using 10.

OID: Do TV stations sell at multiples of 12 to 14?

Robotti: Let's think through the logic. This business requires very, very little capital reinvested. Therefore, virtually everything it generates is free, discretionary cash. Also, it's growing over time at the rate of inflation or more. What's the value of an annuity with those characteristics?

OID: I think Buffett says it's worth a bunch.

Robotti: That's right.

OID: In his annual report several years ago, I believe

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

he said that an after-tax annuity growing 6% per year with no additional capital required would justify a multiple of 25.

Robotti: And I think that's right.

OID: I'm sure he'll be relieved to hear that.

Robotti: So tax-effecting the cash flow from a TV station and even building in minimal capital expenditures, it might warrant a multiple of 14 on pretax cash flow. And by using a multiple of 10, I'm effectively using a P/E of 17, more or less.

OID: And I know you, Gabelli and Buffett are right about it deserving a P/E of 25. But 20's my final offer. So take it or leave it.

Robotti: I'll leave it. But Gabelli's multiple of 14 is probably very close to 25 times after-tax earnings. And using that multiple would add $2-1/2 million to the indicated value of WHBF and nearly $6-1/2 million to that of WOI.

OID: Still $2 million below Gabelli's estimate. But that would nonetheless be another $6 per share.

Robotti: You've got it.

I'M VALUING LYNCH'S MANUFACTURERS AT 5X EBITDA — ALTHOUGH THEY COULD CLEARLY WARRANT MORE.

OID: And I assume there are other private holdings.

Robotti: The last businesses to value within Lynch are Lynch Machinery and M-Tron — which are its original manufacturing businesses.

OID: Now I'm ecstatic.

Robotti: M-Tron makes liquid crystal diodes for clock radios, cellular phones or some such thing.

OID: There's no need to get overly technical...

Robotti: And Lynch Machinery makes machinery which makes glass products — including flat screen TVs. Last year, Lynch Machinery and M-Tron did about $7 million and $2 million of EBITDA, respectively. And I'm valuing both of those at 5 times EBITDA.

However, Lynch owns 90% of Lynch Machinery and 94% of M-Tron. So I estimate that their interests are worth $31.5 million and $9.4 million, respectively.

OID: That sounds very reasonable. But why 5?

Robotti: It's just an old rule of thumb for leveraged buyouts — that you don't want to pay more than 5 times EBITDA. And I think it's a pretty low multiple.

OID: Sounds low. But why might they deserve more?

Robotti: Both have displayed wonderful attributes over the last couple of years. For example, Lynch Machinery's been selling huge amounts to the Far East. And over the last couple of years, both have enjoyed explosive growth. Their earnings have been tremendous and their backlogs have increased significantly.

OID: Good answer.
Are we done?

Robotti: Just about. Finally, Lynch has two assets that I value at cost. First, toward the end of last year, they participated in the purchase of a cable company for $5.2 million. A new entity was formed to hold it. And Lynch owns 60% of that new entity. So I'm assuming — although it wasn't completely clear from the financials — that they funded 60% of the $5.2 million and that the other parties funded the rest. So there's another $3.1 million.

OID: And is that reasonable based on the number of cable subscribers and so forth?

Robotti: I don't know — because I don't know the number of subscribers. But Gabelli would have no reason to overpay somebody for something. And I'm assuming that he knows something about cable properties.

OID: That seems like a safe bet.
And he didn't buy it from a relative?

Robotti: Nope. Finally, Lynch participated in a bid for PCS spectrum. And prospective bidders have to deposit 10% of their bid. So they've deposited $7 million.

What Lynch has done is to form five, six or seven different companies where Lynch owns 49.9% and a minority partner owns the remaining 50.1%. In that way, they get preferential treatment in the bidding process.

OID: Is newsletter editor a qualified minority? Sadly, I understand that poverty isn't one of their criteria.

Robotti: And the minority partners usually have relatively limited capital.

OID: So maybe we do qualify?

Robotti: So Lynch is lending money to the entity that they're setting up. And that money is deposited toward their bids. So I imagine that if they *don't* win — if their bids aren't the highest — their deposit will be returned.

OID: That only seems fair...

Robotti: So there's another $7 million. And that's all their major assets as of last December 31st.

OID: Glory, glory, hallelujah.

Robotti: All told, I come up with $173.1 million worth of assets.

I MAY BE DOUBLE COUNTING SOME DEBT
BUT WHAT THE HECK. LET'S CALL IT $107/SHARE.

Robotti: And as we've gone along, we've netted out debt at each of the operating companies before calculating its equity value and given Lynch credit for the loans due it by each of those companies. Next, we have to net out the relatively small portion of Lynch's debt — of which there are only two or three pieces — that resides elsewhere.

For example, as we discussed, when they bought the telephone companies, a number of them came with debt — this rural electrification stuff — some of it with interest rates down around 3-4%. But to fund the purchase of the

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

telephone company equities, they borrowed at an intermediary holding company level. And that additional debt — which isn't owed by the individual telephone companies — now totals $16.1 million.

OID: Gotcha.

Robotti: Then, there's some additional debt at the holding company level. I think I'm too high on this number — but I know they've been borrowing some money there. On their condensed financial statement for Parent Only, their total current liabilities are $7.6 million. And there were two different fundings last year to draw down their line of credit — of $3.8 and $3.1 million, respectively. So the total due is $6.9 million.

OID: So you're guestimating that Lynch has another $6.9 million of debt at the holding company level in addition to the $16.9 million of telco-related debt.

Robotti: That's right. Therefore, they have a total of $23 million of debt at the holding company level. And based on the totals, I believe I've overstated it somewhat. But I don't know where. So it could be a fair amount less.

For example, the $3.8 million I mentioned may go with Morgan Group. And, if so, that entire amount should be disregarded because I already picked up the value of its equity based on its stock price. And the debt is already netted out of that number by the price buyers and sellers of Morgan Group's stock are willing to pay and in our valuation of the company's intrinsic value.

OID: So you may be double counting the debt.

Robotti: That's right. But $3.8 million divided by their 1.4-odd million fully diluted shares is only about $2.70 per share. So it doesn't really matter all that much.

So I come up with total debt at the holding company level of $23 million. Then they have $1.3 million of cash. So there's net debt of $21.7 million. Therefore, deducting their $21.7 million of net debt from their $173.1 million of net assets leaves them with net equity of $151.4 million.

Then, Lynch has 1.39 million shares outstanding. But that's before stock options and phantom stock.

OID: Wake me up when it's over.

Robotti: For the phantom stock, Lynch has agreed to make a cash payment for the differential between the market price of Lynch and the strike price — which makes them more or less equivalent to options. So I factor in the dilution from all of those:

There are options for 24,500 shares at $23-1/8, 1,428 shares at $58-1/2 and 7,400 shares at $63. Their exercise would give Lynch another $1.1 million of assets and slightly over 33,000 additional shares.

OID: Believe it or not, I think I follow you.

Robotti: So asset value becomes $152.5 million. And I estimate that they have 1.4233 million shares outstanding on a fully diluted basis. Therefore, I calculate that Lynch's net asset value per share is just over $107.

BOB ROBOTTI'S
VALUATION GUESTIMATES
FOR LYNCH CORP.
(AS OF DECEMBER 31, 1995)

	(millions)
Telephone companies	$47.3
Morgan Group shares	11.5
Spinnaker (ex-Brown-Bridge)	45.0
Brown-Bridge	2.5
Equity in Public Affiliates:	$106.3
Quad Cities TV Station	$5.5
Des Moines TV Station	10.3
Lynch Machinery	31.5
M-Tron	9.4
Cable investment	3.1
PCS Auction deposits	7.0
Non-Public assets:	$66.8
Total Operating Assets	$173.1
Telco Acquisition Debt	$16.1
Other Holding Company Debt	6.9
Holding Company Cash	(1.3)
Total Non-Operating Debt	$21.7
Total Net Asset Value	$151.4
Options & Phantom Stock	
24,500 shs @ $23-1/8	$0.567
1,428 shs @ $58-1/2	0.084
7,400 shs @ $63	0.466
Option/Phantom Stock Exercise	$1.117
Fully Diluted Asset Value	$152.5
Divided by Shares Outstanding (1,423,300 fully diluted)	÷1.423
Indicated Value	$107.1

LYNCH SEEMS CHEAP ON AN EARNINGS BASIS, TOO — ALTHOUGH EBITDA CAN BE VERY MISLEADING.

OID: Of course, that's before a big capital gains tax that would be due on any sale.

Robotti: That's true. But that's generally the case with *any* going concern.

OID: Absent situations where book exceeds market or where the company has loss carryforwards in excess of the gain, I guess.

Robotti: Lynch's book value is around $25 per share.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

So, clearly, a very large potential tax liability would be due on the liquidation of the company or on the sale of many of its assets. If their basis for tax purposes were the same as their book value and they liquidated its pieces for $107, then there might be a tax due of $33. So he might only net the current stock price.

OID: And even using Gabelli's $150 valuation, using your assumptions, shareholders would only net $100.

Robotti: That's true. But when would that happen? I don't think Gabelli has any interest in selling any of these businesses. So shareholders get an interest-free loan from the government in the amount of any taxes that would be due on a sale. That's why I use pretax figures, too. It's a safe bet that Gabelli's not going to liquidate this company.

So the exercise of what would happen if the company were liquidated is worth doing. But it's not the reality of the situation.

OID: Have you evaluated Lynch on an earnings basis?

Robotti: Gabelli points out that Lynch's EBITDA was up 40+% last year.

OID: More like 68% actually. But who's counting...

Robotti: And they've announced that they expect it to be up more than 50% *next* year. But part of the reason it's up is that they bought Central Products during the year and incorporated its EBITDA.

And that doesn't tell you the other side of the coin — which is the financing costs associated with that growth. It doesn't tell you anything about the capital costs that they incur to get the additional EBITDA.

OID: Is the EBITDA he references their pro rata share or does it include the earnings of the portion of their holdings that they don't own?

Robotti: It's closer to the latter. Plus, it gets very complicated because it includes partial year figures for acquisitions during the year and nothing for anything bought subsequently.

OID: Cutting through all of the complexity, when you look at Lynch in terms of how it's priced relative to earnings, what do you come up with?

Robotti: In a nutshell, after I make a variety of adjustments, I figure that my $107 figure values Lynch at something less than 8 times EBITDA — with consolidated debt accounting for something over half of that figure.

OID: And Gabelli's $150 estimate?

Robotti: I believe it's closer to 9 times EBITDA. And the current price would be something under 7 times.

OID: And what do those figures tell you, if anything?

Robotti: I don't think that consolidated earnings really tell you very much at all. Segment analysis along the lines of what we've already done is what counts.

SELF-INTEREST AND COMPETITIVE INSTINCTS
WILL PULL GABELLI MORE TOWARDS LYNCH.

Robotti: But, again, the most important element here isn't even the valuation. As I mentioned, Gabelli said Lynch was worth $12 when he first bought it 10 years ago. The old valuation was pretty easy to do. And I think these are reasonable numbers. I think $107 is a relatively conservative valuation because there are arguments to be made that some pieces are worth significantly more than the figures I'm using. Some could be worth something less. But as a package, my guess is that I'm toward the low end of valuations on a number of pieces.

OID: You don't have to tell me.

Robotti: And, again, using my $107 figure, Gabelli's compounded Lynch's value at over 24% per year.

OID: And much more using Gabelli's appraisal on both ends.

Robotti: So he's got a record of doing something very successfully for ten years — which is a pretty long time. And he owns 25% of the company. Clearly, he's extremely motivated to see it do well. And going forward, it's going to pull more of his time — for better or for worse — because a little effort on his part with Lynch can have a big impact on his personal net worth. The potential for value-added — both for himself and other shareholders — is quite high.

OID: You left out "please".

Robotti: And if Lynch is worth $100 per share, then his interest is worth $35 million. If it's worth $150, as he says, then it's worth $52 million. When he first acquired it, it wasn't big economics for him. However, today, the potential rewards from Lynch are no longer inconsequential — even relative to *his* personal net worth.

OID: We can't all be ultra-rich investment publishers...

Robotti: And where's the value added for him spending time on the mutual fund business? After all, it's almost become an institutionalized business. I think he can add more value to Lynch and himself if he makes a couple of good deals and structures them intelligently — although, of course, I'm not saying that Gabelli's the kind of guy who's motivated by increasing his personal net worth.

OID: Of course not.

But Lynch may be Gabelli's palette in a way that's at least somewhat similar to Berkshire being Buffett's. And I somehow get the impression Gabelli keeps count.

Robotti: It's funny you should mention that — because Gabelli went on the record in a *Forbes* article that, as I recall, dates back to the late '80s. And in that article, Gabelli talks about Lynch and he said, "It's Berkshire #2."

OID: He's certainly never been one to mince words.

Robotti: And he not only uses the analogy, but he's said, "Sometimes, I think I should just spend more time on Lynch because Buffett spends all of his time on Berkshire, whereas Lynch is just a sideline for me."

Of course, some of that was just quips on his part. But I think there's some reality in those comments, too.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

ALTHOUGH BEING A PART-TIME CHAIRMAN
MAY ACTUALLY BE AN *ADVANTAGE*.

OID: And he is a part-time chairman.

Robotti: That's right. And anyone who knows him knows there's no way he spends 100% of his time on Lynch or anything else. And he never *will*. But a part-time Gabelli is worth more than many full-time chairmen.

OID: Frankly, what amazes me is how well everything sounds like it operates under those circumstances. Are any of those operations' profit margins less than they should be?

Robotti: Yeah. They were definitely disappointed in Morgan Group's performance for the year. Its margins were down — to 3% from 3.6%. They think they should be up at 5%. So they were unhappy with its performance. They thought it was going to earn $1 or more in 1995 — and instead it earned 80¢.

OID: How does he delegate management day-to-day?

Robotti: All these companies have different managers. For example, the TV stations are run by a guy named Phil Lombardo who Gabelli's known for a long time. And somehow they've developed a relationship where Lombardo really runs them and Gabelli is hands-off.

In Spinnaker, these two guys — Boyle and Fleming — brought Gabelli the Brown-Bridge deal to begin with and therefore got that 20% equity interest through the warrants in that company. And I think that although Gabelli still has a lot of input, he's relatively hands-off there.

And the chairman of Morgan Group is a guy named Charles Baum — whom Gabelli's known a long time. And I get the impression that they have a reasonably good relationship. I think he kind of acts as a barrier and insulator between Gabelli and the actual operating management at Morgan. Plus, they just brought in a guy who'd been at Ryder for 25 years. So Gabelli's not involved that much there either.

Then, a lot of the telephone companies are individually managed by the people who ran them before Lynch acquired 'em. And he's relatively hands-off there.

OID: Sounds like a less idyllic version of Berkshire.

Robotti: Maybe. And I think the advantage of all these companies from the managers' perspective is that they're one step removed from even Lynch. There's been more turnover in corporate personnel at Lynch — possibly because there they deal more directly with Gabelli, who's such a demanding boss.

The operating companies are one step further away. He's not going to run those things on a day-to-day basis.

OID: And absence makes the heart grow fonder.

Robotti: So it's not like being a portfolio manager in his mutual fund group up in Rye. That's his business. And he knows it cold. So he can't *help* but give his opinion and be there all the time.

These are operating companies, physically located someplace else, that he doesn't operate, in businesses he's never run. So he may have significant experience investing in these companies and understand their economics. And I'm sure he's not shy about giving his opinion and that when he does the managers listen. But he's not there day-to-day in the same way that he is in the mutual fund company.

So there's less turnover in the operating companies for a multitude of reasons. But Lynch — which is more of a holding/investment company and more deal oriented — has a lot more direct contact with him. And I get the impression that their turnover reflects it.

OID: So that being a part-time chairman may actually be an advantage for him.

Robotti: I think so. It's probably a good balance. And who can argue with that kind of success?

MARIO KNOWS COMMUNICATIONS AS WELL AS ANYONE.
AND HE KNOWS HOW TO ACCESS CAPITAL CHEAP.

Robotti: And two years from now, Lynch is going to look very different than it does today — for a *lot* of reasons:

First, they've announced that if they're the winner in these PCS auctions that it would cost them $45 million to develop them out. Therefore, they'll have relatively large capital costs coming up. And Lynch is going to have to raise money in one form or another.

OID: Which may explain why he's pumping the stock. But, of course, they only have to spend the money if they win.

Robotti: They think they'll win at least some of them. And so do I. And I say that because they're interested in acquiring these franchises. And they've increased their likelihood of winning by joint venturing their bids with minority partners. Also, the auction gives a preference to small companies. And all of Lynch's entities will qualify not only as minority-owned, but as small businesses, too.

And Gabelli's been around the block. He knows the auction process. He saw what happened in cable. He saw what happened in cellular. He's lived this business for much of his life. He understands the people. He knows who's on the Federal Communications Commission and what those people are like. I think he understands that process as well as anybody.

And he's got a small enough company where he can structure it to put a financing package together and increase the likelihood of winning those bids, too. So this is kind of like shooting fish in a barrel for him.

OID: Fascinating.

Robotti: So assuming he wins those, all of a sudden, they need $45 million of capital to develop them out over some years. Of course, I imagine he'll be able to finance a reasonable amount of that internally one way or another. But they're still going to need to raise capital to do that.

And they need capital to make other acquisitions. I think Gabelli wants to use Lynch as an investment vehicle. How does he do it? Does he sell businesses? Does he sell pieces of businesses? Does he sell some to the public?

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

My guess is that he'll do *all* of those things.

And it's not like he hasn't done those things before. For example, he owned all of Morgan at one time. And he sold a piece of it to the public. So things may come public. Things may get rolled in. Things will go both ways. Some will be sold. Some will be spun off. Some will have pieces sold to the public. And some will be bought in.

But there are two things you can be sure of: first, you know that Gabelli will always be doing something; and, second, for the next two years, you know that he'll be doing even more than he usually does.

OID: And you're not worried about Gabelli diluting shareholders in the process?

Robotti: That's part of the advantage of this situation — because Gabelli will leverage this thing, borrow money and raise capital wherever they need it a lot easier than the average Joe can. And he'll no doubt do it more favorably.

OID: Of course, speaking of raising capital, one thing that Lynch doesn't have that Berkshire does is access to very low cost funds...

Robotti: Yes and no. A year and a half ago, Lynch called the converts that had been outstanding for almost ten years. They had a strike price of $31.50. I think there were $9 million worth outstanding. And maybe $1.5 million worth were converted into Lynch stock. So the vast majority of convert holders — over 80% — took the cash.

And the timing was very fortuitous indeed because Lynch would have experienced a lot more dilution today if those converts were still outstanding.

So that issue provided Lynch with low cost money — because he got to borrow money at a below-market rate for a long time and suffered very little dilution in the process.

OID: That was then. What about now?

Robotti: One of the ways he can lower his costs is to do another convert. However, I don't see that in the picture today. I suspect Gabelli knows that his $150 valuation is on the upper end of the range and is somewhat aggressive.

OID: I strongly resemble that remark.

Robotti: But there's no way he thinks it's only worth $70 or $80. So, in his mind, a convert with only a slight premium to market would lead to significant dilution on the equity side. And to get a lower interest rate at the expense of equity dilution probably isn't worth it to him.

OID: How, then, do you think he'll raise the capital they need — assuming that they have one of the winning bids in the PCS auction?

Robotti: I think he has a lot of options. As I said, maybe he'll do a public offering of one of the other entities that Lynch owns a stake in. One of the options would be for Spinnaker to do its *own* offering — for it to sell stock and for Lynch to sell part of its interest along with it. I don't know if he'd have the ability to do that or not. But that would be a wonderful option for him, I imagine. I would think that if he thought he had the ability to do that, he'd be happy to take some profits on his Spinnaker shares at $82.

OID: Although he'd probably pay a big chunk of the proceeds to the IRS.

Robotti: I think he'd be *more* than willing to live with the tax if he could sell some Spinnaker at that price.

OID: Interesting.

Robotti: And there's no reason it has to be Spinnaker. He has all of these companies. He could sell *any* of 'em. And he probably would have to pay some taxes on the sale, but that would raise some capital, too. And to the extent that he thought a business didn't have a lot of opportunity for growth, that would make sense.

And, frankly, in the grand scheme of things — in the context of Lynch's total capitalization and that of the companies it controls — I don't think raising $45 million over the next three or four years will be all that difficult.

A FASCINATING WAY TO INVEST WITH GABELLI
— AND YET NOBODY AT HIS FIRM CAN BUY IT.

OID: One risk here, I imagine, is the financial leverage. I understand there was something like $175 million of consolidated debt at year end and that it's up since?

Robotti: I don't think that's really much of a risk.

OID: How can you say that?

Robotti: Because nearly all of Lynch's debt is compartmentalized and not cross-collateralized. Therefore, once again, you have to look at it segment by segment.

And when you do that, the most leveraged segments are probably Spinnaker and the telephone companies. They probably cover their interest about 1.9 and 3.6 times, respectively. And, in the case of Spinnaker, I imagine that they'll probably reduce their leverage at some point by way of an equity offering.

OID: So what could turn Lynch into a mistake?

Robotti: Good question. I don't know.

OID: I gather that Gabelli has used leverage — and sometimes lots of it — in his acquisitions.

Robotti: That's right. He's added value by buying things on a leveraged basis and buying them right.

OID: So that if Gabelli were to leverage bad decisions as much as he's leveraged his good ones historically, couldn't that put a hurtin' on Lynch shareholders.

Robotti: Theoretically, yes. But he's done it with small investments. So if any one of those didn't work, he wouldn't have lost much. Therefore, one advantage is that he's not betting the ranch on any single investment.

OID: Certainly, there must be something that could turn Lynch into a mistake.

Robotti: It's a very good question. But, frankly, at anywhere near today's price, I can't think of anything.

OID: Aside from geopolitical disaster, of course, which could turn its debt into an iron weight.

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RAVENSWOOD'S
BOB ROBOTTI
(cont'd from preceding page)

Robotti: I really don't think so — even in that case. How bad do you think it would have to get before their telephone companies couldn't pay their debt service? Frankly, it's hard for me to imagine.

And, as I mentioned, if things ever did get bad enough that one or more segments were in distress, their debt is compartmentalized. So the damage would be limited. Gabelli's aggressive. But he's not a risk-taker really.

OID: Are you sure you're not related?

Robotti: Values could certainly take a temporary hit. But even then, I think the numbers that I'm using build in a margin of safety there.

OID: I don't know why you say that...

Robotti: So here's a guy with a tremendous record — even if his firm's had a tough year or two. But he's clearly a guy who's driven to be successful...

OID: You think so?

Robotti: And, in effect, here's a way to play him that's a lot cheaper than buying his funds. In effect, it's a publicly traded, leveraged buy out pool run by Gabelli.

Yet nobody follows Lynch. Nobody even *looks* at it. And everybody has a negative impression — because when Gabelli first took control of it, investors got overexcited and the stock got ahead of itself. Then, he did the convert issue when the stock ran up to $30. And then it languished for nearly *eight years* afterwards.

Only in the last year has Lynch's stock done anything. As recently as last year, it was as low as $23.

OID: Drop it, already — please. I have enough regrets.

Robotti: Yet, when you go to Lynch's annual meeting, nobody's there. A Gabelli employee said: "Isn't it amazing? Normally, if people know Gabelli's going to be somewhere, a crowd turns out. But nobody comes to this meeting."

And nobody at Gabelli can buy it because it's restricted. So most of the people who would know something about it are restricted from owning it.

OID: And it's certainly not the easiest thing in the world to figure out — or write up, for that matter.

Robotti: And that's great. That's our specialty. That's what makes these things opportunities — because they *are* confusing. The situations where you have to figure out what's there, what each of the pieces are worth, who owns what piece and so forth are exactly the kinds of things we love most. And that's why they're mispriced.

WHY ARE WE A MARKET MAKER, TOO?
BETTER PRICES & BETTER EXECUTIONS.

OID: I understand that besides managing Ravenswood and being a broker, you're a market maker, too.

Robotti: Yep. Ravenswood has 105 positions. And the vast majority of those are relatively small positions. Many, in fact, are downright tiny. And the only reason why we can buy and sell those cost-effectively is that we have a broker-dealer and that we make markets in 80+ stocks in the Pink Sheets and on the Bulletin Board and also some on NASDAQ.

Without having the broker-dealer, we couldn't buy those little things — in part because we'd never *see* 'em. We get an *earlier* shot at buying shares because we get an earlier call. We're further up the queue, if you will, than if we had to wait for a market maker to give us a call and show them to us. A lot of the trading that we do is with other market makers. So we get calls from them, too. But we also get our own calls where a guy at Schwab is selling stock directly. And so we get the first crack at it.

OID: Very interesting.

Robotti: The other reason why we make a market in those things is that they generally tend to trade less and have wider spreads. So our acquisitions cost is a lot less if we can buy it towards the bid — which we can often do as a market maker.

And we get a better sense if there are shares available and where they are. So we think we get better executions — both in terms of price and information.

OID: A very wise contributor tells us that the skills and temperament that make a good market maker are the opposite of those it takes to be a good money manager.

Robotti: I never said we were a *good* market maker. But, of course, the perfect example is Tweedy, Browne. As I mentioned, Tweedy's genesis was as a broker/dealer specializing in inactive small-cap securities 30 years ago.

And some of your other contributors still make a market in certain stocks. For example, Tweedy still makes a market in certain issues — as does Gabelli. And I'm pretty sure that there are others, as well — although as money managers get bigger, they also tend to deal in larger companies. So it makes less sense for them to bother with making markets because there's usually plenty of liquidity in most larger issues anyway.

OID: Is that what you're hoping will be in your future?

Robotti: No. I can be just fine and happy with what I'm doing. A couple of years out, we'll be *plenty* big for me.

Plus, I *know* that I can get performance in this arena. If I had to change the arena I play in, I'd be less confident of being able to do that.

OID: Here's hoping we both face that challenge soon. In the meantime, thanks for sharing some particularly intriguing ideas.

—OID

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THIRD AVENUE FUND'S
MARTY WHITMAN
(cont'd from page 1)

MJ Whitman Advisers versus Graham and Dodd....

The "Graham and Dodd" approach is so often quoted and touted by value investors and portfolio managers that we thought it particularly interesting for our investors to understand how the MJ Whitman Advisers' ("MJWA") "safe and cheap" approach compares.

MJWA is very much like Graham and Dodd ("G&D") in that we both (i) concentrate on long-term fundamentals; (ii) do not address short-term trading considerations and (iii) pretty much ignore all chartist/technical considerations.

However, MJWA's investment style differs significantly in its analysis of the risks associated with the investment in both common stocks and credits. We summarize some of the major differences between the MJWA and G&D approaches to common stock analysis [in the table below].

Graham and Dodd (G&D) focuses on avoiding disaster.

In assessing instruments which involve credit risk — i.e. other than those of the government and AAA-rated instruments — G&D concentrate on the analysis of "default" and "market" risk. MJWA's principal concern is credit risk.

The G&D approach centers upon ascertaining whether or not there might be a money default. This approach is basically quantitative; protective covenants in loans are all but ignored. Interest and debt service coverages are examined on an overall basis and there is a great emphasis on how the market price of the bonds will perform.

MJWA assumes disasters will happen and maps workouts.

On the other hand, MJWA actually assumes there will be a money default and then examines how the credit would be worked out — either out-of-court or in a Chapter 11. Bond covenants become key and coverages are determined on a case-by-case basis. Investments are made if MJWA believes that on a worst case basis, the credit will be worked out in a manner that would yield the investor 500 basis points over a comparable performing loan. MJWA asks how a credit will work out if a company files, not where the market will price the credit if the company files.

Six new "safe and cheap" stocks.

Since we last wrote to you, MJWA, in accordance with its "safe and cheap" investment philosophy, has added six new stocks to the recommended list....

•American Physicians Group, Inc. is involved in a number of small medical and financial based businesses. In addition, it owns over 20% of Prime Medical Services ("PMSI"), the country's third largest provider of lithotripsy services, and has a large cash balance. After accounting for AMPH's investment in PMSI on an after-tax basis, AMPH shares are priced at below its adjusted net asset value.

•Chris Craft Industries' principal asset is its 74% holding in BHC Communications. BHC Communications owns three television stations in major markets, has a significant cash position, owns 56% of United Television and is developing America's fifth national television network. A secure financial position and its discount to both its reported book value and estimated private market value underpin our recommendation.

•Evans and Sutherland manufactures hardware and software for highly realistic visual systems for a variety of simulation, training, engineering and virtual reality applications. Simulation products for the U.S. government accounted for 75%+ of sales in 1995. Evans recently announced its intention to purchase Terabit Computer Specialty — a manufacturer of specialized display systems and other components for the simulation industry.

•National Presto Industries, Inc. is a leading manufacturer of portable electric appliances and pressure cookers with a well recognized brand name. While the retailing environment has and may continue to restrain earnings in the short term, National Presto has an extremely strong balance sheet, with over $25 per share of cash.

•PXRE Corporation provides reinsurance products and services focusing primarily on property reinsurance. While we expect PXRE's earnings to come under pressure, its strongly capitalized balance sheet and small premium to book value make it one of our favored stocks in this sector.

•Tecumseh Products Company manufactures compressors (for refrigeration and air conditioning units), engine and power trains (for lawn mowers and snow blowers) and various pumps. Approximately 55% of its sales are to the U.S. market, with the remaining sales to over 99 countries around the world.

Tecumseh has an excellent financial position, long-standing management team, strong supplier and customer relationships, and has worked toward improving long-term return on equity. But short-term earnings may be depressed somewhat by the cost of plant ramp-ups, and, possibly, by a reduction in sales of seasonal engine and power trains.

—OID

MJ Whitman Advisers	Graham and Dodd
•Values a company as a going concern and assesses the likelihood of its involvement in conversion activities.	•Values a company as a going concern.
•Macro factors unimportant — although may present/identify an opportunity.	•Macro factors important.
•Emphasizes quality as well as quantity of a company's resources.	•Emphasizes quantity of a company's resources.
•Emphasizes the understandability of financial statements and a company's ability to access capital markets.	•Emphasizes future earnings power using past earnings and macro indicators.
•Believes shareholder distribution policies should focus on the needs of the company.	•Prefers shareholder distribution policies to meet desires of shareholders.
•Takes long-term business person and shareholder viewpoint.	•Takes shareholder viewpoint.

RICHARD F. ASTER, JR., ASTER INVESTMENT MANAGEMENT

"During the [first] quarter, we took initial positions in Buffets, Equity Residential Properties Trust and Riscorp and established small positions in a number of specialty retailers including Cato Corporation, Heilig-Meyers and Williams-Sonoma.

Retail stocks ... have underperformed the market since the end of 1993 — reflecting poor earnings on the part of the industry. This has resulted in thousands of store closings and a number of mergers, consolidations and restructurings during the past two years. In time, these developments will lead to a more prosperous environment for the survivors. Many participants will resume satisfactory growth rates. The combination of improved prospects and attractive valuations could lead to a more favorable investment climate for retailers during the next few years.

This is an area we plan to focus on and monitor closely in the near future."

Letter to clients — April 1996

Dear Subscriber,

Our friend and contributor, George Michaelis — chairman and CEO of First Pacific Advisors and president and portfolio manager of Source Capital — died as a result of injuries suffered in a freak biking accident that occurred in the Santa Monica Mountains on Saturday, March 9th.

We've tried to remember George through the words of FPA's new chief investment officer Bob Rodriguez and hope to include the poignant comments of another of Michaelis' associates in our website-to-be.

But the most fitting comment I could make about George Michaelis is that when I've written my final edition, I only hope I'll leave my firm and my family as well prepared and be missed half as much. If so, I'll consider myself to have been a fabulous success indeed.

It was truly a privilege to have him as a contributor. And he will be missed — although we're pleased at the prospect of continuing to enjoy the contributions of those he recruited and worked with — including Bob Rodriguez and Bill Sams. Thanks again, George.

Despite a stock market which is anything *but* a bargain by virtually any measure you might wish to choose, we're pleased and excited about this edition's assortment of ideas. As always, we never cease to be amazed at the ability of our contributors to find bargains which are compelling — and not relatively speaking, but on an absolute basis.

•For example, FPA Capital's Bob Rodriguez says he doesn't see the grand slam-type bargains today that he did in 1989. But he then proceeds to tell us about one that's grown its sales and cash flow per share 18-20% per year for 10 years that's selling at only about 90% of book value — and another with a history of high profitability that's recently undergone a significant management upgrade and is selling for less than 8 times normalized earnings. (Both, incidentally, have been repurchasing their shares.)

We were also impressed with the good sense underlying the investment formula which he describes and the good results he's achieved with it. Although few of us might match his skill in its application, we suspect that most of us would be well advised to keep it in mind.

Also, we wish space constraints hadn't prevented us from including his comments about the long periods (and dramas) he's typically had to endure before his holdings have begun to reflect their underlying value (as well as the instances where he was wrong).

•Ravenswood Investment Company's Bob Robotti then shines his flashlight on some fascinating ideas which he believes are being ignored and/or misunderstood today. Among them are a property and casualty insurance company selling at only 60% of book. Some dog, you say? Apparently not. This company's president reportedly has a long history of earning an underwriting profit.

To us, these look like bargains one might be thrilled to buy at current prices in the aftermath of a *bear* market — much less following an extended bull market run. However, only time will tell.

Meanwhile, we're already back on the hunt for our next edition's batch (in-between annual meetings, of course). And we don't believe you'll be disappointed by them either. Happy hunting.

Until next edition,

Henry J. Emerson

Your Editor

P.S. As we mention elsewhere, we have fantasies about setting up a website (to be located at http://www.oid.com) and its potential to help us serve you better. Stay tuned.

P.P.S. Thank you for your patience and your support.

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