

February 2010 *CGI Value Focus Coach*: Port Report

Dear VF Member:

It's that time of the year again: Warren Buffett's annual letter to Berkshire Hathaway shareholders and—more importantly for all of us—your managers' report on the VF port holdings. We trust you enjoyed your Saturday breakfast with Buffett—dinner for yours truly in Madras, but I digress. In this month's *Coach*, you'll see, among other things, why we are waving goodbye to Hong Kong based **Cheung Kong Holdings Ltd** (CHEUY).

As we often remind you, we manage a *portfolio*. The merits of holding, buying, or selling an individual stock position depend, in part, on the other holdings in the portfolio, with position sizing often playing an important role.

Assuming that a portfolio of stocks is already in place, the most straightforward but often misleading method of assessing your portfolio weighting involves using current market prices.

However, this presents the problem of relying on Mr. Market to determine your portfolio's weighting—the *very same Mr. Market whose manic-depressive behavior you are looking to take advantage of*.

So, what can you do? The same thing you do when you look to buy an investment: focus on intrinsic value. Using intrinsic value will likely provide a much better reflection of your portfolio weighting compared to one that just relies on current market prices.

With that portfolio management thought out of the way, let's dig in to a review of our holdings, sponsored this month by **Steak 'N Shake** (SNS), your demon on costs leader. Kidding, but only just.

Best wishes,
Ragu Chandrasekaran

Value Portfolio Updates

[Ragu Chandrasekaran](#) and [Jeff Anello](#), CGI Value Focus Managers

Brookfield Asset Management Inc. (BAM) (Ragu)
The big news this week is BAM's 30% investment to pull General Growth Properties Inc. out of bankruptcy. BAM already owned a significant amount of unsecured debt, but it invested \$2.63 billion putting a floor of \$15/share on the common stock, \$10/share for General Growth Properties and \$5/share for a new entity called General Growth Opportunities.

This might not be the last act in a play of many parts, not least Bill Ackman's Pershing Square hedge fund investment or number-one mall developer Simon Properties offer of \$9/share. But if BAM is acting according to its value principles, we shareholders are getting quality assets at a value price. General Growth Properties owns some of the top malls in the country—luxury brands in premier locations—

and at the right price, they offer excellent cash flow and potential real estate appreciation.

BAM has a lot of moving parts, but we own it both because we think that its EV/operating cash flow is reasonable and for the future compounding potential of CEO J. Bruce Flatt. The new deal and other purchases in the last year enhance the company's attractiveness. We might sharpen our pencils if shares were to move suddenly into the higher \$30s and \$40s, but for now **we're comfortable with our margin of safety.**

Winthrop Realty Trust (FUR) (Ragu)

Winthrop is a small investor in commercial real estate, operating as a REIT, and entered the real estate blowup flush with cash. It has invested that cash not only in distressed properties but also in financing. Winthrop buys loans or refinances where borrowers can't obtain credit or want to get out from under loans in excess of the much-lower value of buildings.

What's interesting about being this kind of lender? You can benefit in two ways: first, by a high interest rate, and second, by the possibility that the borrower will default and you will own a building worth much more than your loan.

Winthrop is not without blemishes—it wrote off a large investment in the crash—but this hasn't affected either its stability or its ability to make new deals at rock-bottom prices. **We're happy to hold.**

PNI Digital Media Inc. (fka PhotoChannel) (PN/PNDMF) (Ragu)

PNI continues to grow free cash flow and enhance its balance sheet. We peg its enterprise value to normalized free cash flow multiple at 5–6, and we aren't the only ones that find this

cheap. The company has approved a significant buyback—"normal course issuer bid" in Canada—and will begin buying back shares soon.

At its current valuation, PNI is a value with a margin of safety, but it's not the kind of company we normally own. It's not clear whether its software system that allows retailers to take online and kiosk orders for photos, photo books, gift mugs, and other personalized items is a secure cash stream. On the other hand, once the system is installed, we haven't seen one customer move to a competitor.

We probably overpaid at purchase, but that's no longer relevant. At this price, **we're happy to hold** this position.

Cheung Kong Holdings Ltd. (CHEUY) (Ragu)

We sold off some Cheung Kong Holdings because a large part of its value is in Hong Kong real estate, which—in a rare moment of aligning with conventional wisdom—is universally acknowledged to be not just overvalued, but in a bubble. We think that shares are still worth in the \$20s, but if current Hong Kong and mainland Chinese real estate conditions do not catalyze the stock price, we wonder what would.

We have long ballyhooed our pleasure in owning CHEUY's 49% of Hutchison Whampoa Ltd. and its first-class worldwide infrastructure and retail assets, but not enough to hold indefinitely with no catalyst. **We will sell**, recognizing that owning a company that doesn't appreciate when its main value driver is exploding does offer a margin of safety, but has no more upside potential than cash. This is a close call and not one that if wrong means losses ahead. You may well hold.

Hilltop Holdings Inc. (HTH) (Ragu)

Hilltop is a small position, a call option on the

skills of distressed bank investor Gerald Ford, who has an unparalleled track record in the last savings and loan debacle. It's a vote for a great investor, but one **we hold as a small option only**.

Steak 'N Shake (SNS) (Ragu)

Continuing on the back of an *annus mirabilis* in 2009, Steak 'N Shake posted terrific results for the first quarter of fiscal 2010. While we believe the name change to [Biglari Holdings](#) is questionable, we are comfortable **holding** at today's prices. You can find a discussion on the last quarter's results and some thoughts on valuation [here](#).

Premier Exhibitions (PRXI) (Ragu)

We see the value at PRXI as a combination of the Titanic assets and a call option on the exhibition business.

The appraised value of owned artifacts is \$40 million, carried on the books at a cost of \$3 million. The appraised value of artifacts under litigation: \$110 million. Assuming the cost/appraised value of this set of artifacts is the same as the set of owned artifacts, we can infer a cost basis of \$8.25 million.

If PRXI is able to sell the whole set of artifacts at the appraised value, assuming they get a favorable court ruling, the net cash inflow would be \$101.4 million, at a tax rate of 35% on the gain. This works out to \$2.13/share, with 47.6 million shares outstanding. A discount to this value ought to be accounted for given the time it takes for a favorable ruling and consequent sale.

However, we should balance that against the possibility that PRXI is able to sell these assets for *much more than the appraised value*. In fact, it seems as though Mark Sellers, based on his [comments](#) from Investor Day in Las Vegas,

believes this is a possibility.

As for the option value on the exhibition business, we don't believe it to be worth much today, especially in relation to the value of the Titanic assets. We will **hold**, as we wait for a favorable court ruling.

Sears Holdings Corporation (SHLD) (Jeff)

Sears Holdings reported their year-end numbers recently and Eddie Lampert issued his [Chairman's Letter](#). The numbers looked pretty good: increased cash balances, long-term debt paid down, more share buybacks, and another decent showing by the K-mart unit, which is benefitting from a very successful layaway program. In addition, EBITDA is up due to higher margins, a good sign even in an economy that has been very tough on the big-ticket items (like refrigerators) that Sears sells.

Sears has a long runway to improve the productivity of its stores. If Lampert's plans—which mostly focus on web presence, technology improvements, marketing, and some product initiatives—yield any margin improvements, then Sears will hit a huge home run.

To find these improvements, Lampert's letter focused on where Sears is investing. Indeed, most are technology-based: MySears, Mykmart, mygofer, mobile apps, etc. These are the platforms from which he will fight—not massive store expansion or improvement. As I mentioned in a [recent blog post](#), licensing out brands to other outlets is another prong of the attack.

Besides retail success, I still believe we have enormous downside protection in the value of Sears's real estate, brands, and various operating units, as well as an owner interested in maximizing that value. As the stock dips, the

company's tremendous cash flow generation fuels a stock buyback that further increases the per-share value of the enterprise. We're happy to **continue holding Sears**. Read the Chairman's [letter](#) for a taste of how the company is being positioned.

Contango Oil & Gas Company (MCF) (Jeff)
Finally, Contango also [reported](#) recently. Like Sears, Contango just cranks out cash—aka more of the same. For the quarter, Contango generated more than \$50 million in cash from operations, a \$200 million+ annual run rate at today's production and pricing levels. Contango is generating an enormous amount of cash even without taking into account any production increases from recent drilling success or any for this coming year.

That success shouldn't be taken lightly either. CEO Ken Peak has almost never drilled this aggressively. Knowing his standards, these wells (taken as a whole) will almost certainly boost Contango's value. Add in \$75 million in cash on the balance sheet and the future has never been brighter for this company. We're **enthusiastic owners**.

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If you have any questions, join us on the [Member Forum](#) and thank you so much for being a *Value Focus* member.

Best wishes,
Ragu and Jeff

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Ragu and Jeff own all companies mentioned here. CGI and its managers make buys and sells only after notifying members of the intended trade. Use investing information to help you make your own

decisions. Investing entails risk of loss of principal. We mean it.

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