



LATEEF

INVESTMENT
MANAGEMENT

Lateef Third Quarter 2009 Commentary

The third quarter of 2009 marked the one year anniversary of the failure of the 158 year old investment bank Lehman Brothers, which many consider the climactic event of the credit crisis. A media deluge covered the one year anniversary which included comments by Warren Buffett who likened the surrounding events to a financial Pearl Harbor. What a difference a year makes. Signs of stabilization in the economy are becoming more evident in housing and manufacturing among other industries, and the stock market is responding. According to Case-Shiller, home prices rose sequentially for the third consecutive month in July. The Institute for Supply Management (ISM) index for manufacturing surged above the expansionary level of 50 to 52.9 in August, for the first time in 18 months.

The S&P 500 index nearly repeated its second quarter gain of 15.9% by rising another 15.6% in the third quarter. The S&P 500 has now rebounded 59% from the low in March and is now 19.2% higher for the year. The market reacted to much better than expected earnings reports which were driven primarily by cost cutting and low expectations. During the quarter, 73% of companies in the S&P 500 index reported better than expected earnings as estimated by sell-side analysts for the second quarter, which is a record. We are pleased that 90% of our owned companies reported better earnings than consensus estimates. A common refrain by companies who commented on the current business environment during their quarterly earnings reports, was that business had stabilized and that the worst was behind them, even though visibility and evidence of a sustained recovery were murky.

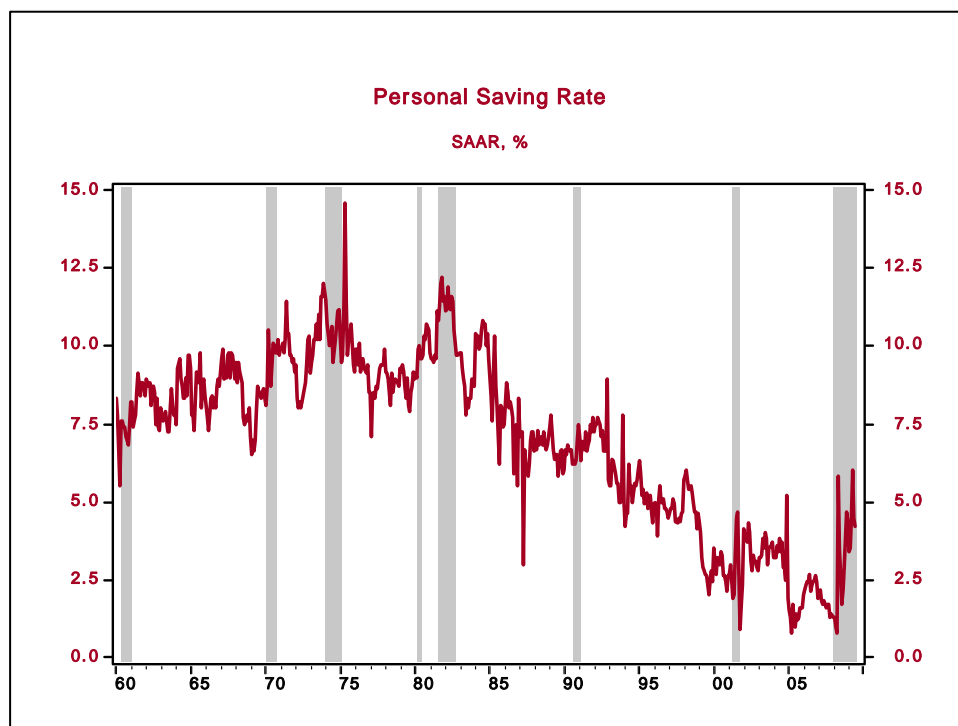
We were encouraged by the comments of the CFO of one of our owned companies, data storage leader EMC, who remarked that, “during the (second) quarter, we experienced more normal linearity compared with Q1...(and that the) customer approval processes and the timing of their spending appeared to be more normal...what the year is now looking to be is to be a little bit more normal from a sequential point of view.”

On the other hand, the CEO of Walgreens, a company we don't own, recently characterized 2009 as one of the most strategic transformational years in its 108 year history and that “we've adjusted our retail model to respond to what we believe will be lasting changes in consumer behavior.” The CEO adds, “we're going to have a tight consumer and a cautious consumer (and) we're going to have to...really drive value... with private brand.”

It is clear that the credit crisis of 2009 and the corresponding recession, like many previous economic upheavals, will define winning companies who will adapt and prosper. Many other companies will inevitably struggle with a response to a “new normal.” The “new normal” refers to an economic recovery that will be tepid, characterized by less consumption, more saving, more regulation and higher taxes. Janet Yellen, President and CEO of the Federal Reserve Bank



of San Francisco, recently said that, “At first glance, history suggests that a vigorous expansion could very well take place following previous deep recessions...(but) this time though rapid growth does not seem to be in store. My own forecast envisions a far less robust recovery, one that would look more like the letter U than V.” She notes that she isn’t alone. The Blue Chip consensus forecast, which reflects the views of nearly 50 professional forecasters, anticipates by far the weakest recovery of the postwar era over the next year and a half. Lastly, Federal Reserve Chairman Ben Bernanke said that while the recession was likely over, the recovery will be slow and will take time to create jobs, “It is still going to feel like a very weak economy for some time as many people still find their job security and their employment status is not what they wish it was.” The free-spending days of American consumerism, fueled by lax credit, are over. Growth will be constrained by the consumer’s desire to retire debt and replenish savings. Consumer debt as a percent of GDP has risen to 96% from 44% when our firm was founded in 1974, and where it had been for the previous ten years. The personal savings rate, which plunged to a 50 year low of less than 1% in 2008, increased to 4.2% as of July, but is still below its 50 year median of 7.4%. The savings rate is likely to continue increasing to pay down debt and replenish lost wealth.



Source: Strategas

We acknowledge that de-levering and tight consumer credit will constrain consumer spending for the short and perhaps intermediate term. We also recognize that the prospects for more regulation and higher taxes are threats to growth. However, we realize that while these challenges are real for many companies, they present opportunities for others that have a compelling value-added competitive advantage, are self-funding with little or no debt, and are poised to capture market share from weakened competitors. While we may face a “new normal” economic environment for a period of time, our time tested research process, that focuses on a



select group of quality businesses that are leaders, provide unique value to their customers, are self-funding, and generate superior investment returns with less risk, is NOT at all new, and very much normal to us. Our consistent process leads us to search for underappreciated growth businesses with high returns on capital while continually reassessing our existing holdings to determine whether new developments continue to meet our original rationale for ownership. Our search led us to buy two new companies, for appropriate accounts, that help their clients save money, work more efficiently and allow them to optimize their unique business offerings.

The first is Accenture which is a leading world class consulting, technology services and outsourcing organization with operations in more than 200 cities and 52 countries. One of Accenture's competitive strengths is its global delivery model where it operates with one common brand and integrated business model designed to provide clients around the world with common best practices and a consistent high level of service. Accenture was formerly the consulting practice of Arthur Andersen. Since becoming a public company in 2001, operating income has grown at a compounded rate of 12%, it has grown its outsourcing business, which helps companies outsource labor to lower labor geographies, to 43% of revenues from 17%. This is significant because outsourcing contracts are long-term, thereby enhancing visibility of revenues. Recurring revenues are now more than 50% of total revenues. The company has also increased its number of "Diamond Clients," which are clients representing more than \$100 million of revenues to Accenture, to 87 from 16 in 2001. Furthermore, of its top 100 clients, 87 have been clients for 10 years or more. Accenture has a reputation of producing strong operators and line managers who are proven executors. They get the job done. Accenture should benefit as companies seek guidance in integrating merged companies and embrace serious cost cutting measures as is occurring in the banking, pharmaceutical and auto industries. Accenture has generated \$14 billion of free cash flow since 2001 and has deployed \$13 billion to repurchase stock. The company has over \$4 billion in cash, no debt, generates a 100% ROIC, and was priced at a P/E ratio of just 13x expected 2010 earnings compared to its historical average of 17.5x and had a free cash flow yield of over 9%.

The second is Teradata which is a unique global leader and pioneer in enterprise data warehousing including enterprise analytic technologies and services. Companies in general are inundated with transactional data from customers. Teradata has proprietary software that works with any hardware platform to allow companies to transform raw business data from disparate departments into useful, insightful and actionable enterprise intelligence. Teradata, for instance, prevented a major U.S. bank's credit card sales group from soliciting customers from the same bank's mortgage holders who were delinquent on their mortgage payments. A Teradata customer we spoke with said that there are hundreds of examples where Teradata's system helped them make better decisions with facts instead of intuition, and make decisions in hours instead of weeks. Teradata uses enterprise wide analytics to optimize decisions as varied as customer loyalty programs, product recalls, supply chain logistics, store location and hiring decisions. Teradata spun out from NCR two years ago and since then, has expanded its product platform, partnerships and sales territories that together offer the opportunity for accelerated revenue growth. Teradata has over \$600 million in cash, no debt, consistently generates free cash flow (it's free cash flow yield was over 10% at original purchase), has a ROIC over 30%, a



conservative plan for growing earnings in the high teens rate, and priced at 17x estimated 2010 earnings.

We sold Costco as recent developments violated our rationale for owning the company. Costco is a terrific experience for shoppers but has been frustrating for shareholders. In the last year, Costco has aggressively lowered its prices ahead of their competitor's prices and ahead of their own product cost decreases. The company has sacrificed sales, earnings, and shareholder value to "wow" its customers with unbeatable pricing to ensure strong member renewals and high foot traffic. Repeated aggressive price discounting to a level where the company admitted it made no profit margin on many popular items, was an offensive strategy by choice and not something they were forced to do. We believe Costco's core value proposition is already so self-evident, that the company didn't need to discount to below cost, and thereby destroy shareholder value. Additionally, despite having an opportunity to capitalize on attractive commercial real estate locations vacated by failing retailers, we were disappointed to learn that Costco is actually slowing down their new store growth.

We also sold Disney which has underinvested the last three fiscal years. We believe the market doesn't fully understand the extent of future spending that Disney is planning for the next few calendar years. Disney is building two new cruise ships that we estimate will cost \$1 billion each, finally renovating major sections of California Adventure which sorely needed updating, is expanding Hong Kong Disney, building an 800 room hotel/timeshare resort in Hawaii scheduled to be completed by 2012 and is buying sports license rights to broadcast European games to grow ESPN overseas. We think all of these are worthy spending initiatives that will eventually improve ROIC, but during the initial investment phase, Disney will bear the cost without the commensurate return which will lower return on incremental capital. Lastly, Disney recently announced the acquisition of Marvel Entertainment for over \$4 billion. The deal is dilutive to earnings for two years and, since the movie license rights for the major characters are already contractually committed to other companies (Sony owns Spiderman), the benefit to Disney will primarily come from licensing the characters for toys and video games. Disney stock had appreciated by about 25% this year as media companies in general rallied on hopes for a cyclical rebound in advertising, and we took advantage to sell into strength.

The portfolio does not have any direct exposure to traditional consumer cyclical companies, retailers, banks or brokers where we believe there is more risk for disappointment in cash generation. We believe our portfolio remains attractively priced, and is poised to benefit from current market opportunities. For instance, one of our companies, Scripps Network Interactive (SNI), whose flagship assets are its ownership of cable television channels Food Network and Home and Garden TV, recently said that record ratings at both channels bode well for negotiating much higher affiliate fee revenues on expiring distribution contracts with cable and satellite distributors as well as higher advertising revenue. The company is benefitting from a nesting phenomenon where consumers are enjoying less expensive forms of entertainment by viewing proprietary content from targeted lifestyle cable channels that resonate with their basic living needs. The company recently said that Food Network ratings are "white hot" and the network is underpaid for its level of viewership. CEO Ken Lowe added that "I am optimistic that this (affiliate fee negotiations) is going to come out in a good place." CFO Joe DeCastro added



that “the scatter market (spot advertising market) has been improving every month for the past two quarters...visibility is still not very good but the tone does feel better...results are somewhat closing the gap toward prior year numbers.”

Other beneficiaries include credit card processors Visa and MasterCard who reiterated that they are on target to meet their goal of growing earnings by at least 20% this year and next. While the average ticket per transaction is down about 10% from last year, frequency of swipes is higher and the pace of debit card usage is strong. At Visa, debit card usage eclipsed credit card usage for the first time this year. Debit cards are typically used for recurring transactions such as bill payment and purchases at pharmacies, gas stations and grocery stores.

Our composite portfolio has a ROIC of 33% vs. 3.7% for the S&P 500, our P/E ratio is on par with the S&P 500 of 16x, and the appreciation potential of our stocks to our estimate of current fair value is 40%. The market research boutique, Strategas notes that as of late September, only 90 stocks, or 18% of the S&P 500 was trading above its pre-Lehman level. Despite the market’s price move this year, we believe our stocks are attractively priced and will benefit from the market opportunities ahead, whether the cycle is a “new normal” or just plain normal.

As always, please contact us with any questions.

Sincerely,

Lateef Investment Management
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