

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

A Business Valuation Approach to Investing



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LEAH R. FRIDAY is a Senior Vice President, portfolio manager, and Investment Analyst for King Investment Advisors, Inc. She has been with the firm since 1995 and has 13 years of experience in the investment business. A CFA charterholder and a Chartered Investment Counselor, she is a graduate of Texas A&M University with a BS in Economics. Before joining King Investment Advisors, she was a research analyst for Capital Research & Management in Los Angeles. She is a member of the Association for Investment Management and Research and serves as President of the Houston society of Financial analysts.

(ZBB500) TWST: Would you start with an overview of King Investment Advisors, the Business Valuation Approach you employ and what specifically you look for in companies?

Mr. Swanson: Since the firm was founded, KING has based its investment decisions on the Business Valuation Approach, or BVA. The approach has three prongs: private market value, historical valuation, and GARP, by which we mean growth at a reduced price. Which one of the prongs we choose depends on where we are in the market cycle and where we are finding opportunity.

The prong for which we are most well known is buying companies that trade at a discount to their private market value. We have a database of companies that have either been broken up or acquired by financial and strategic buyers. We then apply the valuation multiples actually experienced by the companies in our database to companies that are still public in similar peer groups. The companies we find attractive are those that are trading at least 40% below their private market value. And if there is a catalyst present, it's highly probable such stocks will be put on our Buy List. Appropriate cata-

lysts would include consolidation candidates, the potential for corporate restructuring, or a planned spinoff, which would unlock value.

The second prong of the BVA is the historic valuation methodology. This is much more like a traditional Graham and Dodd model where we look at the historic valuation of the company. We look at its different valuation parameters — price to earnings, price to cash flow, price to sales, dividend yield, price to book. If a company is trading at the lower end of those measures, and we think there's a catalyst that could cause it to come back sometime in the next 18 to 24 months, we would consider adding that stock to the Buy List.

Swanson: Arguably, Capital One has the best management in the group. It has been beaten up recently because it is in the process of acquiring Hibernia Corp., headquartered in New Orleans. Even though Capital One negotiated a significant reduction to the original purchase price due to Hurricane Katrina, Wall Street is still worried about the credit problems that may hurt Hibernia Bank's customers.

The third prong is GARP, or growth at a reduced price. With that, we are trying to find companies that are trading at a discount to their EPS growth rate. So a company that has a five-year expected earnings growth of 20% and is trading at a price/earnings multiple of 12 times, would be an attractive candidate for the Buy List.

TWST: How has that approach worked for you over the past 12-18 months?

Ms. Friday: Historically, BVA has worked very well for us. In particular, we have had a lot of success with the private market value and GARP legs of that stool. We have uncovered a lot of value, especially in the small and mid-cap area, where the market is a lot less efficient.

We have underperformed a little bit over the last year, basically due to a lack of exposure in energy. But over the long term, we have outperformed the overall market.

TWST: Do you do any macro analysis prior to selection of stocks?

Mr. Swanson: We are primarily bottom-up stock pickers. But certainly we also look at the macro environment. As an example, we were recently discussing some individual stock names in the consumer discretionary sector. A significant factor in making investments in these economically sensitive stocks today is the outlook for consumer spending next year.

Ms. Friday: Again, such a microanalysis is a secondary consideration to our bottom-up focus.

TWST: What is the outlook for your Business Valuation Approach going forward into 2006? Are you optimistic about the investment climate?

Ms. Friday: I'd say we're optimistic going forward. We think there are definitely pockets, certain areas where we are seeing opportunity and where there are a lot of stocks that meet our buy criteria. There are certainly pockets of the market that are overextended. In energy, for example, we have had an underweighting for quite some time. While we did not have much exposure at the beginning of the year, the group has pulled back as of late. Utilities is another area that is pretty rich right now.

Mr. Swanson: Due to the poor market conditions of the last few weeks, we are finding many companies that should do well over the longer term that have gotten pretty beaten up. We are also adding to holdings we already own that have some short-term problems that have caused the stocks to be depressed. Over the next year, these companies should overcome the obstacles and their stock prices should rise significantly.

Ms. Friday: What is nice about the private market value approach is that it allows you to take advantage of the emotions that drive the market over the short term. I mean, basically, when you are using private market value you are trying to buy \$1 for \$0.50. You're trying to figure out what the cash flows of the company are worth in reality, as opposed to what the market is telling you on a short-term basis. So if you are using that type of approach, you are more long-term oriented. Usually our time horizon is 18 to 24 months. Many times, when you have big selloffs you can find numerous opportunities — and that is definitely kicking in at this point.

TWST: Working from the bottom up, how do you generate your ideas for stocks? Is it mostly in-house?

Mr. Swanson: Yes, many ideas are generated in-house. We have built proprietary screens for each of the three methodologies, whether it is historic valuation, private market value, or growth at a reduced price. Based on the quantitative screens, our industry analysts complete a qualitative review of the companies that could result in a purchase recommendation.

Ms. Friday: We also subscribe to several independent, non-Wall Street research services that help us generate ideas.

TWST: Let's look at the portfolio. How is it structured right now? How many stocks generally do you have?

Ms. Friday: Typically, in a multi-cap portfolio, we own 25 to 35 stocks. Our average position is a 3.3% position (at cost), and we can take anywhere from a 1% to a 5% position, 5% if we believe the risk/reward is extremely attractive. Usually you're going to see

Capital One should actually benefit from these new regulations, as their problem customers will find it much harder to shield their debts from bankruptcy protection. As the company puts its credit quality issues behind them and successfully integrates the **Hibernia** acquisition, this company is worth at least \$95-\$100 just on its internal growth rates. Moreover, given its franchise and scarcity value, it is very possible that a larger financial institution will purchase **Capital One** for over \$100 a share.

Friday: Andrx has had some negative news as of late, and as a result it showed up on some of our screens and looked interesting. They have a pretty good pipeline. They primarily manufacture generic drugs, but they also have a drug distribution channel.

between a 2.5%-3.3% position. Those are typical weightings. I would say, right now, we are holding between 30 and 35 names.

TWST: Are you always fully invested, or do you have a cash position in reserve?

Mr. Swanson: We usually have a small cash position of 2%-3% for transactional purposes, but cash is primarily a by-product of our investment process. If we find enough stocks that we consider to be attractively valued, then we will be fully invested. If we cannot find any names that meet our investment discipline, then we are content holding cash.

TWST: Would you tell us about some of your holdings that you feel are representative of the multi-cap portfolio and the reasons why you were attracted to them?

Mr. Swanson: A stock that recently became attractive again due to a couple of short-term concerns is **Capital One Financial** (COF). The price of **Capital One** had been trading up to the mid-\$80s, and is now back down to the low \$70s a share. **Capital One** is the only pure credit card company left in the United States. All of its brethren, including MBNA and Provident, have been purchased in the last two years by larger financial institutions. **Capital One** has the best management in the group. It has been beaten up recently because it is in the process of acquiring **Hibernia Corp.** (HIB), headquartered in New Orleans. Even though **Capital One** negotiated a significant reduction to the original purchase price due to Hurricane Katrina, Wall Street is still worried about the credit problems that may hurt Hibernia Bank's customers. Additionally on the company's credit card side of the business a number of customers declared insolvency just before the US implemented much tougher personal bankruptcy laws and regulations. This caused **Capital One's** bad loans and charge-offs to pop up in the third quarter of 2005. While this is definitely a short-term problem, over the long term,

1-Year Daily Chart of Andrx



Chart provided by www.BigCharts.com

Ms. Friday: Another one we like is a generic pharmaceutical company called **Andrx** (ADRX). **Andrx** has had some negative news as of late, and as a result it showed up on some of our screens and looked interesting. They have a pretty good pipeline. They primarily manufacture generic drugs, but they also have a drug distribution channel.

The negative news that caused the stock to pull back from the mid-\$20s down to \$14-\$15 was related to issues with the FDA. The company had run into some problems with the FDA regarding their manufacturing facility on the generic side, and they actually cannot receive any new FDA approvals until they meet the demands of the FDA and bring their facilities up to standards. The stock got killed when that news came out, falling about 20% that day.

What is kind of interesting — and this plays into the private market value approach perfectly — is that the company has

this drug distribution arm that is about 50% of their revenues, and it has done extremely well. It is growing its earnings at about 30%-35%. There's been a lot of M&A in that area because before the Medicare reform goes into effect, a lot of the drug distributors want to have as large an arm as possible across the nation, so they're buying a lot of these smaller distribution companies. So this particular division is worth a lot of money for **Andrx** — the value of that division is probably between \$12 and \$15 — and the stock is at \$15 right now. And if you add on to that the fact that they don't have any debt and they have almost \$5 per share in cash, you can get to about \$20 without giving any sort of value whatsoever for the generic manufacturing division. What is interesting is that although they can't receive new approvals, they weren't forced to recall any drugs that were out on the market already. So in reality, you can't give a zero value to that division anyway. It is probably actually worth between \$3 and \$5 a share.

rates and the subsequent flattening of the yield curve. This margin compression has caused a concern over future near-term earnings and has caused Wall Street analysts to reduce their target stock prices.

What many of the sellside analysts are forgetting is the continued growth of **CBH's** deposits. Currently, **Commerce** is still building out branches in New York City, the bank is just entering Boston, and they recently just announced that they're going to go into Florida — they have bought a little bank there. As the yield curve starts to steepen and the margin starts to improve, this stock ought to be worth \$37 as an independent entity. Moreover, **Commerce** has a deposit-gathering franchise so great that a larger bank with a great lending operation could acquire **Commerce Bancorp** at a price north of \$40 a share. I don't think a buyout will happen anytime soon. Vernon Hill, the CEO, is not ready to sell the bank unless someone pays an ultra-high premium price. Regardless, the bank's high franchise value puts a floor on the stock.

Friday: Cephalon is trading at about 13 times earnings. The stock has moved up a little bit since we first bought it. The controversy, the reason the stock is trading at such a low multiple, is that they have had a very successful product called Provigil, which will soon be facing generic competition.

So the sum of the parts of the company is around \$23-\$25, and the stock is around \$15 right now. They are actually meeting with the FDA in mid-November to discuss their facilities, and if they do come to terms with the FDA and they're allowed to start resuming new approvals, the stock is going to move up, I think, to the low \$20s pretty easily. That's one where the market has kind of overreacted. Sometimes, as in this instance, stock prices come down based on emotion — a kind of short-term fear — and that creates nice opportunities for us.

Mr. Swanson: Another stock whose price has come down to an attractive buying range is **Commerce Bancorp** (CBH). In the last few weeks it has been as low as \$28. That is off a high in mid-summer of over \$35. Headquartered in New Jersey, and employing a unique business strategy, **Commerce Bancorp** is to the banking industry what **Wal-Mart** is to the retail industry. Commerce Bank has an intense focus on its customers, which allows it to grow its deposit base very quickly.

While this high, sustainable growth in assets is desirable, it also has a flip side: **Commerce Bancorp** cannot convert these new deposits quickly enough into traditional bank loans. So they are forced to invest the cash into securities portfolios. Banks such as **Commerce**, with large securities portfolios, have seen their margins narrow, due to the Fed's continued drive to raise short-term interest

1-Year Daily Chart of Cephalon



Chart provided by www.BigCharts.com

Ms. Friday: Another one that we like quite a bit is a company called **Cephalon** (CEPH). **Cephalon** is trading at about 13 times earnings. The stock has moved up a little bit since we first bought it. The controversy, the reason the stock is trading at such a low multiple, is that they have had a very successful product called Provigil,

which will soon be facing generic competition. Most of their drugs are for either Attention Deficit Disorder or excessive daytime sleepiness, like narcolepsy. Provigil, which has been a major drug for them, is facing patent litigation in early 2006, and the way the market is pricing it, it's going to be exposed to generic competition.

What people don't seem to be seeing, though, is the pipeline of the company, which is very strong, and the opportunity this company has to protect and expand the life of its existing prod-

ucts. The company should launch six new drugs within the next 18 months. They just launched one a few weeks ago, and they actually have a co-alliance set up with **J&J** (JNJ) to market that product, which should help them significantly in scaling up the launch. They also have a meeting in front of the FDA by the end of the year for a drug called Vivitrex for alcoholism, which could be really a blockbuster product for them. They also have their next generation of Provigil, which has significant advantages over the existing product and should launch before Provigil faces generic competition; hence a nice conversion to the new drug is possible.

Swanson: Dow Jones has control of the finest financial publication assets in the world. On a takeout basis, we think Dow Jones is worth at least \$50. If bidding for the company became heated, the price might even get above \$60 a share. We can't foretell when a successful turnaround by management would occur, or when the company could be sold. But Dow Jones is certainly cheap on an evaluation basis.

What people don't seem to be seeing, though, is the pipeline of the company, which is very strong, and the opportunity this company has to protect and expand the life of its existing products. The company should launch six new drugs within the next 18 months. They just launched one a few weeks ago, and they actually have a co-alliance set up with **J&J** (JNJ) to market that product, which should help them significantly in scaling up the launch. They also have a meeting in front of the FDA by the end of the year for a drug called Vivitrex for alcoholism, which could be really a blockbuster product for them. They also have their next generation of Provigil, which has significant advantages over the existing product and should launch before Provigil faces generic competition; hence a nice conversion to the new drug is possible.

So even though **Cephalon** is facing generic competition on a key product, you are still looking at earnings growth at the company over the next five years of 20%-30%, yet it's trading around 13 times. They also have a great balance sheet, no debt, and very healthy free cash flow.

Mr. Swanson: Dow Jones (DJ) is currently another attractive purchase. For **Dow Jones**, just like the rest of its peers in the newspaper industry, advertising trends have been negative for a series of quarters now. It is trading just above its low, at about \$33 a share. Considering the stock was trading in the mid-\$70s in the year 2000, this stock has recently been a disastrous investment for its controlling shareholders, the Bancroft family. What makes **Dow Jones** interesting is we think the Bancrofts' patience with **DJ's** management has grown very thin. Unless management's recent initiatives to increase revenues are successful, this company could be put up for sale.

Management's key initiative has been the recent launch of the weekend edition of *The Wall Street Journal*. It is still too early to tell, but unless the weekend edition is a resounding success, and

serves as a catalyst for a rebound in the price of **DJ** stock, then the company could well be put on the auction block. The most likely financial buyer would be one of the large newspaper companies. Just recently a rumor circulated that the *Washington Post* was going to make an offer in the mid-\$40s per share for the company. Financial buyers would also be interested in the company. What finer crown jewel would there be for an LBO firm like Kolberg Kravitz Roberts than **Dow Jones**?

1-Year Daily Chart of Dow Jones



Chart provided by www.BigCharts.com

Dow Jones has control of the finest financial publication assets in the world. On a takeout basis, we think **Dow Jones** is worth at least \$50. If bidding for the company became heated, the price might even get above \$60 a share. We can't foretell when a successful turnaround by management would occur, or when the company could be sold. But **Dow Jones** is certainly cheap on an evaluation basis. Plus you're getting paid at least a 3% dividend while you wait.

TWST: You mentioned the dividend. Is one of your investment criteria to look for dividend-paying stocks?

Mr. Swanson: It's not a requirement, but it certainly does help whenever you're in a flat market like we've been in. So no, it's

not one of the basic requirements, but it certainly is a nice little cherry on top of the dessert.

TWST: How does the volatility in the market impact your investment? Is that something you take advantage of?

Mr. Swanson: Market volatility doesn't affect us much because we're such long-term players and bottom-up stock analysts. But certainly when such volatility creates fire sale prices for the stock of attractive companies, we'll be there to take advantage of the situation.

Ms. Friday: That can create opportunities for us.

TWST: What triggers an exit from your portfolio?

Ms. Friday: We sell for three reasons. One — and obviously the one that we like to see — is that the stock has met its price target. Whenever we write up a stock at KING, whenever we make a recommendation, we have an 18- to 24-month time horizon, and the analyst establishes a price target. And we have daily reports that we generate to see where a stock is trading versus its price target. Then once it meets its price target, we'll sell it.

However, I should mention that we're pretty tax-sensitive for taxable clients. It doesn't happen all the time, but sometimes we get lucky and a stock will meet its price target in less than a year. Let's say something gets bought out after 10 months, or something along those lines. Frequently, we will sell that particular stock for a tax-exempt account, but if we think fundamentals are intact or especially if it is a company being acquired and there is a floor under it, then we will hold onto it for a taxable account until it goes long term. We do a pretty good job of being tax efficient.

Friday: A big positive for us is we manage about \$700 million in assets and a mutual fund that invests in stocks of primarily small and medium size companies, so we are a decent sized firm, but we are still small enough to exploit inefficiencies and are actually able to easily buy stocks (without impacting the market price), especially in the small and mid-cap area.

The second reason that we sell is for more attractive alternatives. If we have a particular portfolio that's pretty fully invested and it has a stock where there may be 5% or 10% upside, and if we find something that we have a lot of conviction in that has 50% or 60% upside, then we'll switch. The last reason, which happens every now and then (although we don't like to see it) is if there's a change in fundamentals. We will certainly exit a stock and go ahead and take a loss if we believe the company's future prospects are no longer what they originally were.

Those are the three basic reasons why we sell, but we do have a qualitative or technical component that is not a primary reason why we'd sell a stock, but it does help us with our sell discipline. Every night we run a screen that shows how a stock is performing versus the S&P

500 on a 10-day, 30-day, 50-day and 200-day moving average basis. If something starts underperforming the market (by 10% for a large cap stock and maybe 15% to 20% for a small cap stock because of liquidity issues), then it will be flagged as a possible candidate to sell. It's not an absolute stop loss, but it basically means that analyst needs to convince us as to why we're going to hold on to a particular name.

TWST: Do you have any examples of stocks that you've sold or trimmed back on over the last 12 months or so?

Ms. Friday: Something we trimmed recently was a company called **Endo Pharmaceuticals** (ENDP). We bought this stock a little over a year and a half ago. **Endo** is an interesting specialty pharmaceutical company. They don't have a wide variety of drugs, but they're very specialized in the pain management area and because pain products basically use narcotics, there are a lot of issues with raw materials and the inspection of the manufacturing facilities by the FDA, so it's a high barrier-to-entry market. As a result, the margins are very high. **Endo** has a wide range of products specifically within this niche of pain management.

The stock has actually done very well. They've launched a couple of new products lately. One is a drug called Lidoderm and the other one is a generic version of OxyContin, which were both launched within the last nine months. They have done extremely well and have produced strong earnings growth for the company. The stock has gone from the high teens, where we originally bought it, to \$30. We trimmed it back to a 2.5% to 3.3% position between \$28 and \$30. Since then it's come down to the mid-\$20s because they're doing a secondary offering.

A company called Kelso, which is the group that once took **Endo** private, holds a lot of the shares. **Endo** has been a big winner for us this year.

TWST: What about risk controls? How do you attempt to manage risk in the portfolio?

Mr. Swanson: Leah mentioned this before, but we're bottom-up stock pickers. Probably one of the bigger ways we limit risk is the size of the positions we take in companies. A normal size is 3.3% (at cost) and the most that we'll ever take is a 5% position. Beyond that, there's the sell discipline to which we closely adhere. As Leah said, the technical part of that, which follows the moving averages, keeps us on top of the stocks that we could possibly have losses in and where we could po-

tentially limit the losses. Last is the amount of time we spend analyzing each company and making sure on an individual stock basis that our upside is much greater than our perceived downside at any time.

Ms. Friday: That kind of plays into the idea of buying \$1 for \$0.50.

TWST: What do you feel is distinctive or differentiating in your investment approach from that at other firms?

Ms. Friday: The big hallmark is buying a stock at a discount to its private market value. That's an approach that few other managers use; it's fairly unusual. That's a big factor that makes us different than most other value managers.

Something else that I think is a big positive for us is we manage about \$700 million in assets and a mutual fund that invests in stocks of primarily small and medium size companies, so we are a decent sized firm, but we are still small enough to exploit inefficiencies and are actually able to easily buy stocks (without impacting the market price), especially in the small and mid-cap area. A lot of times you'll find a company with a market cap of \$1 billion, and if you're Fidelity or another large manager, you certainly aren't able to purchase a stock along those lines. We're able to take advantage of the inefficiencies that a lot of other managers aren't able to do.

TWST: Who are your typical investors? Are they mostly institutional or individual?

Mr. Swanson: It's probably about half and half. Half of our money is institutional. Many consultants use us who want exposure to companies that have growth rates without the risks of overvaluation often found in growth stocks. And again, because of our discipline, we want to only buy growth companies at a discount, which fits their bill pretty well.

Ms. Friday: A lot of institutions actually use us because we have very low correlation with other managers and with the indices, which also makes us very different from a lot of other money managers. It is a unique characteristic and many institutions like that about us.

Mr. Swanson: As far as high net worth individuals, they hire us for the same reason, but I think the other thing they hire us for is our level of service, of which we are very proud. If a high net worth client comes to us, they can talk to Leah or Roger King or other members of our firm. They don't get caught up in a bureaucracy or with a client service rep somewhere down the road. We really do take a lot of time knowing our clients and trying to help them out and meeting the individual needs they have.

Ms. Friday: And we pay a lot of attention to the tax efficiency issue. On the high net worth individual side, we also tend to appeal a lot to entrepreneurs. People who have sold their company really tend to understand the whole private market value approach.

Mr. Swanson: I think something else our clients appreciate is that the professionals at KING eat their own cooking. Several of

us invest in exactly the same stocks that our clients do because we believe so much in our approach. We certainly have a strict personal trading policy in place. We buy stocks for our clients before we can buy them for ourselves, and we sell stocks for our clients before we can sell them for ourselves, but even given that, a large part of our personal holdings are in many of the same stocks as our clients.

TWST: What advice would you give to investors who are looking to enter the market at this time? Is this a good time or have they let it get too late?

Ms. Friday: It's certainly not too late. As I said, we're fairly optimistic about the future and we do tend to be very long-term oriented. We threw out a few names of companies that we like now. We think there are constantly opportunities being presented by the market when investors who are very short-term oriented get fed up with a company because they missed earnings by a penny or two and the franchise value of the company is worth significantly more than where the stock is actually trading. I certainly think that for somebody who's coming into the market now, if we got a new account, they wouldn't be fully invested immediately, but there are a lot of very attractive buys out there right now.

Mr. Swanson: From a contrarian's point of view, the wall of worry is so great now that it appears to be an opportunistic time to invest in the market. The issue that everyone is the most worried about is how much longer the Fed is going to continue to raise short-term rates, and whether we'll be subject to an inverted yield curve. Once the market perceives the Fed is through raising short-term rates, the stock market could take off as it did in 1995. We don't know when this change in perception will take place, but a true investor needs to be at least partially invested now.

TWST: Thank you.

Note: Opinions and recommendations are as of 11/4/05.

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