
Successful Stock Picking Through Private-Market Value

■ Why Hire KING?

For over a quarter of a century, King Investment Advisors, Inc. (KING) has generated superior long-term returns for its clients through a focus on value investing. We are a bottom-up oriented research firm and have successfully uncovered value in the market via a methodology called the Business Valuation Approach (BVA).

One prong of the BVA is our focus on companies with solid franchises that are generating significant cash flows, and are selling in the public market at a significant discount to our appraisal of their private-market values (PMV).

We define PMV as the value an informed third party would pay to purchase all of the assets of a given company. We calculate PMV by scrutinizing the balance sheet, as well as the company's cash flows. It intrigues us if a company trades at a minimum of a 50% discount to its PMV; we would consider the stock as a possible buy. KING has benefited from M&A activity over the years because of this emphasis on buying stocks trading at a steep discount to their PMV; a company with solid fundamentals and strong cash flows, trading at 50 cents on the dollar, usually does not stay unrecognized for long.

Our skill in identifying companies trading at a discount to their PMV and our ability to accurately calculate these values is what truly sets us apart from other money managers.

■ The Proof

Since 1995 (the year that KING first began tracking M&A activity in client portfolios), a total of 55 small- and mid-cap companies held in our clients' portfolios have been acquired.

Average gain (from buy to sell)*	Average holding period*	Average number of acquisitions in a year*
87.5%	1.0 years	3.4

**Information is as of 3/31/10*

What is compelling about this data is how it validates our selection process of purchasing companies that are trading at a 50% discount to their private-market values (or 50 cents on the dollar). Theoretically, based on these calculations, there should be 100% upside to a given stock. *Since 1995 the average gain over our holding period with these announced acquisitions has been 89%, solid evidence that our methodology is sound and our PMV calculations are accurate.*

The key variable of our PMV approach lies in our ability to focus on inefficiently valued companies that possess high, and somewhat predictable cash flows combined with high barriers to entry and solid, niche franchises. Another key variable is the presence of a catalyst to unlock shareholder value. A catalyst may take many forms such as industry consolidation, a major share repurchase, a sale or spin-off of a division, a change in management, or a major new product launch.

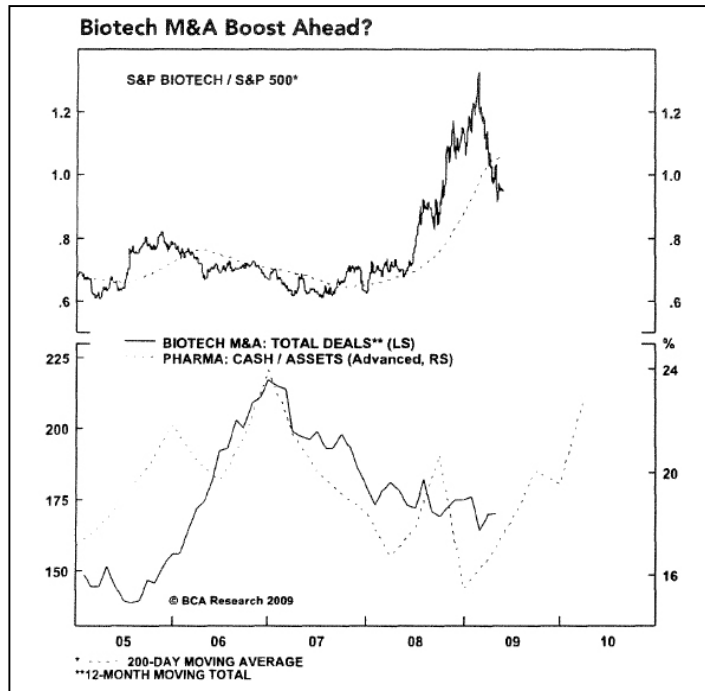
In addition, since we manage focused portfolios (on average, clients own 30 to 35 stocks), one or two transactions per year—particularly at a nice premium—can have a significant impact to their long-term returns. Over the past 16 years, our clients have benefited from an average of three transactions a year (i.e., approximately 8.5% to 10% of the portfolio has benefited from acquisition activity).

■ Outlook

Industry consolidation is a theme which we believe will accelerate throughout 2010. Many large-cap companies, especially outside of the financial industry, are flush with cash yet are facing declining revenues in the near future. Specific examples today include large-cap pharmaceuticals and medical device companies, many

consumer goods companies, and many large-cap tech companies. Cash may not be held long in the pockets of industry giants, especially with small- and mid-cap valuations just off their historical lows.

Within our portfolios we currently own many healthcare companies selling at prices well below their PMVs. Collectively, these are companies with high margins, unique franchises, strong pipelines, and possess the ability to generate solid cash flows as well as strong earnings growth. Due to the proposed healthcare reform initiatives, we believe that many large-cap companies will see their margins squeezed and will attempt to seek earnings relief by buying companies that are focused on growth areas such as cancer research, or are focused on smaller, more unique niches in healthcare which are better insulated from pricing pressures. As a result, a wave of M&A activity may emerge.



■ Summary

Historically, KING has had very good success in discovering value in the healthcare, financial, technology, and consumer staples industries. While we do not depend on mergers to generate superior long-term returns, the ability to benefit from consolidation activity is a by-product of our research process and has certainly benefited our clients over the long run. Our ability to identify undervalued companies with steady cash flows, coupled with a catalyst to unlock value, has been consistent over the past 30 years.