

## Standing on Principal

*Combining a keen eye for value with a tenacity for instigating corporate change has proven to be a winning formula for Jeffrey Ubben's ValueAct Capital.*

While known as one of the industry's best activist investors, Jeffrey Ubben is more than happy for his investments to work out without his firm's active participation. "We don't pick fights," he says. "But when the train goes off the track, you need to do something about it."

Active or passive, Ubben's ValueAct Capital has produced market-trouncing returns since its founding in 2000. Now with \$4.5 billion in assets, it has earned a net annualized 13.5%, vs. an average 0.4% annual decline for the S&P 500.

Bolstered partly by what he expects to be an active M&A environment, Ubben sees value today in such areas as insurance brokerage, Internet services, healthcare and financial software. [See page 2](#)

### INVESTOR INSIGHT



**Jeffrey Ubben**  
ValueAct Capital

**Investment Focus:** Seek companies for which "short-term pain" is masking attractive long-term potential that the market at the moment doesn't appear willing to recognize.

## On Balance

*It's when conventional wisdom turns negative on a company that Daniel Bubis goes to work, to the significant benefit of his Tetrem Capital investors.*

### INVESTOR INSIGHT



**Daniel Bubis**  
Tetrem Capital Management

**Investment Focus:** Seeks companies in which the market's overreaction to setbacks has lowered expectations further than he believes the business fundamentals warrant.

Having grown up around his family's produce business, Danny Bubis saw early the rigors of the market economy. "If you buy a case of bananas for \$5 and the market price tomorrow is \$4, you're selling it for \$4," he says. "You learn that markets change, not always in your favor, and that buying well is the key to success."

Bubis has applied those lessons well as president of Tetrem Capital, which now manages \$5.7 billion in U.S. and Canadian equity assets. Over the past ten years, its U.S. equity composite has earned a net annualized 7.3%, vs. 0.8% for the S&P 500.

Targeting mostly blue-chip companies whose stars appear to have faded, he's finding opportunity today in such areas as specialty retail, energy, information technology and investment banking. [See page 12](#)

### Inside this Issue

#### FEATURES

**Investor Insight: Jeffrey Ubben**

Finding, or working to create, upside shareholder value in such companies as Willis Group, VeriSign, C.R. Bard, Valeant and Misys. [PAGE 1 »](#)

**Investor Insight: Daniel Bubis**

Playing off investor fear to find mis-priced value in such firms as Best Buy, Suncor, Microsoft, Goldman Sachs and Mullen Group. [PAGE 1 »](#)

**Uncovering Value: Hitachi**

Is the negative conventional wisdom in such full force here signaling a potential opportunity? [PAGE 19 »](#)

**Uncovering Value: Eagle Rock**

Will this energy MLP idea pay off as well as a similar one Terry Fitzgerald offered up a year ago? [PAGE 20 »](#)

**Editors' Letter**

The liberating aspect of not having to be 100% right all the time. [PAGE 21 »](#)

#### INVESTMENT HIGHLIGHTS

INVESTMENT SNAPSHOTS	PAGE
<a href="#">Best Buy</a>	<a href="#">15</a>
<a href="#">C.R. Bard</a>	<a href="#">8</a>
<a href="#">Eagle Rock Energy</a>	<a href="#">20</a>
<a href="#">Goldman Sachs</a>	<a href="#">16</a>
<a href="#">Hitachi</a>	<a href="#">19</a>
<a href="#">Misys</a>	<a href="#">10</a>
<a href="#">Mullen Group</a>	<a href="#">18</a>
<a href="#">Suncor</a>	<a href="#">17</a>
<a href="#">Valeant Pharmaceuticals</a>	<a href="#">9</a>
<a href="#">VeriSign</a>	<a href="#">7</a>
<a href="#">Willis Group Holdings</a>	<a href="#">6</a>

**Other companies in this issue:**

[Alere](#), [Cisco](#), [Dell](#), [Fluor](#), [Gartner](#), [Gen-Probe](#), [Lockheed Martin](#), [McGraw-Hill](#), [Microsoft](#), [Monsanto](#), [New York Times](#), [Polycom](#), [Research in Motion](#), [Sara Lee](#), [Snap-on](#)

# Investor Insight: Jeffrey Ubben

ValueAct Capital's Jeffrey Ubben describes how he hedges without shorting, why he may take 18 months to build a core investment, why he expects M&A activity to take off in the coming year, why he resists the “macro” fetish, and why he sees unrecognized value in Willis Group, VeriSign, Valeant Pharmaceuticals, C.R. Bard and Misys.

In what ways do you distinguish your style of activist investing from what you see others doing?

**Jeffrey Ubben:** We've seen public-market activism become more synonymous with media-driven campaigns meant to generate short-term price moves, so we have felt the need to distinguish that style from our own so as not to be tarred with the same brush.

Our interest starts first with the quality of the business. We're not looking for trouble, for quick deals to be made, for fixes, *per se*, or even for board seats. We buy good businesses at good prices, where we're willing to take on the short-term risk – the near-term negative data point – because we think the long-term gain is compelling. If the stock goes up, we look like traditional value investors who made a nice investment.

But probably half the time things don't work out that way. We're 18 months in, with a full position, and the stock is where we bought it or lower. But we've proved out the industry structure, we've proved out our investment thesis and we really believe in the asset. It's at that point we go to the board and management and say we've been your default buyer, we own 5-10% of your company, and we'd like to buy more but we won't do so without a board seat. The stock is underperforming, we believe we have a deep understanding of your business, we have a deep knowledge of capital markets, and we want all the information that's available to board members to help craft a strategy that creates value for all shareholders. We ask management and particularly the board to do the same level of due diligence on us that we have done on them, and provide them with a list of references who can attest that we have been patient, constructive board participants.

What are the key elements of what you consider a high-quality business?

**JU:** At a basic level, the product or service being sold is critical to customers but is only a small part of their cost structure, and the customer relationship tends to be sticky and recurring. So you think of a VeriSign, whose customers pay them \$7 per year for a web address that is central to their business. Or a C.R. Bard, whose catheters protect against infection and make up only a small part of the total cost of a surgical procedure, but if they don't work, the patient dies. Or a Willis Group, which as an insurance broker helps provide risk-management solutions that are clearly on the critical path for all businesses. Generally, we end up in intellectual-property-based businesses that can price off of a value-add rather than some sort of cost basis.

We also focus on industry structure. We like concentrated industries with two or three primary players. As value investors, we are typically buying the underperformer. There are issues to fix, but the customers are rooting for you and the leading competitor, with high margins and a high stock price, is probably not going to go for the jugular. In the past that's meant buying, say, Reuters against Bloomberg in information services, Reynolds and Reynolds against ADP in auto-dealer software, or Insurance Auto Auctions against Copart in the salvage business. Today it's something like Willis against a Marsh & McLellan or Aon in insurance brokerage.

For quality-of-business reasons, we now focus on companies with between roughly \$1 billion and \$8 billion in market cap. The \$500 million company is unlikely to have as global a footprint and as diversified a customer base as we want, and the business generally is less mature and more volatile. We've invested success-



Jeffrey Ubben

## Creating an Asset Class

In our interview with him five years ago (VII, January 31, 2006), ValueAct Capital's Jeff Ubben bemoaned the state of the art in activist investing at the time: “Much of what you see today is 'buy shares today and then tomorrow throw a hissy fit.' That's a problem for me, because that style is transparent and could discredit all activists. Boards can say activists are just worried about making their quarterly or monthly performance numbers, and there's something to that, frankly.”

After a total of 15 years practicing what he calls “strategic-block” investing – taking big stakes in public companies and working closely with them to realize obscured value – Ubben remains surprised that his style isn't more prevalent: “Corporate governance is busted in this country and the agency/principal problem is alive and well. So while there are many ways to make money in this business, I do wish more public investors would develop a governance skill set. A shareholder-director's role in the boardroom is going to add value and can be hugely impactful. Until more people develop the skills to take advantage of that, activist investing won't ever really become the asset class I think it should be.”

fully in smaller companies over the years, but it can be more hair-raising than I'm comfortable with at our current asset size.

### Why not go higher than \$8 billion?

**JU:** We want to eliminate the “what you don't know” risk. With bigger companies there can be many different business units with distinctly different trajectories, making it harder to identify the core engine that truly drives the bottom line. There's also just a greater possibility that you miss something important, like environmental liabilities, or underfunded multi-employer pension plans, or work rules in a region that limit your ability to sell businesses. When you have a true owner mentality about companies you invest in, you have to care about those types of risks and liabilities that increase the real price you're paying for the enterprise.

### Describe a recent example where a passive investment went active.

**JU:** In 2007 we made a core investment in Sara Lee [SLE] at an average price of around \$14. In retrospect we overpaid for what was a lower-quality business than we usually buy. Food isn't a terrible business, but the gross margins – which are pretty indicative of the value-add in the business – are around 40%, while at most of our companies they're closer to 65%.

With the stock at \$8 in the bear market, I went to the board and said the business was not performing, with an operating margin of 7% and capital spending that consumed too much of the cash flow. I did not have a specific recommendation because I needed more information, but we suspected that the right strategy was to get smaller to get better – sell lower-quality assets so that management could focus its energy on the higher-margin, higher-market-share businesses. That is a strategy we end up employing in a majority of our active investments.

I also was upfront with my concerns about the incumbent CFO. I suspected the holding company structure put too much power in the hands of the incumbent executive, so Brenda Barnes, who

was a talented CEO, did not have her hands on the dials like one would want.

Inside the board room, I used the facts, the poor forecasting record, and the lack of accountability for missed budgets to lead a conversation on the desirability of a new CFO. Once the new CFO came on board last year, everything got easier. We sold businesses, cut costs and reduced capital spending, resulting in a balance sheet that allowed for a significant return on capital to shareholders. Having sold approximately 35% of its revenue

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### ON ACTIVISM:

**The basic reason our investment strategy adds value is that board members are classic agents, not principals.**

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stream, the company is smaller and focused on growth categories with much higher gross margins. The company is also easier for investors to understand and, not surprisingly, easier to manage. [Note: Following recent takeover speculation, SLE currently trades at \$17.50.]

I wasn't trapped by any public agenda that they should change management, or sell XYZ division, or put the whole company up for sale. In fact, some things I understood once I got in the boardroom changed my perspective. We sold some businesses I didn't think we were going to sell and kept some businesses I didn't think we were going to keep – all because I had better information. I've made the mistake once before of committing publicly to a given course of action, due to an entrenched management and board which required a proxy contest. Once on the board, I was compromised by a public plan that was not cleanly executable.

From a portfolio perspective, we count on the smart value investments we make that require little in terms of activism to generate a lot of our incremental returns. Fortunately or unfortunately, however you want to view it, it is very hard to find great businesses selling at great prices with

great management teams. By combining our good stock picks with an ability to influence the direction of our underperforming ones – turning potential disasters into at least reasonable returns – you can end up with a pretty good track record.

### Why aren't the types of things you're calling for getting done without you?

**JU:** I could go on about that for hours, but the basic reason our investment strategy adds value is that board members are classic agents, not principals. The information board members get about what shareholders want comes from the CEO. However well-intended, board members mostly lack enough fundamental knowledge about the business to challenge the CEO on the performance of the business or new strategies to create value. Always, they don't have enough money on the line to have the sense of urgency we have as owners. It's a blueprint for inertia.

Our goal when we get in the boardroom is to make sure the board has all the facts and is making fact-based decisions. Sometimes we bring new information from work we've done outside the company. You can move a boardroom when you stay focused on the facts, but it can take time. For example, you may know management is the problem, but it's often only after they indict themselves with several missed budgets that we can really lead change. It can require much more patience than most public investors can muster, but our ability to tolerate and work through that has helped us eventually get more done.

### Do you tend to focus on particular situations or industries?

**JU:** Given the types of businesses we want to own, we end up looking primarily in applied technology, software, medical equipment and pharmaceuticals, information services and niche business services. At any given time, there are 500 to 600 companies that pass our quality screens and are in our market-cap range.

What gets our interest is when a target company's share price goes down to the

point where the free-cash-flow yield – EBITDA minus real capital spending, minus incremental working capital, divided by enterprise value – is at least 10%. We particularly like it when companies are underperforming for reasons fully in their control. For example, when Gene Hall took over as CEO of Gartner [IT] six years ago, he took guidance down because he was expanding and reconfiguring the company's sales force and changing the way its syndicated research was sold. That made it look like a busted company to some investors, but we agreed with the strategy and loved that he was willing to take on short-term pain for longer-term benefit. We still own it.

Something similar is happening today at Willis Group. They are sitting at the very low end of their margin range over the past 10 years because they're adding salespeople, which is expensive, with the goal of taking market share in a down insurance cycle. When the cycle turns and prices double, that increased share will cause earnings to take off.

The reason we have to do at least cursory work on 100 companies per year is that it is really hard to find the three or four that in addition to the 10% free-cash-flow "coupon," can also generate growth in free cash flow of at least 10% per year. In most value situations, too much of the company's revenue is tied to mature and oftentimes declining product lines. But when we can see 6-8% organic growth combined with margin gains producing double-digit free cash flow growth, that's interesting.

If we can buy 10% current coupons and if the coupon grows at 10%, the math says we will generate an annual 20% unlevered return. That's the target for each position we hold and it's what we expect out of the entire portfolio.

**You often take your time in building a core position. Why?**

**JU:** We will take roughly 18 months to make a core investment, which given our asset base and the fact that we hold 13 to 17 core positions, means at least a \$300 million holding. After taking a relatively

small position, we'll look to further establish our relationship with the board and management, which should allow us a deeper understanding of both the organization and the business. Management will say the business is going to do this based on how they're managing it, and if it does this, that's helpful, and if it doesn't, that's also interesting. The analytical process is highly iterative, which we consider a key way to manage risk.

If we're talking with a CEO whose stock has gone from \$20 to \$10 – which is

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**ON THE NEW YORK TIMES:  
It's more of a trade in an undervalued stock than anything – dual-class stocks go against our principles.**

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typically the type of value situation we're in – we don't see the merit of an ambush attack where you put out a press release with your agenda. We're trying to build a relationship that establishes us as the patient, deep-knowledge investor in their company. That facilitates our ability to get into boardrooms in a constructive way.

**When do "farm-team" investments never make it into a core position.**

**JU:** Sometimes the stock price just gets away from us. We bought Polycom [PLCM], which makes voice and video communications equipment for businesses in competition primarily with Cisco, at around \$27 in the third quarter of this year. As we were gearing up and doing a ton of work, the shares took off. We ended up selling not long ago at \$36. [Note: PLCM now trades around \$39.]

Another fairly recent example was Gen-Probe [GPRO], which is in the medical-diagnostics business. It's a very high-quality company, but as we dug into the diligence, we concluded its blood-screening business was more growth-challenged than we originally thought, making it hard to pencil out a 20% annual return.

We made decent money on it, but we sold well before it was a core position.

One farm-team investment we own today that is unlikely ever to go core is the New York Times Co. [NYT]. We bought seven million shares a few weeks ago at just over \$8 in a block sale from Harbinger Capital. We support management's strategy to defend circulation revenues with a metered paywall, we believe premium content will benefit from the multiple distribution channels available today, and we expect advertisers to pay up for the company's targeted audience. But it's more of a trade in an undervalued stock than anything – dual-class stocks go against our governance principles, so we will not get more deeply involved.

**We're curious how something like tool-maker Snap-on, Inc. [SNA] attracted your attention.**

**JU:** If you're asking because it's more of a widget-type company than any other I've described, you're right. It does have a strong brand, premium pricing and unique distribution in its tools segment, but the thesis here was driven by our view of the global economy a year ago – that it was doing much better than the market believed – and we wanted a way to play that with an industrial that allowed us to sleep at night, which Snap-on is. Management was very focused on margin improvement in the downturn and has shown an ability to launch new products, grow in adjacent product categories and build out critical infrastructure in high-growth emerging markets. We've already made nearly 40% on our investment so it's not as attractively priced as some of the stocks we'll speak about later, but we still own it and believe they're very much on the right track.

**Of the five stocks you highlighted when we last interviewed you [VII, January 31, 2006], four have been bought out, with ValueAct leading the buyout in one of those. Is that typical?**

**JU:** We've been on the board of 27 of the 60 core investments we've made since

2000 and, of those, we've executed divestitures or entire company sales in about 20. As I mentioned earlier, that's been driven by our belief that getting smaller often means getting better. At Sara Lee, it meant selling the household-products and body-care business in Europe and the bakery business. At Misys, it meant selling the medical-records software business to focus on financial enterprise software. When all goes well, the result is a high-quality business with plenty of free cash flow that is simpler and more investable. That can be interesting to private-equity or strategic buyers.

I'd add that our being on the board hasn't been a prerequisite to smart M&A. VeriSign selling its web Authentication Services unit earlier this year, for example, was a surprise to us but we believe will be nicely accretive to the enterprise.

**Some are expecting a big increase in M&A activity in 2011. Do you agree?**

**JU:** We do. Private equity firms, many of which as public companies have committed to getting bigger, have a tremendous amount of cash that we believe they're going to start putting to use. On top of that, while corporate M&A is still hovering closer to the low end of its 20-year range, that's coming around. Corporate America took their margins up and delivered on earnings totally out of internal operations. Revenue growth is harder to come by, which leads to acquired-growth strategies. Managements have been waiting for the domestic economy to improve and for headlines to get a little better, which makes them momentum investors just like everybody else.

We're already seeing a pickup in activity in our portfolio companies – which have been both buyers and sellers of individual businesses – and nearly all of which would in their own right be attractive buyout candidates for a financial or strategic buyer. One reason for our trying not to go above \$8 billion in market cap is that the deals we expect to get done will not be the mega-deals, but in the same range we've focused on from a market-cap perspective.

**Turning to some specific ideas, describe the upside you see in insurance-broker Willis Group [WSH]?**

**JU:** Willis is the third-largest insurance broker, helping middle-market to large businesses manage risk. The business is characterized by recurring revenue (90% client retention rates), attractive margins (above 20%), and minimal capital requirements (2-3% of revenue). Roughly 40% of sales are in North America, with the rest international or from reinsurance.

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**ON INSURANCE PRICING:**  
**Rates have been soft for seven straight years . . . it's almost impossible we won't get a cycle turn over the next four.**

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The insurance-brokerage industry has an attractive structure with limited buyer concentration and three big players – Aon, Marsh Mac and Willis – which are consolidating the marketplace. In the insurance value-chain, brokers own the end-customer relationship and serve the critical role of matching the capital of competitive, fragmented insurers with the specialized risk-management needs of clients. They truly act in a consultative role and get paid well for it.

What's unique about Willis is its reliance on middle-market business, built brick by brick from the ground up and difficult for competitors to crack. Compared to Aon and Marsh Mac, where maybe 70% of their business is fee-based because that's what large clients want, 70% of Willis' business is commission-based. That hurts in a soft cycle like we're in now, but in a hard cycle the incremental profit contribution is very high as the same amount of work results in higher revenue.

Because it has lower national-account exposure, Willis has market share to take on national accounts. They are using the soft cycle to invest in their sales force,

particularly targeting bigger clients. They hired former AIG CEO Martin Sullivan with that mandate, and while he's controversial because AIG's derivatives blew up on his watch, he's got a pretty good Rolodex and track record in building the insurance business at AIG.

**Is part of your bet on the insurance pricing cycle turning?**

**JU:** Insurance rates have been soft for seven straight years and cumulative premiums have shown negative growth for three straight years – the first time that's happened in thirty years. We have tracked insurance premiums as a percentage of GDP and found that prior cycles hit bottom when premiums get down to 3% of GDP. The market hit 2.9% last year and will likely be at that level again this year. We think it's almost impossible we won't get a cycle turn over the next four years, either from increased catastrophes or just because insurers have released all the reserves they can and can't any longer support negative underwriting cash flow due to low rates.

From an investment perspective, we think we'll still do fine here regardless of the cycle. Willis' international and reinsurance franchises are growing in the mid-to-high single digits and earn 27-30% operating margins. In the U.S. the company has been aggressive in centralizing non-customer-facing functions, which will drive margin as overall revenues start growing again from competitive share gains. With all the cash flow the company generates, it should also be in a position to take advantage of the current valuation and aggressively repurchase shares, a course of action we've been advocating.

**With the share price recently at \$34.60, how are you looking at valuation?**

**JU:** We estimate adjusted diluted earnings per share of \$2.90 in 2011, so the stock currently trades at a forward P/E of just under 12x. We're modeling a cycle turn by 2013, resulting in earnings of around \$4.10 per share, so with no change in the

**INVESTMENT SNAPSHOT**

**Willis Group Holdings**  
(NYSE: WSH)

**Business:** Provider of insurance brokerage and risk-management consulting services for multinational and middle-market clients in a wide variety of industries worldwide.

**Share Information**  
(@12/29/10):

<b>Price</b>	<b>34.59</b>
52-Week Range	26.07 – 34.98
Dividend Yield	3.0%
Market Cap	\$5.90 billion

**Financials (TTM):**

Revenue	\$3.33 billion
Operating Profit Margin	24.3%
Net Profit Margin	13.1%

**Valuation Metrics**  
(@12/29/10):

	<b>WSH</b>	<b>S&amp;P 500</b>
Trailing P/E	13.6	18.0
Forward P/E Est.	11.8	14.6

**Largest Institutional Owners**  
(@9/30/10):

<b>Company</b>	<b>% Owned</b>
Southeastern Asset Mgmt	8.9%
Invesco	5.3%
ValueAct Capital	5.1%
Mackenzie Financial	4.7%
Bank of NY Mellon	3.9%

**Short Interest** (as of 11/30/10):

Shares Short/Float	0.6%
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**WSH PRICE HISTORY**



**THE BOTTOM LINE**

With its commission-based revenue structure and sales-staff investments in the down cycle, the company is well-positioned to prosper as the insurance-pricing cycle turns, says Jeff Ubben. With no change in today's forward multiple, the shares would trade closer to \$50 within two years if the company hits his \$4.10 target for 2013 EPS.

Sources: Company reports, other publicly available information

forward P/E we'd expect the shares within two years to be closer to \$50.

Even if the insurance cycle doesn't turn, we're probably looking at a 12-13% IRR over the next couple years from today's price, as 3-4% revenue growth translates into even higher margin growth and cash gets returned to shareholders from dividends and share buybacks. As a base gain, that's pretty good. If the home-run upside seems to be out of the market's time horizon, that plays right to our strength.

**We're not hearing much of any activist play here.**

**JU:** We have developed a fine working relationship with the CEO, Joe Plumeri, and support him and his team's plans. It's equally important that our interests appear well aligned with his, as he owns \$100 million worth of stock.

**Explain why VeriSign [VRSN] is an excellent example of "getting smaller to get better."**

**JU:** We followed VeriSign for years, admiring its website registry business as a strong secular grower, but we couldn't get comfortable with what we considered to be an undisciplined acquisition strategy.

As the company reversed course and divested thirteen businesses over the past three years, we've now made it a core investment.

After agreeing in May to sell its Authentication Services business to Symantec, VeriSign is a pure-play on the Naming business. There can only be one registry per top-level domain, and VeriSign is the registry for the .com and .net domains. This is a contractual monopoly, with significant barriers to entry due to the scale and complexity of operating these two large registries. As the traffic director for the world's .com and .net traffic, VeriSign's offer is mission-critical both to its customers and to the global economy. For all that, they charge only about \$7 per website per year.

Much of the opportunity we see here is reminiscent of our past technology investments: a refocus on the core business, a recurring revenue stream, high margins, a fortress balance sheet and a willingness to return excess capital to shareholders. Also consistent is that growth investors have fled the stock – tech investors do not know what to do with a company that is shrinking.

**What makes you optimistic about growth?**

**JU:** We believe the slowed domain-name growth in recent years is more cyclical than secular, so VeriSign's revenue growth is poised to rebound as Internet adoption, e-commerce, ad spending and new business formations return to normalized growth rates. Revenue growth appears to have bottomed at around 8%, and we expect it to return to at least 10% per year as both renewal rates of existing domain names and registrations of new names improve.

On top of that, there's also significant potential to improve margins. VeriSign still has an overhead structure designed to support a much larger company. Over the next two to three years, we believe the combination of modest price increases and a reduction in corporate costs will result in the operating margin rising from around 43% today to closer to 50%.

Describe the company's contracts to run its registries.

**JU:** The contracts are with ICANN [the Internet Corporation for Assigned Names and Numbers], which give VeriSign a perpetual right of renewal as long as it fulfills its service obligations. The .com contract does have to be approved by the Department of Commerce, however, so there is some uncertainty about renewal that can spook investors.

The current .com contract is up for renewal in 2012, and after spending considerable time and energy to understand the issues at hand, we're comfortable

that VeriSign's position is highly unlikely to be at risk. The scale, stability and security of the company's network – which manages over 60 billion queries a day with no downtime – cannot be replicated easily and we find it difficult to imagine the government would put the integrity of the Internet at risk by playing hardball in negotiations and awarding the contract elsewhere. Even if the company were forced to give on price, or on the level of contractual price increases, it would likely outgrow any concessions pretty quickly due to the ridiculously high margin earned on the incremental unit.

What upside do you see in the shares from today's price of \$32.90?

**JU:** We're expecting revenue from 2011 to 2013 to increase from around \$800 million to \$980 million, and for EPS to go from \$1.60 to \$2.50. So if today's forward multiple of 21x doesn't change, the implied stock price two years out would be \$51. It's also not a stretch to assume that if we're right on growth, the quality and earnings visibility of the business and the fact that it's now a pure play would result in an upgrade in the multiple.

One of the key tenets behind our thesis is that the company returns to shareholders a significant portion of its cash position, which will be approaching half of the market cap due to the Authentication Services' sale and the \$400 million per year of operational free cash flow. We believe management and the board realize that the window for returning cash by buying back undervalued stock could be narrow, and that they have a comprehensive plan for the cash. The uncertainty over the .com contract renewal could actually be a blessing, if it keeps the valuation down long enough for shares to get bought back cheaply.

There's some risk that it all doesn't happen as fast as we're counting on, but we're confident that a board that includes Lou Simpson, who is retiring after a distinguished career at GEICO, will do the right thing.

You remain active in healthcare – has the changing regulatory environment given you cause for concern?

**JU:** We try to stay out of harm's way with regulatory issues. For C.R. Bard, most of its products are mid-tech and at low price points, but they're also clinically differentiated and selected by the physician as a tiny part of a bundled procedure. As long as there's a benefit, the price point is low and you have the trust of the doctor, those types of things are much less vulnerable to systemic cost cutting. For Valeant Pharmaceuticals, most of its products are branded generics or over-the-counter, so there's little reimbursement risk.

**INVESTMENT SNAPSHOT**

**VeriSign**

(Nasdaq: VRSN)

**Business:** Provider of Internet naming and infrastructure services, serving as the exclusive registrar for .com, .net, .[name] and other generic top-level domains.

**Share Information**

(@12/29/10):

<b>Price</b>	<b>32.91</b>
52-Week Range	21.21 – 37.18
Dividend Yield	0.0%
Market Cap	\$5.66 billion

**Financials (TTM):**

Revenue	\$1.07 billion
Operating Profit Margin	36.8%
Net Profit Margin	89.7%

**Valuation Metrics**

(@12/29/10):

	<b>VRSN</b>	<b>Nasdaq</b>
Trailing P/E	6.2	12.8
Forward P/E Est.	22.2	16.8

**Largest Institutional Owners**

(@9/30/10):

<b>Company</b>	<b>% Owned</b>
Wellington Mgmt	7.3%
Delaware Mgmt Bus Trust	6.9%
ValueAct Capital	6.9%
Vanguard Group	5.2%
State Street Corp	3.8%

**Short Interest** (as of 11/30/10):

Shares Short/Float	6.2%
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**VRSN PRICE HISTORY**



**THE BOTTOM LINE**

Assuming cuts in overhead costs and a modest increase in domain-name growth as rates of Internet adoption, e-commerce and ad spending normalize, Jeff Ubben thinks the company can earn \$2.50 per share by 2013. If he's right, at the same forward multiple at which the stock trades today the share price in two years would be above \$50.

Sources: Company reports, other publicly available information

There is going to be increased consumerism in healthcare, so you want to own companies that are part of the solution, not part of the problem. We own a large position in Alere [ALR], for example, which makes point-of-care diagnostic tests. The idea is that quick-turn tests – say sticking your finger in an Alere machine in the emergency room to determine if you're having a heart attack – will more quickly identify whether there's a problem and, if so, what it is. The savings of time and money by forgoing further potentially unnecessary tests and procedures can be substantial.

Walk through your specific thesis on C.R. Bard [BSR].

JU: We have a long history with Bard, dating back to an investment I made in it in the 1990s when I was at Blum Capital. At the time, the company had an R&D-intensive, swing-for-the-fences strategy and was sinking too much capital into a very competitive angioplasty business. I advocated to the CEO at the time to divest that business and focus on less capital intensive, more stable product platforms in which the company had huge market shares. That strategy remains intact today.

Bard now has a diversified portfolio of more than 25 different product lines and it has become a machine in launching multiple new products and line extensions that drive incremental – not revolutionary – improvements in clinical benefit, convenience or patient safety. You lower the risk of infection with your latest catheter. You introduce a tissue-based hernia-repair product that's more effective than the competition's. You make a port access needle that's less painful to the patient. This constantly moves them into adjacent new markets or allows them to raise prices in existing franchises. They do all that spending only 7.5% of revenues on R&D and with a 65% gross margin.

Bard also has what we consider a defensive growth profile. They have mostly #1 and #2 market shares in the 30-70% range, but the product portfolio

is so diversified that any single product recall or competitive loss won't damage earnings meaningfully. Brands and sales relationships matter in these markets, so shares only shift gradually. Even through the tough environment, revenue growth was in the mid-high single digits in 2008 and 2009 and should come in this year at around 7%.

We take it you're well out of activist mode here.

JU: We think this is a great management team. They listen, they invest intelligently and they deliver. In their analyst meeting

earlier this month they indicated they expected 5-8% organic growth in revenues next year, 10% net income growth and 14% EPS growth because they were accelerating share repurchases. They believe in the business and aren't afraid to put some debt in the capital structure to invest in their own stock.

Our financial model over the next four years shows steady 13-14% annual earnings growth, driven by 7-8% sales growth and share repurchases. That assumes no growth in margins, which is likely to be conservative. Even with all that, the shares until very recently traded near a 10-year low in valuation.

INVESTMENT SNAPSHOT

**C.R. Bard**  
(NYSE: BCR)

**Business:** Develops and markets medical products, with primary focus on disposables and implantable devices for oncology, urology and vascular procedures.

**Share Information**  
(@12/29/10):

<b>Price</b>	<b>92.70</b>
52-Week Range	75.16 – 95.72
Dividend Yield	0.8%
Market Cap	\$8.61 billion

**Financials** (TTM):

Revenue	\$2.68 billion
Operating Profit Margin	28.3%
Net Profit Margin	17.9%

**Valuation Metrics**

(@12/29/10):

	<b>BCR</b>	<b>S&amp;P 500</b>
Trailing P/E	18.8	18.0
Forward P/E Est.	14.8	14.6

**Largest Institutional Owners**

(@9/30/10):

<b>Company</b>	<b>% Owned</b>
Fidelity Mgmt & Research	10.6%
Bank of NY Mellon	6.4%
T. Rowe Price	4.8%
ValueAct Capital	4.6%
Vanguard Group	4.0%

**Short Interest** (as of 11/30/10):

Shares Short/Float	4.2%
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**BCR PRICE HISTORY**



**THE BOTTOM LINE**

Jeff Ubben believes the market isn't recognizing the company's ability through organic growth and aggressive share repurchases to increase earnings per share at a 13-14% annual clip over the next four years. At 16x his 2013 EPS estimate of \$8.10, the shares within two years would trade closer to \$130, a 40% premium to today's price.

Sources: Company reports, other publicly available information



The stock, at a recent \$92.70, is still near an all-time high. What potential do you see from here?

JU: The market loves companies today that are showing a lot of growth because they're coming off a cyclical bottom. Earnings went from \$4 a share to \$1.50 and then people are tripping over themselves to buy the stock when earnings go back to \$4. Then you've got something like Bard that has grown consistently and has a solid growth profile going forward due to demographics and new products, trading at less than 15x next year's estimated earnings.

If we look out to 2013, we estimate the company will earn around \$8.10 per share. So with a slight increase in the forward multiple to 16x, the shares two years from now would be in the \$130 range. There's a strong case to be made that the earnings and multiple can be higher – especially if the industry environment improves. In cases like this where we see so little downside, we don't need to be aggressive in defining the upside. It tends to take care of itself.

You've owned drug company Valeant [VRX] for more than five years. Why is it still interesting?

JU: We originally bought Valeant in 2007 on the premise that the glory days for pharmaceutical companies were over. The company had \$1 billion in revenue and a highly diversified product portfolio of branded generics, over-the-counter and off-patent drugs, with little risk from patent cliffs or managed care. But management in our estimation was misallocating resources into R&D, so we saw an opportunity to cost-cut our way to good returns. We led the charge to change management and within two quarters the company had sold its Western European business to focus on the U.S., Canada and emerging markets. R&D was cut from \$100 million to \$30 million. We partnered out the entire new-drug pipeline so the company could focus primarily on in-line products.

With the new business model in place,

Valeant was generating so much free cash that we started buying up businesses at tiny multiples – 3-5x earnings – in emerging markets like Poland and Brazil. The ValueAct partner who sits on the board, Mason Morfit, leads the primary diligence on every acquisition, and the company basically became a value investor in a global pharmaceutical industry that's trading at low earnings multiples because the public market is correct that the industry is misallocating resources. After 14 acquisitions in 2009, the company had become one of the only emerging-market-focused pharmaceutical companies you could buy on the public market.

By last year we'd set our sights on bigger fish, which culminated in the merger announced in June with Biovail, creating a company with approximately \$2 billion in revenues and generating \$700 million in free cash flow per year. The deal was structured so that we retained Biovail's low corporate tax rate, but Valeant's management and board will run the company. Unlike traditional pharma, even after the Biovail acquisition the company faces no major patent expirations it has to scramble to replace.

Will the management playbook remain the same?

INVESTMENT SNAPSHOT

**Valeant Pharmaceuticals**  
(NYSE: VRX)

**Business:** Develops, licenses and sells branded specialty and generic pharmaceuticals worldwide, with primary focus on the neurology and dermatology markets.

**Share Information**  
(@12/29/10):

<b>Price</b>	<b>28.45</b>
52-Week Range	13.64 – 30.80
Dividend Yield	1.3%
Market Cap	\$8.53 billion

**Financials** (TTM):

Revenue	\$907.7 million
Operating Profit Margin	22.4%
Net Profit Margin	(-11.5%)

**Valuation Metrics**

(@12/29/10):

	<b>VRX</b>	<b>S&amp;P 500</b>
Trailing P/E	n/a	18.0
Forward P/E Est.	n/a	14.6

**Largest Institutional Owners**

(@9/30/10):

<b>Company</b>	<b>% Owned</b>
Fidelity Mgmt & Research	13.5%
Ruane, Cunniff & Goldfarb	11.5%
ValueAct Capital	9.1%
T. Rowe Price	3.5%
Iridian Asset Mgmt	2.6%

**Short Interest** (as of 11/30/10):

Shares Short/Float	10.8%
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VRX PRICE HISTORY



THE BOTTOM LINE

Valeant has refashioned itself as a lean pharmaceutical company focused on branded generics and OTC drugs sold in North America and emerging markets, says Jeff Ubben. Through organic growth, cost savings and continued M&A activity, he expects the shares to have a 20% annual "return profile" over at least the next few years.

Sources: Company reports, other publicly available information

**JU:** Mike Pearson, Valeant's CEO, has implemented a culture of truly low-cost operations and a philosophy of selling or partnering all R&D programs. That's anathema to pharmaceutical companies, but produces fantastic economic results. Now with a company twice as big, Mike will have more opportunities to do what he does best on the operational side – projected annual cost synergies have increased to \$300 million from the \$175 million announced initially – and there remain excellent M&A opportunities. The company is still small enough that doing select \$30-40 million deals can move the needle, but the footprint is so global that nearly everything has big synergies attached to it as well.

**What do you like about the branded-generics business?**

**JU:** Unlike the traditional patented pharmaceutical business, the products have no patent cliffs. These are long-tail products, with 30-40 year lives and inelastic demand profiles. The brand means something and the pricing power for what are still relatively inexpensive drugs is high.

**How are you looking at valuation with the shares trading around \$28.50.**

**JU:** The stock is trading at less than 12x the free cash flow of \$2.50 per share analysts are estimating for 2011. So the question is whether management can put all that cash to work at high returns, and we believe it will. We don't need any change in the multiple to imagine a 20% return profile for the shares, half from organic growth and half from acquisitions.

**What's the biggest risk?**

**JU:** There is very high execution risk, which likely contributes to a lower valuation. I don't have a problem with that because we're so integrated, through Mason's presence on the board, into the workflow of the company.

In only five of our 60 core investments have we gotten through the divest-and-restructure phase and then started feeding

assets like this to a management team because we believe so much in the opportunity. These are big wins that become lower risk over time. We don't have to create a whole new idea when there's a great management team in place and when we're part of the capital-allocation process.

**You've also done a lot of heavy lifting at software company Misys [MSY:LN]. What's the opportunity there today?**

**JU:** Misys turned out to be a bigger turnaround than we thought. Having already sold three businesses at the company to focus on its software franchises in the financial and healthcare sectors, we concluded that to maximize value we needed to finish the job and recently engineered

the sale of most of the company's 56% stake in publicly traded Allscripts-Misys Healthcare Solutions. What's left at Misys is a core-banking software business that provides systems for the broad array of transaction processing done at banks in Europe and emerging markets, and a capital-markets and trading software business that is now #1 globally on the buy-side and sell-side.

One important aspect of the opportunity today is the recent launch of the company's integrated BankFusion software platform, which has the potential to transform its core-banking business from a flat revenue profile into a high single digit grower. The key to growth in that business is to roll out ancillary products that are valued by a sticky installed base of customers, allowing your systems to

**INVESTMENT SNAPSHOT**

**Misys**  
(London: MSY:LN)

**Business:** Provider of software systems used in core banking and capital markets operations of financial institutions primarily in Europe and emerging markets.

**Share Information**  
(@12/29/10, Exchange Rate: \$1 = £0.65):

<b>Price</b>	<b>£3.39</b>
52-Week Range	£1.97 – £3.43
Dividend Yield	0.0%
Market Cap	£1.30 billion

**Financials** (FY ended May 2010)

Sales	£782.3 million
Operating Profit Margin	14.6%
Net Profit Margin	7.8%

**Valuation Metrics**  
(Current Price vs. TTM):

	<b>MSY:LN</b>	<b>Nasdaq</b>
P/E	40.5	12.8

**MSY:LN PRICE HISTORY**



**THE BOTTOM LINE**

Trading at only 15x pro-forma estimated earnings for its 2012 fiscal year, Jeff Ubben believes the market is undervaluing the company's potential as a stand-alone business or as the acquisition target of a strategic buyer. "There's a good chance this will be one where we make most of our money in a fairly short period of time," he says.

Sources: Company reports, other publicly available information

become more integral to a bank's workflow. Misys hadn't really launched any new products in years, but the customer response to BankFusion – which extends the company's presence from the back office more into the retail side – has so far been quite promising.

The capital-markets and trading business, after the recently announced acquisition of software vendor Sophis, will now generate roughly 70% of the company's EBITDA, up from 50% previously. That business is already growing at a double-digit rate with 25%-plus margins.

**How cheap do you consider the shares at a recent £3.40?**

**JU:** The current P/E of 15x analysts' pro-forma earnings estimates for the fiscal year ending May 2012 is not at all expensive for a company with the potential to grow organically at a double-digit rate and with significant margin upside as it consolidates operations. They currently have operating margins on a pro-forma basis of 22-23%, while you tend to find margins in similar businesses with high maintenance revenues at closer to 30%.

We believe the strategic value of the business, which is now investable, clean and bite-sized, is very high. The current multiple of revenues, less than 2.5x, is half or less what we could imagine a corporate buyer would be willing to pay. We've done OK on this investment so far, but as is often the case, there's a good chance this will be one where we make most of our money in a fairly short period of time.

**How did ValueAct's strategy hold up through the financial crisis?**

**JU:** People don't believe business quality is a hedge, but if your valuation discipline holds and you get the quality of the business right, you can take a 50-year flood, which is what 2008 was, and live to take advantage of it. We incurred a markdown in 2008, and it was arguably just that. You may have to accept a bit more volatility with our fund than in a long/short fund, but we followed a down 2008 with

a very strong 2009 and 2010 and would put our three-year returns up against anybody's. The key is avoiding businesses that get snuffed out at the bottom.

One mistake I did make was not returning capital to investors in 2007 from all the buyouts in our portfolio, which had left us with close to \$2 billion in cash out of \$5 billion in total assets. I'm in the deployment business, so ended up going further out on the quality curve and dug some holes by overpaying for businesses like Sara Lee, Advanced Medical Optics and MDS, Inc. We're really good at bottoms because we don't panic, but we expect to be better at tops than we were last time. We'll be more willing to sit with cash or give it back.

Money managers typically sell either greed or fear. Private-equity firms were great at selling greed five years ago, while hedge funds today are terrific at selling fear. The problem is you can get trapped by that – if you've sold fear, it's difficult not to invest in a fearful way. That can leave you in just a bunch of trades rather than being truly long in high-quality investments.

**Do you have any view on whether the market today is closer to a top than to a bottom?**

**JU:** We are distinctly not a top-down firm, so the best indicator for us that the market is pricey is when we don't have enough in the pipeline and none of our current positions is underwater. It is somewhat concerning that we have only one farm-team investment – which I can't tell you about – in which I can imagine putting tons of money to work, and that we have only one position that is underwater. But we love what we own and our portfolio trades for only 13x earnings at a time when interest rates are low and the global economy is growing 4-5% per year. Quality is still undervalued.

I talk to investors who have just been in New York and who want to know my macro view and whether I think Japan is going to be a vortex that pulls the whole global economy down with it. Their eyes glaze over when I start talking instead about C.R. Bard's Foley catheters or the new BankFusion software at Misys. But that's what matters to us. Our goal is to find earnings streams that are defensible in good times and bad and that also demonstrate secular growth. It's frankly an advantage to not get overly distracted by macroeconomic concerns, which can make it hard to pull the trigger on a great business when the opportunity presents itself. **VII**

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