ValueInvestor INSIGHT

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The Leading Authority on Value Investing

Value Unbound

JANA Partners' Barry Rosenstein excels at identifying companies that are successfully reinventing themselves … as well as provoking those that should.

Rather than compete for deals with bigger private-equity funds than the one he ran at the time, Barry Rosenstein started JANA Partners with Gary Claar in 2001 to bring a private-equity approach to equity investing. "We saw better ways to profit from the discounts at which public companies were trading to their private-market values," he says.

Indeed. Rosenstein's JANA now manages \$6.5 billion and its flagship fund since April 2001 has returned 23.6% per year after fees, vs. 3.3% for the S&P 500.

Focusing on companies undergoing change that is unappreciated by the market, Rosenstein and Claar are finding value today in such far-flung areas as gasoline refining, interdealer brokerage, power production and IT outsourcing.

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INVESTOR INSIGHT

Barry Rosenstein
JANA Partners LLC

Investment Focus: Seeks companies in the process of transforming themselves that are both fundamentally cheap and have identifiable catalysts for unlocking value.

It Pays to be Skeptical

Son of legendary hedge-fund manager Lee Cooperman, Wayne Cooperman is more than making his own name for himself as a value-hunting expert.

INVESTOR INSIGHT

Wayne Cooperman
Cobalt Capital

Investment Focus: Seeks companies benefiting from secular or cyclical trends and that are undervalued for what he considers inaccurate or short-sighted reasons.

No one would mistake Cobalt Capital's Wayne Cooperman for a bright-eyed optimist when it comes to investing. "I tend to always be more negative than positive on the market – there are just too many things that can go wrong," he says. "But we're usually able to find stocks we think will do well in any environment."

He's being modest. Since 1995, Cobalt Capital's original fund has delivered an average annual return of 25.7% after fees, vs. 9.6% for the S&P 500. Overall, the firm has \$2.6 billion under management.

Cooperman's search for "above-average businesses trading at below-average prices" is uncovering opportunity today in several smokestack industries, including energy, steel and mining.

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Ahold, American Tower, Arecelor Mittal, EMI, GlobalSanteFe, Houston Exploration, ICAP, Noble, OSI Restaurant Partners, SBA Communications, Six Flags, Transocean, Wacker Chemie, Yahoo

Investor Insight: Barry Rosenstein

Barry Rosenstein and Gary Claar of JANA Partners (with colleagues Marc Lehmann, Kevin Lynch, August Roth and Gregg Schultz) describe why they never run out of ideas, how their partnership leads to better decisions, why their brand of activism isn't trendy and why they think Valero, Ingersoll-Rand, Tullett Prebon, Mirant and Maximus are mispriced.

Your career paths were different before coming together in 2001 to form JANA. What were some of the most important inputs to how you invest today?

Barry Rosenstein: My early experience was working with entrepreneurs like Asher Edelman and Sam Zell, who had very transactional perspectives on investing. That informed our value-plus-catalyst approach and also our willingness – which was fairly unique when we were starting out – to be activists and not just let things play out on their own.

I also learned a lot about what not to do. I guess it was my good fortune to work with several egomaniacs during my career, and I promised myself that when I started my own business that I'd create a much different environment than what I'd experienced. It wasn't going to be all about me and we weren't going to treat people like commodities. We try to have an inclusive environment and treat people well and with great respect.

Gary Claar: Starting out as a lawyer, I approached this business as an outsider and was very much a student of what worked. Working at [well-known hedge fund] Perry Partners, I saw how they grew from their bread-and-butter in risk arbitrage to taking that event-driven mindset and applying it to the stocks of companies that were more broadly undergoing change. The mainstream often doesn't price these situations right and there's a lot of opportunity to combine fundamental analysis with judgment on how events will play out.

I also strongly identified with Joel Greenblatt's first book [*You Can Be a Stock Market Genius*], which taught how to profit from special situations such as spinoffs, restructurings and bankruptcies that can often be inefficiently priced. We still want to learn from the great investors of our era and have formed relationships with many of them in order to make ourselves better all the time.

Describe in more detail your value-plus-catalyst approach.

GC: We're selecting for companies that are entering episodes of their public lives in which they're going to be transformed. We do both the fundamental valuation work as well as an analysis of the probabilities of successful, value-unlocking outcomes. We tend not to focus on short-term opportunities in which we may have no real edge, or on very long-term, buy-and-hold-forever investment themes. There's a medium term where the risk/reward can be quite high if we stick to our value-plus-catalyst discipline.

Barry Rosenstein

Gary Claar

Unlimited Partnership

To hear him tell it, Barry Rosenstein's first steps toward a career in finance were unexceptional at best. On his accounting degree from Lehigh University: "Good training, but I hated it." On his first job at accounting firm Price Waterhouse: "I was probably the worst employee in the history of the firm." On working for Merrill Lynch after earning an M.B.A. from Wharton: "I never really fit in there."

Rosenstein hit his stride after leaving Merrill Lynch in 1985 to work for then high-profile takeover artist Asher Edelman, which he followed up by starting a series of investment partnerships focused on mergers and acquisitions. On the lookout for a partner to start a hedge fund in 2001, Rosenstein met Gary Claar, a one-time corporate lawyer who had worked as in-house counsel at Perry Partners before starting his own investment firm in 1999. They formed JANA (an acronym created from the first names of Rosenstein's children) and opened for business in April 2001.

"We had a very natural separation of duties from the start," says Claar. "I find it very distracting to leave my desk and Barry doesn't think he's working if he's sitting at a desk. He's out meeting people, finding ideas, building our network of contacts and resources and creating the buzz about JANA. I'm at my desk overseeing operations, from research to trading to risk management. My favorite analogy for how we work together is to Bono and The Edge of U2. Bono is the quintessential front man, destined for greatness. But The Edge pulls together everything necessary to make it sound like a rock band."

The hedge-fund industry grew up by preying on the inefficiencies created by the mutual-fund mentality of only departing from a benchmark index weighting with reluctance. Events that transform companies can complicate things when you're focused on, say, having an 8% weighting in industrials. That's why these types of companies can often be mispriced. There's also change going on and the market can be remarkably slow in shifting its focus from how things have been to how they will be.

By focusing on low valuations and on companies undergoing change, we find our stocks to be less correlated to the market. So with low or reasonable market exposure, we try to capitalize on the potentially tremendous re-ratings of valuation that can occur over one to three years. That's where we've been successful, either when the company leads the change or when we've been part of it through activism.

Are you more often anticipating change or trying to respond early to it?

GC: It can be either. A company may be ripe for a transformative event, but we can't yet say what form it's going to take or when. At the right price, we'll leap right in. There also could be an announced event, which will get us looking at a situation and trying to project what the company will look like two years out.

BR: One of the nice things about our strategy is that while it is very well defined, it's also very broad. We'll look at almost anything as long as we're comfortable with the industry dynamics, the stock is trading at an attractive multiple of sustainable free cash flow – ideally trading at a free-cash-flow yield of 10% or greater – and we can see a catalyst or catalysts for unlocking value. Companies are always restructuring, recapitalizing themselves, spinning off non-core businesses and selling underperforming units. There has never been, nor do I think there will ever be, a shortage of ideas for us to look at.

How do you find your best ideas?

GC: Ideas primarily come from just following what companies are doing. We look at new companies created from IPOs, spinoffs, corporate breakups or when companies exit bankruptcy. We look for companies that don't have heavy institutional ownership and for which the sell-side is generally negative, but that we think are addressing their failings through management and strategy changes.

ON VALUATION:

One way we focus on absolute rather than relative valuation is by always asking whether we could LBO the company.

Activist-type opportunities come from identifying companies that should be doing more for shareholders, but some sort of bottleneck is keeping that from happening.

Often we're just trying to do the work early before sell-side analysts jump on the story and the company finds its right shareholder base and valuation level. We'll talk about Ingersoll-Rand later, but what originally appealed to us was that we didn't think the company was getting credit from the market for how significantly and well it has been transformed. In two years, we think that will be evident to everyone who looks at the stock.

Using one specific recent example, what attracted you to Yahoo?

GC: We chuckle about how much flak we got when Yahoo appeared on our last 13F [the quarterly report on their holdings that investment managers must file with the SEC]. We bought it because after a disappointing 2006 the company was briefly trading at the same multiple as some beleaguered newspaper companies. That made no sense. We're comfortable with how they're addressing the competitive challenges they face and they're in a category that is growing much faster than most of the businesses we look at. But net of stakes in Alibaba in China and Yahoo Japan, the shares traded temporarily at only around 10x EBITDA.

Do you follow strict guidelines when it comes to valuation?

GC: Valuation is an art. We don't rely on sell-side crutches like, "Well, the group trades at 18x earnings and this is at 15x earnings so it's cheap." You have to be able to think outside the box and normalize any comparison between businesses. The opportunity is in seeing the unique attributes of a business and how it should be valued. While [Pershing Square Capital Management's] Bill Ackman didn't get McDonald's to break itself up, he did communicate to investors how they should look at the business differently and apply a higher multiple to the cash flows.

Kevin Lynch: One way we focus on absolute rather than relative valuation is by asking in almost everything we look at whether we could LBO the company. Are the cash flows sustainable? Could you put leverage on it? If you can't leverage the business because it isn't stable enough, that tells us a lot about how valuable the company is.

How do you manage risk?

GC: We're fairly concentrated, with about 70-75% of our capital in our top 20 positions, so we know what we own and don't need a lot of statistical analysis to figure out where we're exposed. We think concentration is the key to big performance, but we also have no desire to have our year depend on one or two things working out, so we have generally kept our largest positions at 5-8% of total capital and make sure those big positions are not particularly speculative or highly levered. We're proud that we've never had a loss in an individual position cost us more than 1.5% in performance.

We're conscious to avoid too much

single-industry or commodity exposure – it's unusual for us to have a net industry exposure of more than 10%. We're also long/short, running now at about a 70% net exposure, 120% long and 50% short. Because of that and the fact we believe our longs have relatively low market correlation, we don't worry that much about gaming the market or predicting macro trends.

Do you often pair shorts with longs?

GC: We expect our shorts to stand on their own even if they are hedges against a long position. We don't believe in just muting our volatility or buying our investors market protection – we want to have well-researched shorts to make a profit.

Each position we have on the long side does have a certain amount of market sensitivity. Often it's very low, so we don't feel any need to try to offset it elsewhere. In other cases, say when we took a big position in Time Warner and had a large concentration in media and cable, we did look for offsetting shorts that were correlated to the problem areas in cable or print media that could affect Time Warner.

Are there any particular short themes you're pursuing today?

GC: We think credit spreads are still unsustainably tight, which is producing some short ideas. Certain REITs, for example, are trading at crazy valuations that we expect to correct in a different credit environment.

Describe how you use activism?

BR: There's a certain trendiness to activism, driven by the fact that the opportunities for activism aren't always there. In the 1980s you heard a lot about it, but then as valuations changed in the 1990s you didn't hear much about it at all. Now it's popular again, but we've always considered a willingness to be active as just another weapon in our arsenal. Public activism isn't our first choice; we're much happier to work with companies to accomplish our goals without anyone outside of the company ever hearing about it. I think we're able to do that because people know we're serious and that we're prepared to go as far as it takes, but also because we're reasonable to deal with.

ON INVESTING IN EUROPE:

Europe is ten years behind the U.S. in terms of rationalizing corporate structures. Activism will promote change there.

Give us an example or two where you've taken a more public position and why.

BR: In the case of Kerr-McGee, we spent a lot of time talking with management about opportunities to restructure and recapitalize the business, but it became clear they weren't going to do anything on their own. In those cases, quite simply, you're often left with no choice but to take a more public position. [*Note: Kerr-McGee eventually agreed to a $4 billion share buyback funded by asset sales, a strategy that was underway when the company agreed to be bought by Andarko Petroleum last summer.*]

A few years ago we were involved with a financial-services technology company called InterCept, which we thought was trying to steal the company from shareholders. The company reported a bad quarter, the stock dropped precipitously and, miraculously, the next day management made a proposal to buy the company at a depressed price of $12 per share. They formed a special committee of the board to evaluate the offer and we heard that multiple corporate buyers showed up with interest at much higher prices. Then they mysteriously called the auction off. It was obvious to us that no friendly solution would be possible with these people. We bought up to 9.9% of the company and filed notice that we were going to run a slate of directors against them. The board capitulated and we eventually got the company sold for $19 per share within six months.

How is one of your more recent activist positions, in Houston Exploration [THX], playing out?

BR: We tried very hard to get the company to restructure itself and buy back stock, with no success, so ultimately came to the conclusion that the right alternative was for the company to be sold. We made a bid ourselves last summer, but the subsequent fall in natural-gas prices reduced the amount we were willing to pay. We affiliated with a strategic buyer, Forest Oil, which ultimately prevailed in buying Houston Exploration in January. We plan to roll our stake into the new combined company, which we think has a lot of upside from cost savings and an ability going forward to recapitalize its balance sheet.

How active are you outside the U.S.?

BR: We've generally had between 15-20% of our capital invested in non-U.S. equities, though the level can be higher or lower depending on opportunities we find. We think Europe is particularly attractive right now – it's probably ten years behind the U.S. in terms of rationalizing corporate structures and activism is becoming more accepted and will continue to promote change there. In addition to building out our team in Europe, we've also had one of our partners working out of Hong Kong for the past two months, looking at opportunities in China and the Far East.

Describe some representative European ideas that have caught your attention.

GC: We keep an eye on IPO markets for companies that might be mispriced at the outset. One we found last year was German chemical company Wacker Chemie [WCH.GR], which was a substantial private company that went public in order to pay down debt after buying out two big strategic partners. It's a very well-managed company with market leadership in high-growth market segments, but was priced at the IPO like a mundane diversified chemical company. It's been successful for us so far, but we still own it because it's well below our estimate of intrinsic value.

Gregg Schultz: Ahold [AH.NA], the Dutch supermarket retailer, is a perfect example of a company in the process of transforming itself to create value. It's still universally hated by the sell-side, after almost going bankrupt a few years ago because of an accounting scandal. They have high-quality assets with leading market shares in Europe and North America, producing non-cyclical earnings that should grow every year. They are also in the process of divesting several non-core operations, including the U.S. Foodservice distribution business that we think will command a high multiple.

With the shares trading at €8.70, Ahold's market cap is around €13.5 billion, but we expect them to receive some €5.5 billion this year from the sale of non-core assets. We think they'll pay down €2 billion of debt, leaving them with €3.5 billion – 25% of the current market cap – to return to shareholders over the next year or two. On top of that, as they start paying regular dividends again and make progress in turning around the Stop & Shop business in the U.S., we expect the multiple to expand significantly from the current 11.5x our estimate of roughly €0.75 per share of earnings power. Our share price target is around €12.

This is the type of company Barry mentioned that is just now catching up in rationalizing its capital structure. At this valuation, you wouldn't see a company like this in the U.S. – it would have been acquired long ago.

Back to the U.S., describe your interest in refiner Valero Energy [VLO].

August Roth: The company is the largest independent gasoline refining company in the U.S., with about 3.3 million barrels per day of throughput capacity. We originally become shareholders of Valero after they acquired Premcor – in which we were one of the largest owners – in 2005. We liked the deal and did quite well with our stake in Valero until selling it in the first half of last year.

We got back in early this year because we saw another change coming in the company. The founder, Bill Greehey, last year ceded the CEO role to Bill Klesse, a long-time industry veteran who had joined Valero through an acquisition in 2001. While Greehey clearly built a substantial company, he was very focused on growth and the company historically has had lower returns on capital than its peers, partly from high-priced acquisitions and partly from higher capital spending. Under Klesse, we expect the strategy to be more focused on maximizing shareholder value.

In what way?

AR: Valero's core strengths are its largest refineries – processing at least 150,000 barrels a day – that have access to multiple sources of water-borne crude oil. That allows them to more efficiently purchase crude, which is their largest cost component. They also prefer more complex refineries that are able to process heavy,

INVESTMENT SNAPSHOT

Valero Energy
(NYSE: VLO)

Business: Largest North American gasoline refiner, operating 18 plants with capacity to refine 3.3 million barrels of oil per day. Also operates 5,500 retail gasoline outlets.

Share Information
(@3/29/07):

Price	**65.14**
52-Week Range	46.84 – 70.75
Dividend Yield	0.7%
Market Cap	$39.35 billion

Financials (TTM):

Revenue	$91.03 billion
Operating Profit Margin	8.8%
Net Profit Margin	6.0%

Valuation Metrics
(Current Price vs. TTM):

	VLO	S&P 500
P/E	7.4	20.1
P/CF	5.8	14.1

Largest Institutional Owners
(@12/31/06):

Company	% Owned
Fidelity Mgmt & Research	9.9%
Barclays Global Inv	6.3%
State Street Corp	3.5%
Vanguard Group	2.7%
Neuberger Berman	2.7%

Short Interest (@ 3/12/07):

Shares Short/Float	1.9%

VLO PRICE HISTORY

THE BOTTOM LINE

New management is focused on efforts to maximize shareholder value, says August Roth, including the sale of non-core assets, share buybacks and the recapitalization of the company's balance sheet. Along with continued strong refining margins, he says, the resulting EPS increases could within two years take the shares "into the triple digits."

Sources: Company reports, other publicly available information

sour crude oils as opposed to the light, sweet versions.

The company has already announced it is exploring strategic alternatives for its Lima, Ohio plant and we expect similar announcements for refineries that don't meet the criteria for core assets. The Lima plant, for example, is big enough, but it's not particularly complex and doesn't enjoy the same multiple crude sources of many of the other plants.

The positive margin environment in refining makes it a good time to sell plants, but in such a cyclical business is it a good time to buy a refiner's shares?

AR: We believe strong margins will continue for a lot longer than the market seems to think. Refiners make money on the difference between what they pay for crude and the market prices for refined product. In the past, those market prices have tended to fall sharply when demand turns down. But the supply side of the refining business has changed considerably as integrated oil companies have sold refining assets, which are now largely owned by a small number of rational, independent companies like Valero. At the same time, decades of underinvestment under oil-company ownership and newer environmental restrictions have kept refining capacity constrained. We think that makes it more likely that refiners will be able to maintain their margins in a broader variety of oil-price scenarios.

How inexpensive are the shares, trading recently around $65?

AR: Valero trades at around 7x our 2007 earnings estimate and at a 10% free-cash-flow yield. That's very cheap for the largest refiner with the best asset base and with what we now think is the best management team. It's still valued as if earnings will fall off a cliff next year, which we don't believe is likely.

Given the current strength in refining margins, Valero will be able to sell the assets on which they earn the lowest returns for a substantial premium to the implied asset value given by the current stock price. If they then use the proceeds to buy back the undervalued shares, we see that creating a lot of value. They also have plenty of capacity to increase debt, from the current 15% ratio of net debt to total capitalization to as much as 25-30%. With the free cash flow it earns – $3.5 billion this year – the company could be in a position to repurchase 15-20% of the total outstanding shares.

At only 9x my 2007 earnings estimate, which we think is justified, the stock would trade at around $85 per share. That's before they sell any assets or do a share buyback, which could take the shares – without making aggressive assumptions – into the triple digits.

Gary described Ingersoll-Rand [IR] earlier as a company that has transformed itself, but nobody seems to have noticed. What has caught your eye?

Marc Lehmann: Ingersoll-Rand has gone through a long transformation, focusing on less-cyclical and higher-margin businesses, and we don't think most people know the company very well. It got out of businesses like oilfield-services and automotive parts and now has generally market-leading positions in the industries in

INVESTMENT SNAPSHOT

Ingersoll-Rand
(NYSE: IR)

Business: Diversified industrial conglomerate with primary operations in climate-control systems, compact vehicles, construction equipment and security products.

Share Information
(@3/29/07):

Price	**43.33**
52-Week Range	34.95 – 49.00
Dividend Yield	1.6%
Market Cap	$13.34 billion

Financials (TTM):

Revenue	$11.41 billion
Operating Profit Margin	12.6%
Net Profit Margin	9.0%

Valuation Metrics
(Current Price vs. TTM):

	IR	S&P 500
P/E	13.2	20.1
P/CF	7.3	14.1

Largest Institutional Owners
(@12/31/06):

Company	% Owned
Barclays Global Inv	8.4%
NWQ Inv Mgmt	4.3%
Wellington Mgmt	3.8%
Southeastern Asset Mgmt	3.1%
Fidelity Mgmt & Research	2.8%

Short Interest (@ 3/12/07):

Shares Short/Float	2.1%

IR PRICE HISTORY

THE BOTTOM LINE

With mid-single-digit revenue growth, continued expanding margins, share buybacks and a large acquisition – for which the company has both the managerial and financial capacity – Marc Lehmann believes IR can earn $5.80 per share by 2009. Even with no multiple expansion from today, the shares would then trade in the mid-$70s.

Sources: Company reports, other publicly available information

which it competes, such as refrigerated display cases and trucks, compact equipment (under the Bobcat brand), golf carts and security products like Schlage locks.

We've been at company presentations where the only business anyone asked about during a 45-minute Q&A were businesses related to home building, like Bobcat and the lock and security businesses. That indicates to us a surprising lack of understanding about the breadth of their products and services. That provides, of course, part of the upside, as the Street eventually recognizes the stability and quality of the overall business.

Just last month the company sold a road-paving equipment business to Volvo for 13x earnings before interest and taxes, at a time when the company overall was trading at 10x EBIT. We think that's an indication of the quality of the businesses they have.

Has the transformation of the company started showing up yet in its operating metrics?

ML: Over the past five years, operating margins have increased from about 5% to 12.5%. The return on invested capital has increased to around 15%. Compared to only a few years ago, the company's EBITDA has approximately doubled, while its net debt is down 50-75%. Those numbers even underestimate some of the progress they've made, given the raw-materials cost increases they've experienced in the past few years. On EBIT of $1.4 billion last year, the company says raw-materials price increases cost it an additional $100 million.

Through innovation and new products, we think revenue growth should be at least in the mid-single digits, before acquisitions. We expect continued margin improvement to 14% by 2008, through a combination of six-sigma efficiencies, sourcing improvements and some moderation in materials costs. On a pro-forma basis for the sale of the road-paving business, we expect the revenue growth and operating leverage to result in earnings per share increasing from $3.20 last year, to $3.80 this year and $4.55 in 2008.

As the metrics continue to improve, what upside do you see for the shares, now around $43.30?

ML: If we're right about earnings, even at the less than 14x multiple at which the company currently trades on 2006 pro-forma EPS, you'd have a price within the next 12-18 months of 40% above today's level.

ON INTERDEALER BROKERS:

They're entering the sweet spot of their maturation. The number of investment products gets bigger every year.

What's more interesting is that we know the company thinks it's overcapitalized and that management has been frustrated by not being able to find a more meaningful acquisition in recent years. We think it's likely they will find a larger acquisition this year, which they will finance as much as possible through debt. They also have been buying back stock, including a new $1.5 billion program initiated at the end of last year, for which they won't need to borrow any money.

So if we make conservative assumptions about the pace and price of planned share buybacks, assume they make a $4 billion acquisition at 10x EBITDA before synergies, and that free cash flow is used to pay down debt, we arrive at a base case of around $5.80 per share in earnings by 2009. If that happens, you've got a stock that could be at least in the mid-$70s.

What could go wrong?

ML: In any industrial business, of course you have to worry about potential competition from China. We've tried to be very conservative about our assumptions on growth and profitability. We assume a decent economy and that they don't miss any big product cycles, though these really aren't the kinds of businesses where that's likely to happen overnight anyway.

Because it's domiciled in Bermuda, the company's tax rate is half the rate of its peers. Some people worry that favorable tax treatment might be threatened, but from all our work we've seen no reason to believe that will be the case.

Tell us what's behind your interest in London-based Tullett Prebon [TLPR].

GS: The company is an interdealer broker, which puts together very large buyers and sellers for almost all over-the-counter financial products. Its customers are primarily global financial institutions and the products are things like forward foreign-exchange contracts, corporate bonds, interest rate swaps and forwards, energy options and forwards, credit derivatives and equity options. It's a relationship-driven business, with people being the primary asset.

The company recently went through a de-merger, which separated the higher-quality Tullett Prebon business from Collins Stewart, a traditional, low-margin U.K. stock brokerage business. As part of that, the company is recapitalizing itself and just paid a large special dividend to shareholders. We're often interested in spinoffs and we got involved when the de-merger was announced.

Is interdealer brokerage an attractive business?

GS: There are basically five large competitors in this business in the world. Tullett is number two, with a 20-25% share, behind ICAP, which is also U.K.-based and has about 30% of the market. We like ICAP also, by the way, but Tullett is significantly cheaper.

We think interdealer brokers are entering the sweet spot of their maturation. The number of investment products in the world gets bigger and the products themselves get more complicated every year. Products like credit-default swaps didn't exist five years ago and now the volume is growing 100% per year. We see interdealer brokers continuing to benefit from more trading of more products by bigger and bigger players. The business should be much less cyclical than that of equity exchanges, as market volatility actually increases demand for many of the products these guys trade.

Is the prospect of electronic trading more of an opportunity or a threat?

GS: These are complicated products so trades typically still need human intervention, though parts of the business are slowly becoming electronic. That's an opportunity, since electronic margins are twice those of the voice business. The move to electronic trading is also a risk, however, since ICAP is considered the electronic-platform leader and could take market share in certain products if Tullett doesn't keep up. Given the measured pace at which the transition to electronic will take place, though, we don't expect Tullet to have any difficulty staying competitive.

At the current price of around 487p, how are you looking at valuation?

GS: With margin expansion from cost cutting after the de-merger and with top-line revenue growth in the high single digits, we think Tullett can earn 40p per share in 2008. So you're paying 12x earnings for a company with smart management, a strong #2 market position, and that can grow what we think are non-cyclical earnings at 10%-plus annually.

Our basic price target would be the 2008 earnings times a more appropriate 15x multiple, or about 600p. You also get a decent annual dividend on top of that. That's pretty solid upside on its own, but the bigger upside comes in a takeover. We think there's a very high probability Tullett will not exist as an independent company in a few years. If you're one of the big cash exchanges, you're in a rather cyclical business with people trying to attack your monopoly status. Buying a company like Tullett would be a perfect way to expand your global products in a less-cyclical business. The London Stock Exchange already tried to buy ICAP last year, but it didn't work out because of price.

Exchange-company stocks trade for as high as 25x earnings. A deal for Tullett at even 20x would still be highly accretive.

Your next idea, Mirant [MIR], has moved up strongly over the past six months. Why is it still attractive?

AR: The company and its industry, independent power production, have a somewhat checkered past. After the deregulation of the electric utility industry, independent power producers like Mirant generally overbuilt and ran into trouble. Mirant itself went bankrupt in 2003. But an important part of our thesis is that we think the industry has rationalized itself and is exiting a period of low margins.

Mirant has been selling off non-core assets to focus on markets around Washington, D.C., in California and in the Northeast. Given constraints on transmission capacity in and out, each market has its own supply and demand fundamentals and Mirant's remaining markets are among the best in the country.

The outlook for the broad D.C. market, for example, is very strong. Power authorities typically want to have about 15% excess generating capacity above peak load demand in order to protect against outages. The reserve margin in the D.C. region in which Mirant operates is projected to be only 6-7% by 2010. That's potentially bad for consumers, but it's very positive for independent producers like Mirant. A declining reserve margin translates into higher power prices because the marginal unit of energy dispatched to meet new demand will be a less-efficient unit. That will raise the mar-

INVESTMENT SNAPSHOT

Tullett Prebon
(London: TLPR)

Business: Second-largest global inter-dealer broker, trading over-the-counter financial products like foreign-exchange contracts and interest-rate swaps.

Share Information
(@3/29/07, Exchange Rate: $1 = 509.7 pence)

Price	**487p**
52-Week Range	464p – 534p
Dividend Yield	1.2%
Market Cap	£1.03 billion

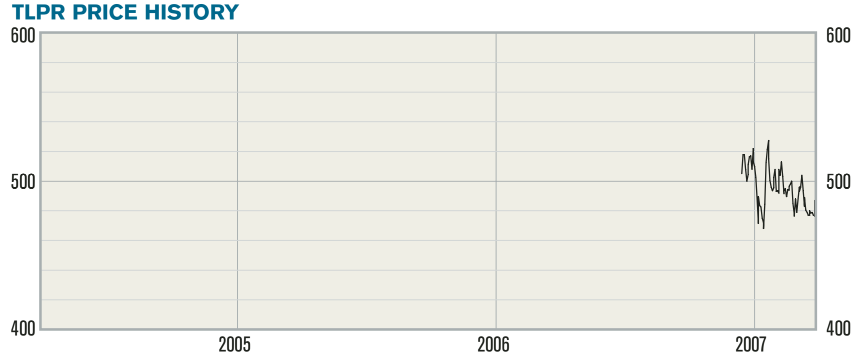
Financials (Year-end 2006)

Revenue	£.654.1 million
Operating Profit Margin	17.6%
Net Profit Margin	12.8%

Valuation Metrics
(Current Price vs. TTM):

	TLPR	FTSE
P/E	n/a	16.8

TLPR PRICE HISTORY



THE BOTTOM LINE

Gregg Schultz believes the 12x forward multiple at which the shares trade is too low for a company that has a strong market position and that can grow non-cyclical earnings at 10%-plus annually. While appropriate multiple expansion would result in a 25% share price gain, he believes even bigger upside is likely from an eventual takeover.

Sources: Company reports, , other publicly available information ket-clearing price for all power generators in the region – the last unit in basically sets the price. So Mirant will benefit both from improving margins at profitable plants and the ability to run currently unprofitable capacity at a profit.

Another big profit driver for Mirant will be so-called capacity payments that are starting to be paid in high-demand areas. To maintain adequate generating capacity, system operators – and, ultimately, rate payers – are paying existing owners of generating capacity to keep marginal plants open that they might otherwise have shut down.

The formulas are complicated, but these payments – which start from the D.C. region in May – will be a profit windfall for companies like Mirant. In the D.C. region alone, capacity payments could provide $400-$500 million in incremental EBITDA to Mirant within three years. For perspective, the company guidance for 2008 EBITDA – which we think is overly conservative – is $914 million.

That sounds almost too good to be true for a company trading at 6.5x trailing earnings?

AR: The investment thesis works if the capacity payments don't come in that high. At even a peer multiple of just over 9x our estimate of 2007 EBITDA, the stock would trade at around $50, 20% above the current price [of about $41]. That doesn't take into consideration the massive profit upside we eventually see from the capacity payments.

It also doesn't account for the high likelihood that the company will be recapitalized. Assuming all the announced asset sales close, Mirant will have around $3 billion in net cash, or $11.50 per share. On top of that, it has targeted a leverage ratio – net-debt-to-EBITDA – of 4x. So on $1 billion of annual EBITDA, there's another $4 billion that could be available. That's $7 billion – 70% of the current market capitalization – that could be used to buy back stock, pay dividends or even be used in a takeover of Mirant.

What are the biggest risks?

AR: With reserve margins at the levels projected, it would take a pretty severe demand shock to alter the story here. The bigger risk is that regulators and politicians get concerned about companies like Mirant making too much money. As risks go, that's not the worst one to have.

Why is Maximus [MMS] one of your favorite smaller-cap ideas?

KL: Maximus is a leading provider of outsourced IT services to state and local governments. They are very well-established in their primary markets and have customers in all fifty states, doing things like administering aspects of the New York State welfare program or handling the education and enrollment services for Colorado's Medicaid program. They compete mostly with bigger outsourcing firms, like Accenture, EDS, IBM and a unit of Northrop Grumman that is focused on this area.

There are several nice things about this business. It's not particularly price-sensitive, because state and local governments often don't want to deal with switching costs and the aggressive rebidding of contracts. The programs Maximus works on

INVESTMENT SNAPSHOT

Mirant
(NYSE: MIR)

Business: Independent energy producer operating primarily in California, the mid-Atlantic and Northeast, with 17,500 megawatts of electric generating capacity.

Share Information
(@3/29/07):

Price	**40.94**
52-Week Range	23.36 – 41.52
Dividend Yield	0.0%
Market Cap	$10.48 billion

Financials (TTM):

Revenue	$3.10 billion
Operating Profit Margin	38.7%
Net Profit Margin	60.1%

Valuation Metrics
(Current Price vs. TTM):

	MIR	S&P 500
P/E	6.8	20.1
P/CF	5.6	14.1

Largest Institutional Owners
(@12/31/06):

Company	% Owned
Paulson & Co.	5.8%
JANA Partners	3.5%
Tudor Inv Corp	3.0%
Deutsche Bank	2.4%
Barclays Global Inv	2.2%

Short Interest (@ 3/12/07):

Shares Short/Float	2.1%

MIR PRICE HISTORY

THE BOTTOM LINE

Serving growing, capacity-constrained power markets, Mirant should greatly benefit from rising prices and so-called capacity payments to keep plants open, says August Roth. He says the shares are worth 20% more at a peer multiple on 2007 EBITDA, and significantly more as the "massive profit upside" from capacity payments kicks in.

Sources: Company reports, other publicly available information

don't go away, so as long as they do a good job they can generally keep contracts for a very long time, resulting in a roughly 90% retention rate.

Another positive aspect is that Maximus doesn't need to reinvent every new product – a product that works in one state doesn't require a lot of development to work in another one. That's a barrier to entry Maximus benefits from. There's also little threat of the business going overseas – state and local governments don't want to outsource to India.

Finally, the trend toward outsourcing is a secular one and the need for governments to figure out how to save money is not going to go away. The penetration of outsourced services in the company's potential markets is probably only around 20%. You'll never get to 100% penetration because of the sensitivity of some of the programs, but there's still a very large growth upside.

Why isn't the company more profitable?

KL: It's been suffering from a nightmare contract – which has been losing almost $25 million per quarter – as a subcontractor for Accenture with the state of Texas. The company announced earlier this month important steps toward a resolution of that problem, which caused the stock to go up 9% in a day. We expect those losses to go away over the next couple of months and like the fact that Maximus actually retained Texas as a customer on a cost-plus basis in a couple of areas.

We see no reason why the company can't get back to the 10% operating margins they were earning before the Texas mess. Along with the 6-8% revenue growth we expect going forward, the company should be able to earn around $80 million in EBITDA less capital spending in the fiscal year that ends in September 2008.

What upside potential do you see for the shares, now trading around $34.40?

KL: Especially in smaller-caps like this, we do a lot of M&A work to try to figure out what the company would be worth to someone else. The relationships and existing contract base Maximus has would be very valuable to any of the bigger players looking to expand in state and local markets. The company is also likely to attract financial buyers who see it as an undervalued asset.

We think a 10x multiple of EBITDA minus capex would be conservative, given what financial guys pay for companies like this. That would make the company worth $800 million, plus $164 million of cash on the balance sheet, for a total private-market value of $43-44 per share. We think a strategic buyer would pay even more, given that they wouldn't have to spend nearly the $20 million in capex Maximus currently spends.

Our feeling is that either Maximus gets margins up on its own or someone else will come along and do it for them. Either way, shareholders will benefit.

What general principles do you follow in deciding when to sell?

BR: In the cases where we've been right, we're disciplined about getting out when something hits our intrinsic value. We don't invent new reasons to hang on because we've fallen in love.

INVESTMENT SNAPSHOT

Maximus
(NYSE: MMS)

Business: U.S. provider of outsourced program management, consulting and systems integration services primarily to state and local government agencies.

Share Information
(@3/29/07):

Price	**34.36**
52-Week Range	22.35 – 35.99
Dividend Yield	1.1%
Market Cap	$746.1 million

Financials (TTM):

Revenue	$699.3 million
Operating Profit Margin	(-3.4%)
Net Profit Margin	(-2.4%)

Valuation Metrics
(Current Price vs. TTM):

	MMS	S&P 500
P/E	n/a	20.1
P/CF	n/a	14.1

Largest Institutional Owners
(@12/31/06):

Company	% Owned
JANA Partners	13.1%
Morgan Stanley	9.8%
Wellington Mgmt	7.9%
Royce & Assoc	7.9%
Barrow, Hanley, Mewhinney & Strauss	6.9%

Short Interest (@ 3/12/07):

Shares Short/Float	9.2%

MMS PRICE HISTORY

THE BOTTOM LINE

Attractive industry dynamics and the resolution of a money-losing contract should allow the company to return to its historical 10% operating margins, says Kevin Lynch. At 10x his estimate of fiscal-2008 EBITDA less capital spending, the shares would trade for around $44. "We think a strategic buyer would pay even more," he says.

Sources: Company reports, other publicly available information

We also try very hard to own up quickly to exposed flaws in our investment thesis. A recent example was with EMI, the music company, in which we've invested very successfully in the past and which we consider an obvious buyout candidate as the industry consolidates. At the end of last year they came out with a stunningly bad earnings revision, which hurt the stock and prompted us to add a bit to our position. Less than a month later they came out with another big downward revision and we sold. We concluded the business was much less analyzable than it had been and that we – or EMI, for that matter – didn't have a good enough understanding of where the business was going.

Are you close to a similar conclusion about theme-park operator Six Flags [SIX]?

BR: We still think that's going to work. New management took over too late last year to really put in place the marketing programs necessary for the spring and summer seasons. They also underestimated the change required and the time it would take to influence the customer base. At the current share price [around $6], we're about $1 below our average cost and still own about 5% of the company. I think Mark Shapiro, the CEO, is very good and will get it right, although it's clearly taken longer than we expected.

Has the recent volatility in the market spooked you at all?

BR: I only worry about our individual positions. We have no edge in solving the mysteries of the macro economy, so we diversify, pick the best risk/reward opportunities we can find and don't worry much about things we can't control.

Barry and Gary, you've obviously made a lot of right decisions since starting JANA. How does your working relationship foster good decision making?

BR: One of the biggest drivers of our performance has been avoiding big mistakes. This is where I think our partnership really works. I'm constantly out there trying to come up with ideas and to make things happen and Gary is constantly pushing back and pointing out the flaws.

GC: Barry knows that he can get quite excited about new ideas and that he benefits from having people around him who can be the foil and ensure that we objectively weigh the merits and risks. Since he and I think very differently, the decisions that get through both of us tend to be compelling.

BR: I mentioned earlier how there's no ego involved in what we do. We have a first-class team and we're just trying to earn the best returns. I've seen too many businesses – investment firms and others – run into the ground by impressive people who start to think they're smarter than everyone else. That's when big mistakes get made. There are enough ways to screw up in this business without bringing it on yourself because of ego.