ValueInvestor INSIGHT
The Leading Authority on Value Investing
May 27, 2011

Impeccable Logic

They and the companies they invest in may not be particularly well known, but Dennis Delafield and Vince Sellecchia have built a record worthy of wide acclaim.

Dennis Delafield's first job in 1957 was at a small investment firm in Florida, but it wasn't exactly the culmination of a life-long ambition. "They offered me a job and I needed one," he says. "I didn't know a stock from a bond."

The career match couldn't have been better. Still going strong at 75, Delafield and partner Vincent Sellecchia now manage $2.2 billion for Tocqueville Asset Management, the bulk of which is in the Delafield Fund, which has earned a net annualized 11.6% over the past 15 years, vs. 6.5% for the S&P 500.

Trafficking in "misunderstood and unloved" companies, they are finding opportunity today in such areas as shoes, anti-theft systems, industrial equipment and chemicals. See page 2

INVESTOR INSIGHT

Dennis Delafield, Vincent Sellecchia
Delafield Fund

Investment Focus: Seek companies undergoing positive change whose share prices indicate the market is skeptical, or unaware, of their future prospects.

Comeback Trails

Long-term investors spend considerable time trying to separate fact from fiction in corporate plans. For Lloyd Khaner, that's proven to be time very well spent.

INVESTOR INSIGHT

Lloyd Khaner
Khaner Capital

Investment Focus: Seeks companies requiring operational and strategic repair – after the turnaround has commenced but before the market appears to believe it.

He followed in his father's footsteps in the investment business, but Lloyd Khaner didn't go down exactly the same path. "My Dad was very much a cigar-butt, 50-cent-dollar kind of investor and very good at it," he says. "That's not what I do."

Khaner has proven very good at what he does as well, focusing on high-quality companies that have lost their way and have first-class management leading the turnaround. Since he took full control of Khaner Capital's portfolio in 1997, it has earned a net annualized 11.1%, vs. 6.2% for the S&P 500.

With companies in need of revival always in ready supply, he sees particular value today in fast food, software, asset management and industrial products. See page 9

Inside this Issue

FEATURES

Investor Insight: Delafield Fund
Roving off the beaten path to find value in such companies as Collective Brands, Albany International, Ferro and Checkpoint Systems. PAGE 1 »

Investor Insight: Lloyd Khaner
Looking for signs of unexpected recovery and finding them today in Sonic Corp., Cadence Design, Och-Ziff and Illinois Tool Works. PAGE 1 »

Strategy: Real Estate
In a sector where recovery has been fitful at best, two experts assess today's opportunity set. PAGE 16 »

Uncovering Value: Skechers
Is the market right in treating the trend-conscious shoe company as if it's a one-hit wonder? PAGE 21 »

Editors' Letter
Advice for those trying to win at the Loser's Game of investing. PAGE 22 »

INVESTMENT HIGHLIGHTS

INVESTMENT SNAPSHOTS	PAGE
Albany International	5
Cadence Design Systems	13
Checkpoint Systems	6
Collective Brands	4
Ferro	7
Forest City Enterprises	18
Henderson Land	19
Illinois Tool Works	14
Och-Ziff Capital Management	12
Skechers	21
Sonic Corp.	11

Other companies in this issue:
Campbell Soup, Celanese, Kennametal, Lennar, Plexus, School Specialty, Sears Holdings, Stanley Black & Decker, Starbucks, St. Joe, Tyco International, Weatherford, Xerox

Investor Insight: Lloyd Khaner

Lloyd Khaner of Khaner Capital explains the primary impediments to company turnarounds, why investing in the Jack in the Box restaurant chain was a pivotal experience, whether his long-time gold bullishness is intact, and what he thinks the market is missing in Sonic Corp., Cadence Design, Och-Ziff Capital Management and Illinois Tool Works.

You joined your father's investment firm in 1991, when it was focused mostly on deep-value "cigar butts." Why did you gravitate toward a somewhat different value orientation?

Lloyd Khaner: There are many ways to succeed in this business, but my focus from early on has always been on companies that had proven, thriving businesses that for some reason have hit a wall. It could be they got caught up in growth for growth's sake and lost control of quality or operating discipline. It could be that success had blinded them to changes in their markets that required bolder strategic or business-model adjustments. But at the core are valuable competitive strengths that often, but not always, require new management to bring back into focus. It's not a question of creating something brand new from scratch, which is inherently risky, but more about getting back to basics. If it works, the payoffs can be much better over time than the 50-cent dollar going to a 80-cent dollar.

One big influence for me was investing in the Jack in the Box restaurant chain in the early 1990s. I was the first person from the buy-side or sell-side to visit the company after an *E. coli* outbreak at their restaurants had killed four customers and made hundreds more sick. On the plane out to San Diego, I sat next to a woman with her baby who saw all the Jack in the Box material I was reading and asked if I was with the company. She explained how she preferred Burger King, but because her husband was a Jack in the Box fan, they'd switch off between one and the other. I asked what she thought about the *E. coli* problem and, with her baby on her lap, she said she understood it was an accident and that they were still eating there as often as before. The immediate realization was that this company had an opportunity to come back, reputation-wise, but more broadly, it hit home for me that in this country you can make bad mistakes, but if you own up to them and make clear what you're doing to make it right again, you can have another chance. There was obviously more to buying the stock than that, but the company ended up doing the right things and the business came back better than ever. I owned it for eight years, buying around $4 and selling above $20.

I took away two key lessons from that. The first is that it takes a lot to kill a strong, established franchise even if a company loses its way. Think IBM. Think McDonald's. The second is that the right management can make all the difference in whether the business comes back. The strength of the franchise and the quality of management are what I spend most of my time on (*see box*).

What about Warren Buffett's famous quote about which reputation remains intact if a great manager meets a bad business?

LK: While we're very management-focused, we're also very clear on the fact that nobody's going to turn around a bad company in a bad industry. One thing my father taught me at a young age was not to fall in love with companies or the people running them. You look for companies that, despite current challenges, have proven business models, true value propositions, rational competition and a strong balance sheet. Jim Keyes, who turned around 7-Eleven and is the type of CEO we'd follow almost anywhere, took over Blockbuster and ran into a dying industry, an over-leveraged company and a financial crisis. I don't care how good he is, that was not going to be turned around.

Lloyd Khaner

Betting on the Jockeys

Having earned a Masters degree in dramatic writing from New York University and spent time on a screenwriting fellowship at Amblin Entertainment, Steven Spielberg's former production company, Lloyd Khaner knows a thing or two about character development. Thus he's quick to describe the profile of what he considers the ideal turnaround chief executive: "It's usually a first-time CEO, between 48 and 52. They have 25 to 30 years of experience, but have never had a #1 spot before. They're seeking out a challenge, have everything to prove and, while they've surely done very well financially, they probably haven't yet had that huge payday, which they badly want."

Khaner considers his best source of ideas to be the database of some 500 executives he's compiled since entering the business in 1991, made up of what he considers first-class CEOs as well as their current or former top lieutenants. He's automatically pinged when anyone on the list takes a new position, joins a board or otherwise makes news. "It's not fool-proof, but people who have had success reliably put themselves in positions to continue to succeed," he says. "We're often happy to go along for the ride."

Timing would seem to be of paramount importance in betting on turnarounds. How do you think about that?

LK: We actually categorize turnarounds as one-year, three-year or five-year turnarounds, primarily as a discipline to avoid buying too early. The time needed to get a company back on track is usually a function of how long the business has been struggling, how healthy the balance sheet is, how demoralized the culture has become and how healthy the industry is. In a one-year turnaround, for example, the problems have relatively recently surfaced, the balance sheet is still solid and the industry is in pretty good shape. In something like that we're prepared to invest fairly quickly and may exit fairly quickly as well.

Is Starbucks [SBUX] a recent example?

LK: This is one that, in retrospect, we didn't pull the trigger on quickly enough. When the stock got below $10 two years ago, it was just too early for me because the plan to fix things wasn't yet clear, and if that plan included shutting down the growth engine and even pulling back – which I thought was necessary – I wanted to see evidence of that actually happening before buying in. By the time I was convinced they were on the right track the stock was already up 50%, but the good news is I recognized the upside was much higher than a share price of $15. Store experiences have been improved, there are more value-priced menu options, the Via instant-coffee line has been a big hit, and the international growth opportunity, particularly in China, is tremendous. They've taken the McDonald's turnaround playbook, which has played out over several years, and are really only in year two. [*Note*: Starbucks shares recently traded around $36.50.]

Are you much slower to buy into the more arduous turnarounds?

LK: Three-year to five-year turnarounds almost always require a deep infusion of outside management talent, a change in culture, an overhaul of the cost structure and some fairly dramatic shifts in operational execution. We want to identify these potential turnarounds early, but it's often only after a year or two of careful study that we're ready to act. Depending on the situation, we want to see tangible evidence – say, an increase in gross margins, declining inventory levels or reduced operating expenses – that the turnaround is working.

If we believe the shares can double or triple if we're right – which isn't a stretch if earnings and valuations are starting from particularly depressed levels – we have no problem leaving the first bump in the stock price on the table. We're helped by the fact that once the market has given up on a company, it can be quite slow to embrace it again.

ON TIMING:

If we believe the shares can double or triple, we have no problem leaving the first bump in the price on the table.

How would you characterize your timing on Xerox [XRX]?

LK: This is a case where we sat out the classic turnaround phase, executed by previous CEO Anne Mulcahy, but started getting interested when the company acquired business-process outsourcing leader Affiliated Computer Services 18 months ago. We believe ACS is an excellent business and that the acquisition fundamentally changes the character of Xerox to something that is far more interesting than a company fighting against an inexorable decline in black-and-white printing.

We bought six months ago and the stock has done nothing, but we believe the catalyst will be 15-20% earnings growth over the next couple of years, which will allow them to pay down debt and buy back stock. At 8x next year's estimated earnings [based on a recent share price of just under $10], the market is valuing Xerox as if it were another Kodak, which we don't at all believe will prove to be the case.

What are the primary reasons companies don't turn?

LK: The first one is too much debt, which acts like an anchor on companies that have to be so focused on keeping themselves afloat that they can't or don't do the operational things necessary to get back on track.

The second is a dying industry, which you can't overcome. There may be short-term investment opportunity at times when an industry is in decline, but that's not the type of thing I typically want to invest in.

When we spoke five years ago [*VII*, April 28, 2006] you identified Campbell Soup [CPB] as a long-term turnaround, but the stock is trading only marginally higher than it was then. Have you given up on that one?

LK: We actually did OK on the stock when it ran up a bit in late 2006, early 2007, but we haven't owned it for some time. We concluded that soup, which is still the dominant part of the company, just isn't as popular as it once was as a convenient meal. There are so many alternatives and Campbell's hasn't come up with answers on the product side that have resonated enough with consumers to make a big difference. I don't know what would make me interested again. The truth is they'd probably be better off as part of a bigger company, but that's not something I'd want to bet on.

How did the potential revival of drive-in restaurant chain Sonic [SONC] get on your radar screen?

LK: I've paid attention to the company since the 1990s, after management at Jack in the Box told me they considered Sonic the gold standard in the industry for product innovation and operating excellence. It has more than 3,500 restaurants, 87% of which are franchised, with the largest concentration in the south cen-

tral and southeastern U.S. They're known for having better-quality food, car-hop service, a wide beverage selection – nearly 40% of sales come from drinks – and for a willingness to customize any combination of food or drink on their menu. If you want Sprite and root beer and milk mixed together with crushed M&Ms, they'll do it.

The stock was always too expensive until Sonic fell into the classic growth-for-growth's-sake trap, which resulted in kind of an across the board breakdown in operational control, product innovation, marketing effectiveness and, ultimately, profitability. Over the past three years the company has endured the pain of repairing the damage.

Describe the key elements of the turnaround plan.

LK: They stopped all new unit development, closed poorly performing units, increased base pay for company-owned store managers and stressed store cleanliness and efficiency everywhere.

Research and development for product innovation has been increased and they've again started to roll out exciting new products, like a Spicy BBQ Burger, 6-inch all-beef hot dogs with ample toppings for only $1.99, and a new Double Stuf Oreo ice cream dessert that I can attest is fantastic.

They have also carefully rethought pricing and now have a "laddered" menu with more of a value component to go with traditional premium items. This gives the customer more options and should help generate both new and repeat visits. I'd add that the general environment in the quick-service restaurant industry for passing on food and packaging cost increases is better today than it has been in years, with fewer players willing to be the price spoiler in a rising-cost environment.

We believe the turnaround inflection point here is upon us. Last quarter comp sales at company-owned stores went positive for the first time in three years, and the company came out soon after the earnings call to say comp sales growth was accelerating and would probably reach 4-6% this year.

The stock responded nicely to that news, rising 13% on the day of the announcement. Now trading around $11.50, what upside do you see in the shares from here?

LK: Assuming that comp sales grow 3-5% annually over the next three years and that operating leverage kicks in as revenues rise faster than costs and the company benefits from a unique ascending royalty-rate system – in which the percentage royalty paid by franchisees increases as sales rise – we expect annual bottom-line growth in excess of 20% through 2013. By then we're estimating $1 in earnings per share and, because the franchise model requires little in the way of capital spending, $1.35 in free cash flow per share.

What's that worth? I think an 18x multiple on 2013 EPS is more than reasonable, which would result in a share price of $18. Now that store-level service has stabilized and is improving, we think there's a good chance the company can re-engage on unit growth and that they're far from saturating their potential markets. If unit growth re-accelerates, the multiple could be even higher.

INVESTMENT SNAPSHOT

Sonic Corp.
(Nasdaq: SONC)

Business: Operator or franchisor of more than 3,500 quick-service drive-in restaurants located primarily in the south central and southeastern United States.

Share Information
(@5/26/11):

Price	**11.49**
52-Week Range	7.28 – 11.86
Dividend Yield	0.0%
Market Cap	$710.1 million

Financials (TTM):

Revenue	$543.8 million
Operating Profit Margin	15.3%
Net Profit Margin	5.0%

Valuation Metrics
(@5/26/11):

	SONC	Russell 2000
Trailing P/E	26.1	49.5
Forward P/E Est.	21.7	22.5

Largest Institutional Owners
(@3/31/11):

Company	% Owned
Fidelity Mgmt & Research	14.6%
Wellington Mgmt	9.5%
Invesco	8.0%
Dreman Value Mgmt	5.8%
Deustche Bank	4.9%

Short Interest (as of 5/13/11):

Shares Short/Float	12.9%

THE BOTTOM LINE

The market is underestimating the scope and speed of the company's broad-based turnaround after it fell into a growth-for-growth's-sake trap, says Lloyd Khaner. Assuming solid comp-store sales growth and significant operating leverage, he expects $1 in estimated 2013 EPS to warrant a target share price of $18 within two years.

Sources: Company reports, other publicly available information

It's interesting that the long-time CEO, Cliff Hudson, led the turnaround. Is that unusual?

LK: It can certainly happen. People like Cliff, who has been Sonic's CEO since 1995, don't like losing and can bring a real fire to getting things back on track. It's important to note, though, that he did over the last three years name a new head of company-owned stores, a new head of marketing and a new head of information technology. Some new blood is often important in refreshing and refocusing the overall leadership.

What's the investment case for one of your non-turnaround ideas, Och-Ziff Capital Management [OZM]?

LK: Och-Ziff is one of the largest institutional alternative asset managers, with approximately $29 billion in assets under management. For clients around the world, it operates four primary investment funds that employ a wide variety of strategies, including convertible and derivative arbitrage, fixed income, long/short equity, merger arbitrage and structured credit.

The company runs truly "hedged" funds that typically have 120-130% long exposure offset with an 80-90% short exposure. Based on their strategy and backed up by strong historical performance, they offer the kind of "I can sleep at night" investment options that large institutions often crave. For that, they are paid on a traditional hedge fund scale, earning an average 1.75% management fee and 20% of annual appreciation as an incentive fee.

That all makes for a highly scalable and profitable business. As assets grow, expenses don't at all grow commensurately once you reach critical mass, which Och-Ziff reached a long time ago. Based on "economic income," which excludes non-cash charges from the reorganization it did prior to going public in 2007, the company's operating margins are in the mid-50% range and we believe are likely headed over 60% for the year ending in December.

This may provoke an admittedly self-serving answer, but what makes you optimistic about the future of the hedge fund business?

LK: As evidenced by their performance, hedge funds by and large protected investors much better during the financial crisis than non-hedged asset managers. In a world that financial-market-wise is not going to be a safe place for some time, we believe managers like Och-Ziff will prove to be a magnet for institutional assets. Their funds were down far less than the market in 2008, more than made up any losses in 2009 and, importantly, they never put up any "gates" to client withdrawals when the crisis was at its worst. In general we've heard from clients that the company was highly transparent and responsive throughout the crisis, a reputation you want to have when managing other people's money.

Another factor in favor of alternative managers is the fact that institutions have been sitting on very large fixed-income allocations that are going to have to be redeployed. With interest rates and the prospects for capital appreciation so low, pension funds and other similar institutions will have a hard time meeting obligations with too much fixed income.

INVESTMENT SNAPSHOT

Och-Ziff Capital Management
(NYSE: OZM)

Business: Investment manager offering a range of hedge funds focused on credit, equity, special situations, convertible and merger arbitrage, and private investments.

Share Information
(@5/26/11):

Price	**14.59**
52-Week Range	11.74 – 17.56
Dividend Yield	3.6%
Market Cap	$1.41 billion

Financials (TTM):

Revenue	$953.5 million
Operating Profit Margin	51.3%
Net Profit Margin	(-31.6%)

Valuation Metrics
(@5/26/11):

	OZM	S&P 500
Trailing P/E	n/a	16.6
Forward P/E Est.	9.9	13.5

Largest Institutional Owners
(@3/31/11):

Company	% Owned
Bank of NY Mellon	3.1%
T. Rowe Price	2.8%
Thornburg Inv Mgmt	2.6%
HSBC Holdings	2.3%
Century Capital	2.3%

Short Interest (as of 5/13/11):

Shares Short/Float	5.1%

THE BOTTOM LINE

Lloyd Khaner believes the company will be a prime beneficiary as institutional investors seek greater stability of returns and reallocate low-potential fixed-income holdings to alternative asset managers. The shares currently trade at 55% of his $27 target price, and he estimates they'll earn a dividend yield on this year's company earnings of 8.5%.

Sources: Company reports, other publicly available information

Inflows have been positive – hitting $2.7 billion last year for OZM – and while it's impossible to be precise about timing, we believe money could come in at a much faster clip over the next couple of years. Ultimately, there's no reason why the company can't manage more than twice the assets it currently does.

With the shares at recent $14.60 – down more than 50% from the 2007 IPO – how are you looking at valuation?

LK: Wall Street assigns different multiples to alternative asset managers' management-fee and incentive-fee streams. The management fees might earn a 19x multiple, while the more volatile incentive fees earn more like 9x. In OZM's case, we believe the resulting blended multiple of around 13x is unfair, because its incentive fees won't be as volatile as those of other publicly traded alternative managers, most of which are private equity firms.

So using a more reasonable 15x multiple on our 2012 EPS estimate of just over $1.80, we get a target price of more than $27. On top of that, because OZM is a master limited partnership, it has to pay out a high percentage of its earnings as a distribution to shareholders. Assuming an 85% payout, the dividend yield on our 2011 estimate is 8.5%, and on our 2012 estimate is 10.3%.

The biggest risks?

LK: There is some risk that the hedge fund compensation model comes under attack, but the company says they've had more pushback on management fees, which are a much lower percentage of total revenue, than on incentive fees. In general, if people are satisfied with their returns, they have tended to let people get paid what they're paid.

There is also a risk that the tax rate on "carried interest" is increased, which would affect the earnings available to shareholders. I don't have a crystal ball on this issue, but those affected are likely to have up to a 10-year transition period to implement any change. It's obviously something we're keeping our eye on.

Another thing I'd add is that the alignment of Och-Ziff's partners here with those of shareholders is the best I've ever seen in my career. The 19 partners take no salary or bonus, participating in the company's success in the same way we do, as shareholders receiving distributions and benefiting from any appreciation in the stock price.

From hedge funds to software, describe your investment case for Cadence Design Systems [CDNS].

LK: Cadence is a leading global supplier of electronic design automation (EDA) software. EDA software helps companies like Texas Instruments, Intel and Samsung design and manufacture computer chips and printed circuit boards, allowing them to see in advance things like how prospective new chips will perform, whether they'll be compatible within systems, and how much power they'll use. This helps save time and money in the product-development process, which is critical in an environment where the technology has to constantly evolve to meet the needs of end-product computer and smartphone manufacturers.

We started tracking the company in 2007 when Lip-Bu Tan came off the

INVESTMENT SNAPSHOT

Cadence Design Systems
(Nasdaq: CDNS)

Business: Global supplier of software and design tools that help engineers plan, lay out, simulate and verify designs of a wide variety of semiconductors.

Share Information
(@5/26/11):

Price	**10.64**
52-Week Range	5.58 – 11.07
Dividend Yield	0.0%
Market Cap	$2.86 billion

Financials (TTM):

Revenue	$980.1 million
Operating Profit Margin	2.2%
Net Profit Margin	14.8%

Valuation Metrics
(@5/26/11):

	CDNS	Russell 2000
Trailing P/E	19.8	49.5
Forward P/E Est.	26.0	22.5

Largest Institutional Owners
(@3/31/11):

Company	% Owned
Dodge & Cox	16.5%
T. Rowe Price	4.9%
Wellington Mgmt	4.8%
Vanguard Group	4.7%
State Street Corp	2.8%

Short Interest (as of 5/13/11):

Shares Short/Float	9.2%

CDNS PRICE HISTORY

THE BOTTOM LINE

Having implemented a new revenue model, cut costs, and tailored R&D more to customer needs, the company is well-positioned to benefit from what Lloyd Khaner expects to be a positive mobile-device-driven cycle for semiconductors. At 13.5x his 2012 earnings estimate, the shares within 12 to 18 months would trade around $17.

Sources: Company reports, other publicly available information

board to run the company and began cutting operating expenses, refocusing R&D based on closer customer contact, and moving the revenue model to subscription-based payments over a contract life rather than one-time upfront payments. We didn't buy in until last year, though, when we saw bookings start to grow again after a painful decline prompted mainly by the revenue-model switch.

In general, in a business where labor is the largest expense, operating leverage is very high. On top of that here we have costs having been cut and customers successfully migrated to higher-margin subscription contracts. As a result, we think margins are set to take off if revenues grow at the 10-15% annual rate we expect. Management believes, and we agree, that this should eventually be a 25-30% operating-margin business.

What's driving revenue growth?

LK: The semiconductor industry is clearly volatile, but we think there's a strong tailwind for the business from the current upturn in global technology spending and the explosive growth in mobile devices. We consider Cadence a "picks and shovels" way to play that growth – it provides tools that semiconductor product manufacturers desperately need, but it has less technology risk because they can stay device and end-market agnostic.

Is industry competition rational?

LK: The EDA industry has consolidated into an oligopoly led by Cadence, Synopsys, Mentor Graphics and Magma Design. Pricing is more likely to remain rational as a result of consolidation and the fact that the shift to subscription-based revenue takes away some of the quarter-to-quarter jockeying to sign new business by making unprofitable price concessions.

How inexpensive are the shares at a recent $10.65?

LK: We value the shares based on free cash flow, which is higher than net income because depreciation and amortization charges are roughly double capital expenditures. From 56 cents per share in 2010, we estimate Cadence can earn 90 cents to $1 in free cash flow this year and $1.25 in 2012. Based on peer and historical multiples, we believe 13.5x the 2012 number is reasonable, which would produce a share price in the next 12 to 18 months of around $17.

The main risk short-term is that the semiconductor industry takes a turn for the worse. But we wouldn't expect that to change the long-term demand picture for Cadence, and are comfortable the company can ride out any industry volatility. It should have almost $800 million in cash on the balance sheet by the end of this year, while debt – most of which is in out-of-the-money convertible shares – should only be around $600 million.

What do you think the market is missing in Illinois Tool Works [ITW]?

LK: This has always been a good company, but we believe is about to prove it's a great company. It's a multinational manufacturer of a wide range of industrial products and equipment, with 800 operating companies aggregated into eight reportable segments: Transportation,

INVESTMENT SNAPSHOT

Illinois Tool Works
(NYSE: ITW)

Business: Broadly diversified manufacturer of industrial products, systems and equipment, operating through more than 800 decentralized business units worldwide.

Share Information
(@5/26/11):

Price	**56.99**
52-Week Range	40.33 – 58.79
Dividend Yield	2.4%
Market Cap	$28.5 billion

Financials (TTM):

Revenue	$16.52 billion
Operating Profit Margin	15.1%
Net Profit Margin	11.0%

Valuation Metrics
(@5/26/11):

	ITW	S&P 500
Trailing P/E	15.8	16.6
Forward P/E Est.	14.5	13.5

Largest Institutional Owners
(@3/31/11):

Company	% Owned
Northern Trust	8.8%
State Farm	4.5%
Vanguard Group	3.8%
Wellington Mgmt	3.5%
State Street Corp	3.4%

Short Interest (as of 5/13/11):

Shares Short/Float	2.4%

THE BOTTOM LINE

Having aggressively restructured itself during the economic crisis – including making new investments – the company is poised to "blow through" new records for revenues, margins and earnings per share over the next few years, says Lloyd Khaner. At 15x his 2012 per-share earnings estimate of $5, his target price for the shares is $75.

Sources: Company reports, other publicly available information

Industrial Packaging, Power Systems and Electronics, Polymers and Fluids, Food Equipment, Construction Products, Decorative Surfaces, and All Other (which includes a thriving Test and Measurement business). It operates in 57 countries, with 48% of revenues coming from North America, 32% from Europe, the Middle East and Africa, and 20% from Asia Pacific and everywhere else.

While most companies fought to survive during the crisis of 2008-09, ITW aggressively restructured itself through cost-cutting, divesting underperforming operations, expanding through acquisition in higher-growth and higher-margin end-markets and geographies, and buying back its undervalued stock. Revenues increased more than 10% in 2010, even though one key end-market – U.S. residential and commercial construction – was still very weak. As the global economy continues to mend, we expect the company to set records for revenues, margins and earnings over the next couple of years.

What assumptions are you making about profitability?

LK: We're assuming 10-15% annual growth in revenues, split roughly between organic growth and acquisitions. With that growth and the permanent removal of costs in the restructuring, we think operating margins can top 18% by 2012. From earnings of $3.08 per share in 2010, we're estimating $4 this year and $5 next year.

How does that translate into potential upside for the shares, now at around $57?

LK: Given the 10%-plus revenue growth and 20%-plus EPS growth we're expecting, we consider a 15x earnings multiple to be conservative. Applying that to our 2012 earnings estimate, our price target a year out is around $75. That assumes no big stock buyback plans or a dividend increase, both of which are certainly on the table as management looks to allocate the $1.5 billion or so in free cash flow ITW will generate this year.

We've seen ITW show up on the ubiquitous "potential Berkshire Hathaway acquisition" lists that get published from time to time. Why do you think that is?

LK: The main reason is probably that it's a superb return-on-invested-capital company that often doesn't get the respect it deserves from the market. It's ROIC averages 15-17% during cyclical upturns, even though that number gets hit by high levels of goodwill from the company having done so many acquisitions over time.

ON GOLD:

We still own it, but we've had two years without a significant price correction and we might be due for one.

A better reason to me is that the company follows the highly decentralized Berkshire operating model and does an excellent job of identifying accretive acquisitions. No one has or will ask me, but I'd argue that ITW CEO David Speer, who started at the company in 1978, would actually make a great choice as the next person to run Berkshire's operations.

When we last spoke in 2006, you were betting against mortgage originators, saying "it's not going to be pretty as housing prices and/or the economy go south." Nice call – any similar insights today?

LK: It's not as much of a sector-wide bet, but we do believe certain retailers that have no real unique selling proposition and have too many stores that are too big – we call them "commodity retailers" – are going to get their lunch eaten long-term by online retailers and by specialty and discount stores. Real estate values propped the stocks up for some time, but that hasn't proven to be as valuable as people once thought. It's not the only one we see in this boat, but it's hard for us to see how Sears [SHLD], for example, is going to be successful over time.

I'd mention that I prefer to hedge using put options rather than shorting. Options have their challenges because the pricing can be volatile – premiums for the most part are too high now – and because you have to get the timing right, but we like to know how much we can lose if we're wrong, which isn't the case in shorting.

You also last time touted the virtues of gold, which has turned out pretty well. What's your take on it now?

LK: We still own it, but have cut back. I still consider gold a good long-term hedge against inflation and geopolitical risk, but I would not be surprised, in an improving global economy where the dollar stops depreciating, if gold prices stayed where they were or corrected, maybe significantly. Until 2009, gold regularly had intra-year corrections of 20% or more two or three times a year – it is, after all, a commodity. Now we've had two years without a significant correction and, short-term, we might be due for one.

You write a column for Minyanville.com called "Lloyd's Wall of Worry." Why?

LK: I've actually gone through the basic process for 20 years, identifying the major things I believe are worrying equity markets worldwide, such as QE II going away, rising oil prices or sovereign debt problems. It's my way of putting somewhat of a macro overlay on my 100% company-focused investing.

This is hardly scientific, but I've found that when I can list more than 20 fundamental market concerns, that high level of worry is usually priced into the market and it's proven to be a good time to be looking for value. If I can identify no more than 10 big concerns, the market is overly complacent.

So what's the "Wall of Worry" indicator saying today?

LK: My latest list has 20 items. There's plenty to worry about – which may explain why I'm finding quite a few values out there. VII