

“There is no royal road to learning; no short cut to the acquirement of any art.” –Anthony Trollope

*These notes resume the professor’s introduction and definition of terms. The professor stressed studying carefully the essays of Warren Buffett (I highly recommend purchasing the Essays of Warren Buffett. Go here:*

*[http://www.amazon.com/Essays-Warren-Buffett-Lessons-Corporate/dp/0966446127/ref=sr\\_1\\_1?ie=UTF8&s=books&qid=1299603327&sr=1-1-spell by Con.](http://www.amazon.com/Essays-Warren-Buffett-Lessons-Corporate/dp/0966446127/ref=sr_1_1?ie=UTF8&s=books&qid=1299603327&sr=1-1-spell by Con.)*

*A case study to value/analyze **Duff & Phelps** is assigned. Try to do the exercise yourself. All errors are the fault of the note-taker.*

## Class #2

Sept. 14, 2005

Some definitions of **Free Cash Flow** = EBIT – Maintenance Capital Expenditures (MCX) – annual changes in working capital. Changes in annual working capital (WC) are due to working capital changes needed for growth. You need to separate the different types of capex—capex for maintenance and for growth.

I (*Great Investor/Professor*) can’t emphasize enough my recommendation to study the *Value Investor’s Club* because **you can obtain more experience and learn from other’s mistakes**. Go to [www.valueinvestorsclub.com](http://www.valueinvestorsclub.com). A learning tool. Read the ideas rated 5.7 and higher especially with more than 10 recommendations.

I downloaded all the Buffett Letters from Berkshire’s Web-site and then used Google Desktop to search through for any topic.

### Assignment:

I left you with the magic formula last week. Next Week *Richard Pzena* will talk about (*Lear Corporation*) and read *Haugen* book—focus on the concepts. Go here:

[http://www.amazon.com/Inefficient-Stock-Market-Robert-Haugen/dp/0130323667/ref=sr\\_1\\_4?ie=UTF8&s=books&qid=1299603739&sr=1-4](http://www.amazon.com/Inefficient-Stock-Market-Robert-Haugen/dp/0130323667/ref=sr_1_4?ie=UTF8&s=books&qid=1299603739&sr=1-4).

Prepare *Lear Corp.*

An updated chart from last week’s class. Cycles of Value Investing Aug. 2005 (Go to [www.pzena.com](http://www.pzena.com) then click on research to find examples of value investing cycles. Also, go to [www.centman.com](http://www.centman.com) and peruse that web-site).

Aug. 95 to Feb. 2000: a very tough time for value investors; you remember the *Internet* phase. Even if you had a great company with excellent prospects, the market didn’t pay for it. S&P 500 up 163% cumulatively vs. up 91% for Value Investors—72% underperformance. If you are running a fund and you beat the value index, the lowest 20% in BV, you would have underperformed by 70% to 60% over five years. If that happens, people leave. Even *Richard Pzena*, whose firm runs \$50 billion dollars, in March 2000, most of his investors had left. His performance since that time has been so phenomenal. (*Pzena’s fund took another beating in the 2007/2009 credit crisis as Citibank and other financial companies like AIG declined by over 75%*).

From March of 2000 until today, value has outperformed the S&P 500 by 175% and *Pzena* did much better than that. **People left at the wrong time as usual.** If you stick to your guns and your clients don't you can understand the pressures on a manager. You are looking at a chart through four years and say you will stick it out through the value cycle, but that is an awfully long time and many don't survive. Some value managers cheated with a value tilt to the S&P, and they got clobbered. They were cheating to hang in there. Even surviving long term with this simple value model is tough.

*The reader should take a step back and think of the human irony here. Equities have no due date like bonds; equities are perpetual; equities are long-dated financial instruments that confer ownership rights to companies. Therefore, judging the performance of a company within just a twelve or 18 month perspective is lacking in common sense. However most of Wall Street focuses on the next quarter and the coming year. Recency bias can cause analytical distortions.*

This may seem like a minor point, but this is the whole story. Really what **I am always doing is valuing the company when I can.** *The professor is a little like the detective in the TV series, Columbo—keep it simple.*

What happens if it is very difficult to value a company? **Do something else.** That is a very powerful concept if you have the luxury of looking at something else.

The guarantee I made last week is that if your valuation is right, it will usually only take *Mr. Market* two or three years at most—sometimes a lot faster—to get it right. **Do good valuation work by picking your spots and finding what you can do.**

*However, as a non-gifted investor what the professor is telling the class is easier said than done. The investor must know and develop a circle of competence. The investor must know what he knows and what he doesn't. To acquire that knowledge will take experience and self-reflection.*

The way I define value is not low price to book or P/E but **intrinsic value.** You can see price/book has gotten a little less robust over time from out performing at 6% to 3.1% CAGR.

We are talking about the disparity in performance.

The lesser importance of assets with service businesses as in the past industrial period—perhaps a reason **why book value may be losing its importance.**

I analyze each company from the bottom up. I am very value driven  
I don't predict under or out performance of the value cycle.

## **MAGIC FORMULAS**

1. **WHAT YOU PAY:** “Normalized” EBIT/Enterprise Value (What I pay or pre-tax earnings yield). You would value EBIT higher if tax revenues are lower due to a permanent tax change. Take the after-tax yield and see what the differences are. Is EBIT representative of true cash flow. EBIT is a short hand for EBITDA – Maintenance Capex. Different capitalization can skew net income. Differences in tax rates. Using EBIT is a way to compare apples to apples.
2. **WHAT YOU EARN:** EBIT/(NWC + NFA) the denominator shows what I need to invest in the business to get that EBIT. Don't forget to normalize investment capital over the course of a year. What I earn.

I told you about my “magic” formula as my starting point for looking at companies.

**Professor:** You bring up a very important point. These are totally two different things.

This is how much I earn based on what I paid for it (EBIT/EV).

This is what I earn based on what the company paid for the assets that created those earnings (EBIT/IC or (NWC + NFA). Those are two totally separate concepts.

Return on the capital they made on the past. So what? Incremental dollars will make good returns but not as high as they made in the past. I may earn 60% ROIC on the new store versus 70% previously in the old store, but there are no other places to earn as high a return so I will still build that store. But if my pretax returns are between 15% and 20%, it doesn’t take too much to tip the balance against investment.

**NORMALIZATION**

Use normalized EBIT. Look at the normal environment. **This is the art part.** What I think a normal environment might be. There is nothing special going on in regards to the company or the economy. Obviously it is an assessment now we are into the art part of determining “normalized”. For example, the recent credit crisis and real estate collapse may mean large changes to what is a “normal” operating environment for the financial and housing industries. Perhaps these adjustments are too difficult for YOU to make, so you do not invest there.

Here is normalized EBIT divided by capital invested in the business. This is my best guesstimate of what type of business do I have?

When I ran a defense business I had a lot of contact with investment bankers who were pitching acquisitions. They would say, “Well, you can add 20 cents to earnings and make a non-dilutive acquisition by acquiring a business at 9 x EBIT earning 11% pre-tax and that is about flat in growth while borrowing 9.5% partly fixed and partly variable. The spread is 1.5%. Is this worth it for a crappy business? No.

**They slapped on the same multiple we had before even though we would be a lot more levered.** The investment bankers had a 400 page report with a nice cover on it, but when you get down to it, this is the bet you are taking. It looks like a bad bet. *Never slap a multiple on something because a multiple is just a DCF dressed in drag.*

Boil the analysis all down to its essence—**is it a good business at a good price?** Is the bet worth it?

Don’t throw out logic. Ask one simple question. How much do I have to pay? How much am I earning? Do I need to take this risk?

If you have to continually make acquisitions to grow, then it is a different animal.

	Company A	Company
<b>Current Assets</b>	3	3
<b>Fixed Assets</b>	2	7
<b>Goodwill</b>	5	0
<b>Current Liabilities</b>	1	1
<b>Book Value</b>	\$9	\$9
<b>Earnings \$2.00 per share in cash</b>		
<b>Return on Tangible Capital</b>	50%	22%

You are earning 50% on tangible capital (\$2/\$4) unless you have to add acquisitions to get future growth. All you have to replace is fixed assets. Your capital spending will be confined to replacing fixed assets. You don't have to keep replacing Goodwill. Goodwill is a past cost. (See Warren Buffett's writing in the 1983 Annual Report of Berkshire Hathaway on amortization and intangible assets).

This took me a long time to learn, but if I had read Buffett's letter in 1983, then I would have learned this sooner.

### 1983 Berkshire Hathaway Shareholder Letter: Corporate Performance

During 1983 our book value increased from \$737.43 per share to \$975.83 per share, or by 32%. We never take the one-year figure very seriously. After all, why should the time required for a planet to circle the sun synchronize precisely with the time required for business actions to pay off? Instead, we recommend not less than a five-year test as a rough yardstick of economic performance. Red lights should start flashing if the five-year average annual gain falls much below the return on equity earned over the period by American industry in aggregate. (Watch out for our explanation if that occurs as Goethe observed, "When ideas fail, words come in very handy.")

During the 19-year tenure of present management, book value has grown from \$19.46 per share to \$975.83, or 22.6% compounded annually. Considering our present size, nothing close to this rate of return can be sustained. Those who believe otherwise should pursue a career in sales, but avoid one in mathematics.

We report our progress in terms of book value because in our case (though not, by any means, in all cases) it is a conservative but reasonably adequate proxy for growth in intrinsic business value - *the measurement that really counts*. Book value's virtue as a score-keeping measure is that it is easy to calculate and doesn't involve the subjective (but important) judgments employed in calculation of intrinsic business value. It is important to understand, however, that the two terms - **book value** and **intrinsic business value** - have very different meanings.

Book value is an accounting concept, recording the accumulated financial input from both contributed capital and retained earnings. Intrinsic business value is an economic concept, estimating future cash output discounted to present value. Book value tells you what has been put in; intrinsic business value estimates what can be taken out.

An analogy will suggest the difference. Assume you spend identical amounts putting each of two children through college. The book value (measured by financial input) of each child's education would be the same. But the present value of the future payoff (the intrinsic business value) might vary enormously - from zero to many times the cost of the education. So, also, do businesses having equal financial input end up with wide variations in value.

At Berkshire, at the beginning of fiscal 1965 when the present management took over, the \$19.46 per share book value considerably overstated intrinsic business value. All of that book value consisted of textile assets that could not earn, on average, anything close to an appropriate rate of return. In the terms of our analogy, the investment in textile assets resembled investment in a largely-wasted education.

Now, however, our intrinsic business value considerably exceeds book value. There are two major reasons:

(1) Standard accounting principles require that common stocks held by our insurance subsidiaries be stated on our books at market value, but that other stocks we own be carried at the lower of aggregate cost or market. At the end of 1983, the market value of this latter group exceeded carrying value by \$70 million pre-tax, or about \$50 million after tax. This excess belongs in our intrinsic business value, but is not included in the calculation of book value;

(2) More important, we own several businesses that possess economic Goodwill (which is properly includable in intrinsic business value) far larger than The accounting Goodwill that is carried on our balance sheet and reflected in book value.

Goodwill, both economic and accounting, is an arcane subject and requires more explanation than is appropriate here. The appendix that follows this letter - "Goodwill and its Amortization: The Rules and The Realities" - explains why economic and accounting Goodwill can, and usually do, differ enormously.

You can live a full and rewarding life without ever thinking about Goodwill and its amortization. But students of investment and management should understand the nuances of the subject. My own thinking has changed drastically from 35 years ago when I was taught to favor tangible assets and to shun businesses whose value depended largely upon economic Goodwill. This bias caused me to make many important business mistakes of omission, although relatively few of commission.

Keynes identified my problem: "The difficulty lies not in the new ideas but in escaping from the old ones." My escape was long delayed, in part because most of what I had been taught by the same teacher had been (and continues to be) so extraordinarily valuable. Ultimately, business experience, direct and vicarious, produced my present strong preference for businesses that possess large amounts of enduring Goodwill and that utilize a minimum of tangible assets.

I recommend the Appendix to those who are comfortable with accounting terminology and who have an interest in understanding the business aspects of Goodwill. Whether or not you wish to tackle the Appendix, you should be aware that Charlie and I believe that Berkshire possesses very significant economic Goodwill value above that reflected in our book value.

### **Goodwill and its Amortization: The Rules and the Realities**

This appendix deals only with **economic** and **accounting Goodwill** – not the goodwill of everyday usage. For example, a business may be well liked, even loved, by most of its customers but possess no economic goodwill. (AT&T, before the breakup, was generally well thought of, but possessed not a dime of economic Goodwill.) And, regrettably, a business may be disliked by its customers but possess substantial, and growing, economic Goodwill. So, just for the moment, forget emotions and focus only on economics and accounting.

When a business is purchased, accounting principles require that the purchase price first be assigned to the fair value of the identifiable assets that are acquired. Frequently the sum of the fair values put on the assets (after the deduction of liabilities) is less than the total purchase price of the business. In that case, the difference is assigned to an asset account entitled "excess of cost over equity in net assets acquired". To avoid constant repetition of this mouthful, we will substitute "Goodwill".

Accounting Goodwill arising from businesses purchased before November 1970 has a special standing. Except under rare circumstances, it can remain an asset on the balance sheet as long as the business bought is retained. That means no amortization charges to gradually extinguish that asset need be made against earnings.

The case is different, however, with purchases made from November 1970 on. When these create Goodwill, it must be amortized over not more than 40 years through charges – of equal amount in every year – to the earnings account. Since 40 years is the maximum period allowed, 40 years is what managements (including us) usually elect. This annual charge to earnings is not allowed as a tax deduction and, thus, has an effect on after-tax income that is roughly double that of most other expenses.

That's how accounting Goodwill works. To see how it differs from economic reality, let's look at an example close at hand. We'll round some figures, and greatly oversimplify, to make the example easier to follow. We'll also mention some implications for investors and managers.

Blue Chip Stamps bought See's early in 1972 for \$25 million, at which time See's had about \$8 million of net tangible assets. (Throughout this discussion, accounts receivable will be classified as tangible assets, a definition proper for business analysis.) This level of tangible assets was adequate to conduct the business without use of debt, except for short periods seasonally. See's was earning about \$2 million after tax at the time, and such earnings seemed conservatively representative of future earning power in constant 1972 dollars.

Thus our first lesson: businesses logically are worth far more than net tangible assets when they can be expected to produce earnings on such assets considerably in excess of market rates of return. The capitalized value of this excess return is economic Goodwill.

In 1972 (and now) relatively few businesses could be expected to consistently earn the 25% after tax on net tangible assets that was earned by See's – doing it, furthermore, with conservative accounting and no financial leverage. It was not the fair market value of the inventories, receivables or fixed assets that produced the premium rates of return. Rather it was a combination of intangible assets, particularly a pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with both product and personnel.

Such a reputation creates a consumer franchise that allows the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price. Consumer franchises are a prime source of economic Goodwill. Other sources include governmental franchises not subject to profit regulation, such as television stations, and an enduring position as the low cost producer in an industry.

Let's return to the accounting in the See's example. Blue Chip's purchase of See's at \$17 million over net tangible assets required that a Goodwill account of this amount be established as an asset on Blue Chip's books and that \$425,000 be charged to income annually for 40 years to amortize that asset. By 1983, after 11 years of such charges, the \$17 million had been reduced to about \$12.5 million. Berkshire, meanwhile, owned 60% of Blue Chip and, therefore, also 60% of See's. This ownership meant that Berkshire's balance sheet reflected 60% of See's Goodwill, or about \$7.5 million.

In 1983 Berkshire acquired the rest of Blue Chip in a merger that required purchase accounting as contrasted to the "pooling" treatment allowed for some mergers. Under purchase accounting, the "fair value" of the shares we gave to (or "paid") Blue Chip holders had to be spread over the net assets acquired from Blue Chip. This "fair value" was measured, as it almost always is when public companies use their shares to make acquisitions, by the market value of the shares given up.

The assets "purchased" consisted of 40% of everything owned by Blue Chip (as noted, Berkshire already owned the other 60%). What Berkshire "paid" was more than the net identifiable assets we received by \$51.7 million, and was assigned to two pieces of Goodwill: \$28.4 million to See's and \$23.3 million to Buffalo Evening News.

After the merger, therefore, Berkshire was left with a Goodwill asset for See's that had two components: the \$7.5 million remaining from the 1971 purchase, and \$28.4 million newly created by the 40% "purchased" in 1983. Our amortization charge now will be about \$1.0 million for the next 28 years, and \$.7 million for the following 12 years, 2002 through 2013.

In other words, different purchase dates and prices have given us vastly different asset values and amortization charges for two pieces of the same asset. (We repeat our usual disclaimer: we have no better accounting system to suggest. The problems to be dealt with are mind boggling and require arbitrary rules.)

But what are the economic realities? One reality is that the amortization charges that have been deducted as costs in the earnings statement each year since acquisition of See's were not true economic costs. We know that because See's last year earned \$13 million after taxes on about \$20 million of net tangible assets – a performance indicating the existence of economic Goodwill far larger than the total original cost of our accounting Goodwill. In other words, while accounting Goodwill regularly decreased from the moment of purchase, economic Goodwill increased in irregular but very substantial fashion.

Another reality is that annual amortization charges in the future will not correspond to economic costs. It is possible, of course, that See's economic Goodwill will disappear. But it won't shrink in even decrements or anything remotely resembling them. What is more likely is that the Goodwill will *increase* – in current, if not in constant, dollars – because of inflation.

That probability exists because true economic Goodwill tends to rise in nominal value proportionally with inflation. To illustrate how this works, let's contrast a See's kind of business with a more mundane business. When we purchased See's in 1972, it will be recalled, it was earning about \$2 million on \$8 million of net tangible assets. Let us assume that our hypothetical mundane business then had \$2 million of earnings also, but needed \$18 million in net tangible assets for normal operations. Earning only 11% on required tangible assets, that mundane business would possess little or no economic Goodwill.

A business like that, therefore, might well have sold for the value of its net tangible assets, or for \$18 million. In contrast, we paid \$25 million for See's, even though it had no more in earnings and less than half as much in "honest-to-God" assets. Could less really have been more, as our purchase price implied? The answer is "yes" – *even if both businesses were expected to have flat unit volume* – as long as you anticipated, as we did in 1972, a world of continuous inflation.

To understand why, imagine the effect that a doubling of the price level would subsequently have on the two businesses. Both would need to double their nominal earnings to \$4 million to keep themselves even with inflation. This would seem to be no great trick: just sell the same number of units at double earlier prices and, assuming profit margins remain unchanged, profits also must double.

But, crucially, to bring that about, both businesses probably would have to double their nominal investment in net tangible assets, since that is the kind of economic requirement that inflation usually imposes on businesses, both good and bad. A doubling of dollar sales means correspondingly more dollars must be employed immediately in receivables and inventories. Dollars employed in fixed assets will respond more slowly to inflation, but probably just as surely. And all of this inflation-required investment will produce no improvement in rate of return. The motivation for this investment is the survival of the business, not the prosperity of the owner.

Remember, however, that See's had net tangible assets of only \$8 million. So it would only have had to commit an additional \$8 million to finance the capital needs imposed by inflation. The mundane business, meanwhile, had a burden over twice as large – a need for \$18 million of additional capital.

After the dust had settled, the mundane business, now earning \$4 million annually, might still be worth the value of its tangible assets, or \$36 million. That means its owners would have gained only a dollar of nominal value for every new dollar invested. (This is the same dollar-for-dollar result they would have achieved if they had added money to a savings account.)

See's, however, also earning \$4 million, might be worth \$50 million if valued (as it logically would be) on the same basis as it was at the time of our purchase. So it would have gained \$25 million in nominal value while the owners were putting up only \$8 million in additional capital – over \$3 of nominal value gained for each \$1 invested.

Remember, even so, that the owners of the See's kind of business were forced by inflation to ante up \$8 million in additional capital just to stay even in real profits. Any unleveraged business that requires some net tangible assets to operate (and almost all do) is hurt by inflation. Businesses needing little in the way of tangible assets simply are hurt the least.

And that fact, of course, has been hard for many people to grasp. For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.

In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses. This phenomenon has been particularly evident in the communications

business. That business has required little in the way of tangible investment – yet its franchises have endured. During inflation, Goodwill is the gift that keeps giving.

But that statement applies, naturally, only to true economic Goodwill. Spurious accounting Goodwill – and there is plenty of it around – is another matter. When an overexcited management purchases a business at a silly price, the same accounting niceties described earlier are observed. Because it can't go anywhere else, the silliness ends up in the Goodwill account. Considering the lack of managerial discipline that created the account, under such circumstances it might better be labeled "No-Will". Whatever the term, the 40-year ritual typically is observed and the adrenalin so capitalized remains on the books as an "asset" just as if the acquisition had been a sensible one.

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If you cling to any belief that accounting treatment of Goodwill is the best measure of economic reality, I suggest one final item to ponder.

Assume a company with \$20 per share of net worth, all tangible assets. Further assume the company has internally developed some magnificent consumer franchise, or that it was fortunate enough to obtain some important television stations by original FCC grant. Therefore, it earns a great deal on tangible assets, say \$5 per share, or 25%.

With such economics, it might sell for \$100 per share or more, and it might well also bring that price in a negotiated sale of the entire business.

Assume an investor buys the stock at \$100 per share, paying in effect \$80 per share for Goodwill (just as would a corporate purchaser buying the whole company). Should the investor impute a \$2 per share amortization charge annually (\$80 divided by 40 years) to calculate "true" earnings per share? And, if so, should the new "true" earnings of \$3 per share cause him to rethink his purchase price?

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We believe managers and investors alike should view **intangible assets** from two perspectives:

1. In analysis of operating results – that is, in evaluating the underlying economics of a business unit – amortization charges should be ignored. What a business can be expected to earn on unleveraged net tangible assets, excluding any charges against earnings for amortization of Goodwill, is the best guide to the economic attractiveness of the operation. It is also the best guide to the current value of the operation's economic Goodwill.
1. In evaluating the wisdom of business acquisitions, amortization charges should be ignored also. They should be deducted neither from earnings nor from the cost of the business. This means forever viewing purchased Goodwill at its full cost, before any amortization. Furthermore, cost should be defined as including the full intrinsic business value – not just the recorded accounting value – of all consideration given, irrespective of market prices of the securities involved at the time of merger and irrespective of whether pooling treatment was allowed. For example, what we truly paid in the Blue Chip merger for 40% of the Goodwill of See's and the News was considerably more than the \$51.7 million entered on our books. This disparity exists because the market value of the Berkshire shares given up in the merger was less than their intrinsic business value, which is the value that defines the true cost to us.

Operations that appear to be winners based upon perspective (1) may pale when viewed from perspective (2). A good business is not always a good purchase – although it's a good place to look for one.

We will try to acquire businesses that have excellent operating economics measured by (1) and that provide reasonable returns measured by (2). Accounting consequences will be totally ignored.



At yearend 1983, net Goodwill on our accounting books totaled \$62 million, consisting of the \$79 million you see stated on the asset side of our balance sheet, and \$17 million of negative Goodwill that is offset against the carrying value of our interest in Mutual Savings and Loan.

We believe net economic Goodwill far exceeds the \$62 million accounting number.

End

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### Resumption of Class Notes

*Why you use net fixed tangible assets (do not include Goodwill from past acquisitions) in your calculation of invested capital....*

Forget how the company got there. If the company made bad acquisitions so debt is in the EV. Goodwill is a sunk cost in past acquisitions. If management is a serial acquirer that makes bad acquisitions then the future earnings won't be what they say it will be. Adjust. I care about what I have to pay today to generate returns today and in the future. EBIT/EV takes into account for what I paid for it.

If they have land where their factory could be moved and the land used for a higher and better use, don't just take the value of the land without considering the cost of moving the factory. Do the difference between the industrial land and the value of the land.

Why are we taking Net Fixed Assets (NFA)? It is not always right. Say we buy a hotel for \$10 and it is going to last 10 years and we write it down over 5 years and now it is at \$5. But if this goes down to zero, I might half to invest another \$10. This would give me (\$5) a skewed return (being too high) because of not considering replacement and reinvestment into the fixed assets.

Say you have 100 hotels and they are all on different cycles, then on average, you will be correct in using NFA. 10% of your hotels will be refurbished each year over a 10 year normal cycle. That is my quick and dirty for an ongoing business.

Do I have to adjust any numbers based on the unique circumstances of the business. Beware of overstating returns on capital.

*Hooke*, author of Security Analysis, said that you don't control the company so you take the capitalization as is so use P/E. It is the hand you drew. *GI*: I strongly disagree with this—reasonable minds differ—because I have been doing this a long time, and **EV to EBIT** works better than **P/E** because if management doesn't optimally use optimal capitalization then someone will come in and do it for you—the essence of capitalism. Using **EV/EBIT** is the way to go.

Acquisition value is not the same as P/E multiple.

If there are big blips in cap-ex then there will be a hybrid between gross and net.

“Roll-ups mean lose money.”

You spent the money on the stores but you don't receive the EBIT yet, so you must normalize the number for EBIT.

<b>Good Price</b>	<b>Good Business</b>
EBIT/EV	EBIT/(NWC + NFA)

If you are earning 50% to 60% vs. 15% to 20% then we are looking at two different animals. Then what are their growth prospects, what is their growth rate, bargain price, good business?

20% pretax = 12% after-tax. The average for US businesses is 12%.

I don't make money because I am really smart, I make money because I have a big picture in mind for what I am looking to do. The big picture in mind—is the difference between 50% to 60% vs. 15% to 20%.

### Capital Cost: Opportunity cost for my capital

How *GI* compares investments.

For a \$1 of earnings per share after tax what P/E for a non-leveraged company?  
Now I have alternatives for my money, the risk-free return is the 10-year bond is less than 6%, I use 6%. Never lower than 6% even if the rates are 4.5%. You know Buffett confirmed that when rates are below 6%, I use 6%.

Now if the 10-year bonds are 7%, then I use 7% as my bogie.

\$1 at a 16.66 price earnings ratio is equivalent to 6% yield (risk free rate). If my \$1 is going to grow to \$1.40 EPs in two years, then I prefer growth vs. a static 6%.

How do you justify 20x or 5% yield on \$1? If it is growing and I am confident of that growth.

10% pre-tax =  $10\% \times (1 - 40\% \text{ tax rate}) = 6\%$  after-tax.

Compare the opportunities here versus my other choices. I compare a growing 5% yield to a 6% risk-free rate.

When I get the money it is after-tax from the company compared to the after tax stream from the bond.

EBIT/EV portion. Then I look at the ROIC portion.

Two businesses:

Jason's Gum Store: \$400,000 to build and \$200,000 in operating profit so 50% ROIC.

Jimbo's Just Broccoli: \$400,000 earnings \$10,000 = 2.5% ROIC. But compared to the 6% government bond yield, Jimbo is actually losing (2.5% - 6%) 3.5% a year. This is crazy unless he thinks the profits will grow tremendously. Though it seems he is making a little bit of money (2.5%), he is actually throwing money away (-3.5%).

This is how I evaluate each business—what are they doing. I won't pay for a value destroyer. Stay out of Value Traps of just buying low P/E stocks. WEB calls them "cigar butts."

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I want to look at two things:

Am I getting a **good return based on what I am paying** and what are the **incremental returns (MROIC)** on capital? What kind of capital do I have to put in to earn that type of return?

What am I paying and is this a good business? I want to stay out of the *value traps*. I am really looking at normalized EBIT three or four years out vs. last year's EBIT.

How much of the money that I earn can I reinvest at the same rate. The incremental return on capital will affect my growth rate. It will affect how much my dollar will grow over time, then it will what normalized growth rates and earnings will be.

Generally, the way I solve any issues like that are...I look for what things in three years will be worth \$50 and I pay \$25 for them. If it is \$45 or \$55, I don't care; I am not smart enough to fine tune it over time. I am picking my spots. There are not that many companies are trading at that discount. It is \$38 going to \$58 in three years—24% per year. Depending upon how confident I am in that return that may be a great rate of return. Some times I need a higher rate of return depending upon my confidence. I may take a 15% to 20% rate of return despite I like to make more than that. If I am wrong how much can I lose? If I have a lot of room to be wrong and still not lose money. The risk is low.

If the cost of hanging in there is dead money for three years and the \$25 goes to \$30 or wherever, I get an OK return. Generally, if I am good and I get 4 out of 6 right or how many I get. I look out three years. I take my best shot; I look for a wide disparity. I always looking for a catalyst or the market will realize what I see. What will make people see what I see?

This is a special situations class so I would love to have a catalyst on everything I do. Eventually, in three years or more you don't even need a catalyst. There are a lot of things that can happen. **The efficient market people are right but only long term.** But eventually the facts come out. Whatever people were uncertain about now over the next two or three years, they find the answer to. There are a lot of people out there trying to figure out what something is worth.

**So I think the flaw with the efficient market theory is that it often takes a lot more time.** There is often a lot of emotion in the short term and there is much more uncertainty involved, and people take the discounts for uncertainty but there is more opportunity if you have a longer term horizon. In the short term I don't think a stock can trade at \$20 and \$35 and nothing happens and they both can't be right. The economy doesn't change that much. **In the short term, the market may not be efficient, but in the long term the market eventually gets it right.**

Other times a company may buy back stock if they think it is cheap. These little pieces of paper represent the whole company. Eventually all those things work together to get the right price.

We will talk about *Duff & Phelps*. I learned from that—by analyzing the business I was able to make an investment in the Moody's Spinoff.

Break.....

*(See case study material on Duff & Phelps which is in the Appendix below)*

EXERCISE: *Duff & Phelps*...Buy, hold or sell? *Students reviewed the annual report of Duff & Phelps without looking at the subsequent price. See Appendix on page*

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For the next class.....

Quality of Earnings Example: *Commodore*. Work in Process Inventory (WIP) growing faster than Sales.

*Sunbeam* Article in Barron's. *Chain Saw Al* stuffed the channels with inventory. Another trick is to write down inventory to 0. 490 million to \$0. If there are any sales in future periods then sales will be inflated and there will be extra profits. The CEO was manipulating the true economic presentation of the company to investors.

\$92 million in PP&E removes D&A so earnings are overstated.

Drop in allowance for doubtful accounts is less conservative accounting. *Sunbeam* still lost money after all these adjustments.

*Perelman* took stock at \$40 but the company was worth \$7 per share.

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**Each mistake leads to better insights and subtleties.**

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Appendix:

### **CASE STUDY: DUFF & PHELPS**

Next Page

Assignment:

Analyze this business. Assume the highest price in the 10-K's report on quarterly prices H/L approx \$24.12

Is it a good business – use ROIC.

Is it a good price – Ebit/EV?

Is this a good business why or why not? Would you wish to own it?

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Take no more than 50 minutes!



Form 10-K405

DUFF & PHELPS CREDIT RATING CO - DCR

Filed: March 27, 1997 (period: December 31, 1996)

Annual report. The Regulation S-K Item 405 box on the cover page is checked

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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## FORM 10-K

DUFF & PHELPS CREDIT RATING CO.  
(Exact name of registrant as specified in its charter)Proxy Statement dated **March 28, 1997**

## PART I

**ITEM 1. BUSINESS.**

## GENERAL

Duff & Phelps Credit Rating Co. ("Credit Rating" or the "Company") is a nationally recognized credit rating agency. Credit Rating was incorporated in Illinois in 1987 as a wholly-owned subsidiary of Duff & Phelps Corporation, at which time Duff & Phelps Corporation contributed substantially all of the assets and liabilities of its credit rating business to Credit Rating. On October 31, 1994, Duff & Phelps Corporation distributed to its stockholders all of the outstanding shares of common stock of Credit Rating. The dividend of one share of common stock of Credit Rating for each three shares of Duff & Phelps Corporation common stock was distributed to the stockholders of Duff & Phelps Corporation of record as of October 26, 1994. As a result of the distribution, Credit Rating owns and operates the credit rating business as an independent public company.

**PRODUCTS AND SERVICES**

Credit Rating predominantly issues credit ratings on domestic and international corporate bonds, preferred stocks, commercial paper, certificates of deposit, structured financings and insurance company claims paying ability. Credit Rating does not issue a significant volume of credit ratings on municipal securities. Credit ratings typically are issued for a fee paid by the issuer, and are published for access by investors, issuers, investment bankers, traders and the general public. Credit ratings concern only credit quality and are not recommendations to either buy or sell rated securities, certificates of deposit or insurance policies.

Credit ratings are issued in response to requests from issuers or investment bankers. Requested ratings are for corporate short and long-term fixed obligations and structured finance programs, including securitizations of receivables such as auto loans and credit cards, pools of residential real estate loans and pools of commercial real estate loans, as well as single project financings. In addition, claims paying ability ratings are issued for life, property/casualty, financial guaranty and title insurance companies.

Credit Rating's professional staff analyzes the factors which determine an issuer's credit quality and summarizes the basis for ratings. Credit ratings are assigned and reviewed by a Credit Rating Committee composed of senior Credit Rating officers and managers. Ratings are monitored and reviewed at appropriate intervals depending on the type of rating. A watch list is utilized to alert clients to ratings that are under review for potential rating changes. New ratings, the watch list, and changes to existing ratings are primarily communicated through news releases to financial news services, the print media, and through Credit Rating's research publications.

Credit Rating's research services include published reports concerning new issues, detailed and summary reports on issuers, rating guides, comparative statistical guides, and industry research. In addition, Credit Rating's research is delivered to users electronically. Credit Rating is committed to a strong research service as evidenced by a policy of hiring analysts with excellent educational backgrounds, including many with prior employment experience in the respective industries they follow. Credit Rating's research service is widely distributed to domestic and international institutional investors including most of the largest United States mutual funds, banks, trust companies, public and private pension advisors and life and property/casualty insurance companies, as well as investment banks. Credit Rating management believes that its policy of allowing research subscribers direct access to credit analysts is attractive to current and prospective subscribers.

**REVENUES**

Revenue is derived from fees for ratings in connection with debt issuance, annual surveillance of outstanding rated securities, and research subscriptions. Although revenue is sensitive to the level of debt issuance, fees from annual surveillance and research subscriptions tend to stabilize the revenue base. Credit Rating's fee schedule depends upon the type and amount of securities issued, the type of company or issue rated, the complexity of the transaction, and the types of services subscribed to for research publications. Over the past five years, revenues increased from \$18.3 million in 1991 to \$53.1 million in 1996, a compound annual growth rate of approximately 24 percent. This performance reflects a number of factors: increased market penetration by Credit Rating in the traditional corporate rating business, expansion of Credit Rating's structured finance business into new rating sectors, the expansion of international rating activities and the January 1994 transfer of the fixed income research business from Credit Rating's former parent. No single client represented more than 2.5 percent of Credit Rating's revenues in 1996.

Revenues for the year ended December 31, 1996, were \$53.1 million, an increase of 15 percent or \$7.1 million, over the \$46.0 million recorded in 1995. Corporate rating fees rose 13 percent or \$3.2 million while structured finance rating fees increased 29 percent or \$4.6 million. Rating revenue increases were partially offset by a decline in fixed income research revenues of \$0.7 million.

Revenues for the year ended December 31, 1995, were \$46.0 million, an increase of 14 percent or \$5.6 million, over the \$40.4 million recorded in 1994. Corporate rating fees rose \$5.8 million while structured finance rating fees increased \$0.4 million. Rating revenue increases were partially offset by a decline in fixed income research revenues of \$0.6 million.

## **MARKETING**

Credit Rating's marketing staff introduces the rating service to prospective clients, and markets Credit Rating's research services to institutional investors, investment bankers, and other key users of credit ratings. Management of Credit Rating believes that the breadth of its research client base has led issuers to recognize the value of its rating services to purchasers of securities rated by Credit Rating. Credit Rating provides a comprehensive service that includes publicity for the ratings and rating rationale for each issuer. Credit Rating also conducts seminars and publishes timely articles related to securities analysis.

## **COMPETITION**

Credit Rating competes primarily with five other nationally recognized credit rating agencies. Moody's Investors Service, Inc. and Standard & Poor's dominate the market and are much larger than Credit Rating. Since multiple agencies are increasingly used for ratings in the domestic and international markets, Credit Rating management believes that significant growth opportunities exist in the credit ratings market. In addition, more international issuers now have the ability to access the capital markets of the United States for financing than in the past. Further, Credit Rating penetrates the international market through strategic joint ventures and its London and Hong Kong offices.

Structured finance ratings are transaction specific, and while growth of related rating revenue has been substantial, there remains the potential for further growth reflecting continued development of the structured finance markets. As part of its marketing efforts, Credit Rating attempts to identify new product areas or financial services not fully covered by other rating agencies. This strategy has allowed Credit Rating to gain significant market penetration in rating domestic and international structured real estate financings. Moreover, the London and Hong Kong offices primarily reflect perceived opportunities for Credit Rating to continue to penetrate the structured finance rating market and to pursue rating opportunities in the corporate market in Europe and in Asia.

While precise statistics are not available on industry revenues as each of Credit Rating's competitors are privately owned or are part of larger corporations, Credit Rating estimates its comparable 1996 revenues to be equal to approximately 15 percent of the revenues of its largest competitor. Credit Rating's market penetration in the United States, however, is believed to vary significantly depending on market sector. For example, Credit Rating has an inconsequential share of the municipal and mutual fund rating market as historically it has not actively competed in this segment. However, Credit Rating believes its share of the rating business for insurance company claims paying ability, structured financing, and certain segments of the corporate market is much more meaningful. Specifically, in the United States market, Credit Rating has issued claims paying ability ratings on 82 percent of the 100 largest life insurance companies. Credit Rating rates approximately 70 percent of the companies comprising the investor-owned electric utility industry and 75 percent of the largest telephone companies. Of banks and finance companies, Credit Rating rates 80 percent and 66 percent, respectively, of the 50 largest companies. Credit Rating also rates 47 percent of Fortune 100 industrial companies.

Credit Rating believes that significant growth opportunities continue to exist for the following reasons: (1) generally low market penetration; (2) the growing use of multiple agencies for ratings; (3) the increasing number of new financial instruments which require ratings; and (4) the growth of international financial markets. Moreover, as part of its strategy to grow, Credit Rating has established joint ventures with partners in certain North and South American and Asian countries and South Africa (see "-- International") and has offices in London and Hong Kong.

## **INTERNATIONAL**

Credit Rating has entered into joint venture agreements with credit rating agencies in Argentina, Brazil, Canada, Chile, Colombia, India, Mexico, Peru, South Africa and Venezuela as of December 31, 1996 and is pursuing joint venture relationships in several Asian and European countries. Additionally, Credit Rating maintains its designation as a rating agency in Japan, which was granted in October 1992 by the Minister of Finance of Japan.

In July 1994, Credit Rating organized Duff & Phelps Credit Rating Co. of Europe, a U.S. wholly-owned subsidiary with an office in London, to enter the market for rating structured financings and to provide other rating services in the United Kingdom and throughout Europe.

In July 1996, Credit Rating organized Duff & Phelps Credit Rating Co. of Asia, a U.S. wholly-owned subsidiary with an office in Hong Kong, to enter the market for rating structured financings and to provide other rating services in Hong Kong and throughout Asia.

## **EMPLOYEES**

As of December 31, 1996, Credit Rating employed approximately 240 persons. Credit Rating considers its employee relations to be satisfactory.

**EXECUTIVE OFFICERS OF CREDIT RATING**

The executive officers of Credit Rating are as follows:

NAME	AGE	POSITION
Paul J. McCarthy.....	58	Chairman of the Board, Chief Executive Officer, Chief Financial Officer and Director
Philip T. Maffei.....	53	President, Chief Operating Officer and Director
Ernest T. Elsner.....	56	Executive Vice President and General Counsel
Peter J. Stahl.....	47	Executive Vice President
Larry A. Brossman.....	63	Executive Vice President

The executive officers of Credit Rating are elected annually and serve at the discretion of the Board of Directors of Credit Rating.

Mr. McCarthy has been Chairman of the Board of Credit Rating since December 1995 and Chief Executive Officer and a Director of Credit Rating since February 1991. He has also been Chief Financial Officer of Credit Rating since November 1994. Mr. McCarthy was also President of Credit Rating from February 1991 to December 1995. Mr. McCarthy was also an Executive Vice President and a Director of Duff & Phelps Corporation from January 1992 to November 1994 and an Executive Vice President and a Director of Duff & Phelps Inc. from February 1991 until its dissolution in November 1992. From May 1975 to February 1991, he served as President, Chief Executive Officer and a Director of McCarthy, Crisanti & Maffei, Inc., the investment research operations of which were acquired by Duff & Phelps Corporation in February 1991.

Mr. Maffei has been President of Credit Rating since December 1995, Chief Operating Officer of Credit Rating since October 1994 and a Director of Credit Rating since February 1991. From February 1991 to December 1995, Mr. Maffei was an Executive Vice President of Credit Rating. From May 1975 to February 1991, he served as an Executive Vice President, Treasurer and a Director of McCarthy, Crisanti and Maffei, Inc., the investment research operations of which were acquired by Duff & Phelps Corporation in February 1991.

Mr. Elsner has been General Counsel of Credit Rating since July 1995 and an Executive Vice President of Credit Rating since February 1991. Mr. Elsner was a Senior Vice President of Credit Rating from January 1986 to January 1991.

Mr. Stahl has been an Executive Vice President of Credit Rating since July 1994. From January 1992 to July 1994, Mr. Stahl was a Senior Vice President of Credit Rating. From February 1991 to January 1992, Mr. Stahl was a Group Vice President of Credit Rating. From March 1986 to February 1991, Mr. Stahl was Vice President of Marketing of McCarthy, Crisanti & Maffei, Inc., the investment research operations of which were acquired by Duff & Phelps Corporation in February 1991.

Mr. Brossman has been an Executive Vice President of Credit Rating since May 1996. Mr. Brossman was a Senior Vice President of Credit Rating from January 1993 to May 1996, a Group Vice President of Credit Rating from January 1992 to January 1993 and a Vice President of Credit Rating from March 1988 to January 1992.

**ITEM 2. PROPERTIES.**

Credit Rating, which is headquartered in Chicago, conducts its operations through offices located in Chicago, Illinois, New York, New York, London, England and Hong Kong, in which locations it leases a total of approximately 72,000 square feet of office space.

**ITEM 3. LEGAL PROCEEDINGS.**

During 1993, several legal actions were filed against Credit Rating in the U.S. District Court for the Southern District of New York by holders of secured promissory notes ("Notes") of Towers Financial Corporation ("Towers") and holders of bonds ("Bonds") issued by subsidiaries of Towers in five structured financing transactions. Towers collapsed in 1993 amid allegations of massive fraud and is in bankruptcy. Credit Rating had rated the Bonds but had not rated the Notes. It is alleged that \$245 million of Notes were sold that are worthless and that \$200 million of Bonds were sold that have lost much or all of their value. Directors and officers of Towers, lawyers, accountants, broker-dealers and the indenture trustee for the Bonds were also named as defendants in one or more of the actions. The plaintiffs in the actions contend that Credit Rating and the other defendants are liable for losses the plaintiffs have suffered and for punitive damages. The holders of the Bonds also sought recovery from Credit Rating of treble damages under the Racketeer Influenced and Corrupt Organizations Act ("RICO"). It is asserted that Credit Rating, in its ratings and its monitoring of the transactions after ratings were issued, was either fraudulent or negligent in failing to discover the alleged fraud of Towers and its officers or in taking other action that allegedly induced purchases of the Bonds and the Notes. Credit Rating denies these assertions. Credit

Rating's ratings were based upon (and assumed the accuracy of) the information provided to it by Towers and its officers. Credit Rating has taken the position that it cannot be expected to detect fraud or discover variances from the structure of a rated security when the information provided to it demonstrates compliance with that structure. In 1996, the legal actions filed by the holders of the Notes were dismissed by the federal courts and the RICO claim of the holders of the Bonds was dismissed. One holder of Notes claiming to represent holders of approximately \$17 million of Notes filed a class action against Credit Rating in the Circuit Court of Cook County, Illinois alleging the state law claims previously asserted in



federal court. Management intends to vigorously defend these actions, and at this time, cannot make an assessment with regard to such litigation's effect on Credit Rating's financial position or results of operations.

In October 1994, putative class actions were filed in the U.S. District Court for the Northern District of Georgia and in Georgia and New York State Courts on behalf of all persons (the "Plaintiffs") who purchased or renewed life insurance policies, annuities or guaranteed investment contracts (collectively the "Contracts") from or issued by Confederation Life Insurance Company or its subsidiaries ("Confederation") during the period from May 27, 1993, through August 12, 1994. Credit Rating, which had rated the claims paying ability of Confederation, was named a defendant in the action along with two other rating agencies, A.M. Best and Standard & Poor's, Confederation's independent auditor, Ernst & Young, and certain officers and/or directors of Confederation. Confederation ceased operations and was in liquidation allegedly because of a decline in the amount of its assets, a large percentage of which were real estate investments. The complaint in the action alleged that Credit Rating and the other rating agencies knew or should have known of Confederation's deteriorating financial condition and that by issuing and maintaining their ratings they misrepresented Confederation's financial strength and the value of the Contracts, thereby inducing the Plaintiffs to purchase or renew Contracts. It was alleged that Credit Rating and the other defendants' conduct constituted a violation of Section 10(b) of the Securities Exchange Act of 1934, common law fraud and negligent misrepresentation. The complaint sought compensatory damages in an unspecified amount, punitive damages, costs, attorneys' fees and interest. In October and November 1996, the Plaintiffs dismissed without prejudice their claims against the Company in all three cases. In addition, the three parties that originally filed the claims have released the Company from the claims brought in these cases.

Credit Rating is involved in other litigation, which in the opinion of management, would not have a material adverse effect on Credit Rating's financial position or results of operations.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

PART II

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.**

PRICE RANGE OF COMMON STOCK

The Company's common stock has traded on the New York Stock Exchange ("NYSE") under the ticker symbol "DCR" since October 24, 1994. The following table sets forth the high and low sales prices per share for the common stock traded on the NYSE for the periods indicated:

1996			1995		
	HIGH	LOW		HIGH	LOW
Fourth Quarter.....	\$ 24.125	\$ 21.875	Fourth Quarter .....	\$ 16.00	\$ 14.375
Third Quarter.....	22.375	19.125	Third Quarter .....	15.75	12.75
Second Quarter.....	21.25	16.125	Second Quarter .....	13.25	11.875
First Quarter.....	16.00	14.00	First Quarter .....	12.75	8.625

As of February 24, 1997, there were approximately 124 holders of record of the Company's common stock.

DIVIDEND POLICY

During 1996 and 1995, the Company paid a regular quarterly dividend of \$0.03 per share. The Company intends to continue to pay quarterly cash dividends; however, future cash dividends will depend on the financial condition, capital requirements and earnings of the Company. Additionally, the Company's bank credit agreement contains provisions which may limit the aggregate dividends that the Company may pay on its common stock.

**ITEM 6. SELECTED FINANCIAL DATA.**

The following selected financial data of the Company should be read in conjunction with the Company's Consolidated Financial Statements, including the Notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations

(IN MILLIONS, EXCEPT PER SHARE DATA)

<b>INCOME STATEMENT DATA: For December 31,</b>					
	<b>1996</b>	<b>1995</b>	<b>1994</b>	<b>1993</b>	<b>1992</b>
Revenues	\$ 53.1	46.0	40.4	32.6	24.7
Operating expense	35.4	30.1	26.4	18.9	14.2
Income from operations before fees paid to former parent	17.7	15.9	14.0	13.7	10.5
Name use fee paid to former parent	2.0	2.0	2.0	2.0	2.0
Intercompany charges paid to former parent	0	0	0	10.8	5.6
Operating income	15.7	13.9	12.0	0.9	2.9
Interest expense and other	0.1	0.5	0.6	0.4	2.5
Earnings before income tax	15.6	13.4	11.4	0.5	0.4
Income tax expense	6.6	5.8	4.9	0.5	0.4
Net earnings	\$ 9.0	7.6	6.5	0	0

Earnings per Share ( <i>Pro Forma for 1993 and 1992</i> )	\$ 1.54	41.28	\$1.12	\$1.10	\$0.59
Cash dividends paid per common share	\$ 0.12	0.12	0.03	0	0

<b>BALANCE SHEET DATA (AT END OF PERIOD)</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>
Working capital -- exclusive of intercompany receivable/ payable to former parent in 1993 and 1992	\$0.1	1.60	0.3	1.7	0.8
Goodwill	23.1	23.8	24.6	25.3	26.0
Total assets	42.1	42.3	41.0	36.1	35.0
Total long-term debt	5.5	6.0	10.0	15.0	4.3
Stockholders' equity	25.1	26.1	20.8	16.0	16.4

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

Dec. 31,	<b>1996</b>	<b>1995</b>	<b>1994</b>
Revenues	\$53.1	\$46.0	\$40.4
Operating Expenses	35.4	30.1	26.4
Name use fees paid to former parent	2.0	2.0	2.0
Operating income	15.7	13.9	12.0
Interest expense	0.4	0.7	0.7
Other Income	0.3	0.2	0.1
Earnings bef. taxes	15.6	13.4	11.4
Taxes	6.6	5.8	4.9
Net earnings	9.0	7.65	6.5

Weighted average shares	\$5.8	\$5.9	\$5.8
Earnings per share	\$1.54	\$1.28	\$1.12

**RESULTS OF OPERATIONS YEAR ENDED DECEMBER 31, 1996, COMPARED WITH YEAR ENDED DECEMBER 31, 1995**

Revenues for the year ended December 31, 1996, were \$53.1 million, an increase of 15 percent or \$7.1 million, over the \$46.0 million recorded in 1995. Corporate rating revenues rose \$3.2 million while structured finance rating revenues increased \$4.6 million. Rating revenue increases were partially offset by a decline in fixed income research revenues of \$0.7 million.

Corporate rating revenues, which increased 13 percent or \$3.2 million over 1995, include improved performance by all sectors of the corporate rating business and were driven by a strong increase in new client fees. Structured finance rating fees increased 29 percent over the prior year led by the strong performances of the asset-backed and commercial real estate sectors. International rating fees which are included in the above comparisons significantly contributed to the overall growth.

Operating income for the year ended December 31, 1996, was \$15.7 million, an increase of \$1.8 million, or 13 percent, over the \$13.9 million recorded in 1995. This increase reflects the revenue increases discussed above, offset by an increase in employment expense of \$3.7 million and an increase in operating expenses of \$1.6 million. Expense increases can be attributed to the growth in both domestic and international business, which necessitated an increase in the number of employees, additional travel expenses, office expansions and an office addition in Hong Kong.

Interest expense decreased \$0.3 million in 1996 due to the reduction in the average debt balance and interest rate. Other income increased approximately \$0.1 million as a result of dividends received from the Company's international partnerships. Income tax expense increased proportionately with income.

Net income totaled \$9.0 million in 1996, a \$1.4 million or 18 percent increase over 1995. Weighted average shares outstanding decreased 2 percent due to the Company's stock repurchases of 573,391 common shares and equivalents. Earnings per share increased 20 percent to \$1.54 in 1996 compared with \$1.28 in 1995.

#### YEAR ENDED DECEMBER 31, 1995, COMPARED WITH YEAR ENDED DECEMBER 31, 1994

Revenues for the year ended December 31, 1995, were \$46.0 million, an increase of 14 percent or \$5.6 million, over the \$40.4 million recorded in 1994. Corporate rating revenues rose \$5.8 million while structured finance rating revenues increased \$0.4 million. Rating revenue increases were partially offset by a decline in fixed income research revenues of \$0.6 million.

Corporate rating revenues, which increased 30 percent or \$5.8 million over 1994, were driven by a strong increase in renewal revenue of \$3.5 million, while new issue revenues contributed \$2.0 million to the increase, and new client revenues added \$0.3 million. Structured finance rating revenues increased 2 percent over the prior year and were adversely impacted by a more than 70 percent market decline in residential mortgage backed securities new issue volume.

Operating income for the year ended December 31, 1995, was \$13.9 million, an increase of \$1.9 million or 16 percent, over the \$12.0 million recorded in 1994. This increase reflects the revenue increases discussed above, offset by an increase in employment expense of \$2.7 million and an increase in operating expenses of \$0.9 million. The increase in employee compensation was the result of increased incentive compensation based on the 1995 operating results, additional staff needed to support the rating business growth, and staff added to eliminate a substantial portion of the support services provided by the former parent for which costs are accounted for in operating expenses. Operating expense increases were largely due to an increase in travel expense to service the additional business and expenses associated with the Company being an independent public corporation.

Interest expense decreased 4 percent in 1995 due to the reduction in the debt balance. Other income increased approximately \$0.1 million as a result of dividends received from the Company's international partnerships. Income tax expense increased proportionately with income.

Net income totaled \$7.6 million in 1995, a \$1.2 million or 18 percent increase over 1994. Despite the Company's common stock repurchases of 155,333 common shares, weighted average shares outstanding increased 3 percent due to the dilutive effect of common stock equivalents which are weighted based on the Company's stock price. Earnings per share increased 14 percent to \$1.28 in 1995 compared with \$1.12 in 1994, despite higher weighted average shares outstanding.

#### LIQUIDITY AND CAPITAL RESOURCES

The Company has typically financed its operations, which do not require significant amounts of working capital or capital expenditures, through funds provided by operations. For the years ended December 31, 1996 and 1995, capital expenditures totaled \$1.5 million and \$1.4 million, respectively. These capital expenditures were primarily for leasehold improvements, computer equipment and office furniture. The Company expects capital expenditures to approximate \$1.8 million in 1997.

During 1996, the Company repurchased 573,391 of its common shares and equivalents for approximately \$11.4 million. In 1995, the Company had repurchased 155,333 of its common shares for approximately \$2.2 million. Future share repurchases are contingent upon the Company's financial condition, capital requirements and earnings.

The Company has in place a \$10.0 million, four-year revolving bank credit agreement. At December 31, 1996, \$5.5 million was outstanding under the facility at a floating annual rate which was approximately 6.3 percent, compared with \$6.0 million outstanding at December 31, 1995, at approximately 6.9 percent. Commitment fees are accrued on the unused facility at an annual rate of .375 percent and are paid quarterly. The bank credit agreement contains the following financial covenants among others: (i) a minimum net worth test; (ii) a maximum leverage test; (iii) a maximum debt/capitalization ratio test; and (iv) a limitation on indebtedness and capital expenditures. The Company is currently in compliance with such covenants. The bank credit agreement also imposes certain restrictions on sale of assets, mergers or consolidations, creation of liens, investments, leases and loans and certain other matters.

The Company believes that funds provided by operations and amounts available under its credit agreement will provide adequate liquidity for the foreseeable future.

## Report of Independent Public Accountants

## CONSOLIDATED BALANCE SHEETS

(In thousands)  
DECEMBER 31,

1996 1995

## ASSETS

## CURRENT ASSETS:

Cash and cash equivalents.....	\$ 0	\$ 233
Accounts receivable, net of allowance for doubtful accounts of \$219 and \$212, respectively.....	10,298	10,099
Other current assets.....	642	529
Total current assets.....	10,940	10,861

## OFFICE FURNITURE, EQUIPMENT AND LEASEHOLD IMPROVEMENTS,

net of accumulated depreciation of \$3,042 and \$2,249 respectively (Note 1).....

4,540 4,013

## OTHER ASSETS:

Intangible assets, net (Note 1).....	2,319	2,624
Goodwill, net (Note 1).....	23,094	23,840
Other long-term investments (Note 3).....	1,019	621
Other long-term assets.....	214	315

Total assets..... \$ 42,126 \$ 42,274

## LIABILITIES AND STOCKHOLDERS' EQUITY

## CURRENT LIABILITIES:

Accrued compensation and employment taxes.....	\$ 5,756	\$ 4,518
Accounts payable.....	3,193	2,063
Accrued income tax (Note 6).....	576	1,362
Advance service fee billings to clients (Note 1).....	1,314	1,294
Other current liabilities.....	15	18
Total current liabilities.....	10,854	9,255

LONG-TERM DEBT (Note 4)..... 5,500 6,000

OTHER LONG-TERM LIABILITIES (Note 8)..... 717 950

## STOCKHOLDERS' EQUITY:

Preferred stock, no par value: 3,000 shares authorized, zero issued and outstanding.....	0	0
Common stock, no par value: 15,000 shares authorized, 5,152 and 5,541 shares issued and outstanding at December 31, 1996 and 1995.....	5,030	14,371
Retained earnings.....	20,025	11,698
Total stockholders' equity.....	25,055	26,069
Total liabilities and stockholders' equity.....	\$ 42,126	\$ 42,274

The accompanying notes to the consolidated financial statements are an integral part of these balance sheets.

CONSOLIDATED STATEMENTS OF INCOME (In thousands, except per share data)

## FOR THE YEARS ENDED DECEMBER 31,

1996 1995 1994

REVENUES (Note 1)..... \$ 53,083 \$ 45,983 \$ 40,409

## EXPENSES

Employment expense.....	22,512	18,840	16,139
Other operating expenses (Note 2).....	10,812	9,486	8,730
Name usage fees paid to former parent (Note 2).....	2,000	2,000	2,000
Depreciation and amortization (Note 1).....	2,020	1,725	1,544

Total expenses.....	37,344	32,051	28,413
OPERATING INCOME.....	15,739	13,932	11,996
Other income (Note 3).....	283	237	129
Interest expense (Note 4).....	413	712	739
EARNINGS BEFORE INCOME TAXES.....	15,609	13,457	11,386
Income taxes (Note 6).....	6,634	5,825	4,920
NET EARNINGS.....	\$ 8,975	\$ 7,632	\$ 6,466
Weighted average shares outstanding (Note 1).....	5,846	5,953	5,761
Earnings per share (Note 1).....	\$ 1.54	\$ 1.28	\$ 1.12

The accompanying notes to the consolidated financial statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (In thousands)

	COMMON STOCK	RETAINED EARNINGS	TOTAL
BALANCE AT DECEMBER 31, 1993.....	\$ 15,953	\$ 1	\$ 15,954
Net earnings.....	0	6,466	6,466
Stock option exercises.....	43	0	43
Tax benefit.....	93	0	93
Dividend paid to shareholders.....	0	(169)	(169)
Intercompany dividends paid to former parent.....	0	(1,557)	(1,557)
BALANCE AT DECEMBER 31, 1994.....	\$ 16,089	\$ 4,741	\$ 20,830
Net earnings.....	0	7,632	7,632
Stock option exercises.....	337	0	337
Tax benefit of stock options exercised.....	107	0	107
Dividend paid to shareholders.....	0	(674)	(674)
Stock and stock equivalents repurchased.....	(2,163)	0	(2,163)
BALANCE AT DECEMBER 31, 1995.....	\$ 14,370	\$ 11,699	\$ 26,069
Net earnings.....	0	8,976	8,976
Stock option exercises.....	1,141	0	1,141
Deferred compensation.....	47	0	47
Tax benefit.....	833	0	833
Dividend paid to shareholders.....	0	(651)	(651)
Stock and stock equivalents repurchased.....	(11,360)	0	(11,360)
BALANCE AT DECEMBER 31, 1996.....	\$ 5,031	\$ 20,024	\$ 25,055

THE FOLLOWING TABLE PROVIDES A SUMMARY OF COMMON STOCK ISSUED AND OUTSTANDING:  
FOR THE YEARS ENDED DECEMBER 31

	1996	1995	1994
BALANCE AT JANUARY 1.....	5,541	5,650	1
Shares distributed/issued in spin-off.....	0	0	5,625
Repurchases of common stock.....	(525)	(155)	0
Stock option exercises.....	136	46	24
BALANCE AT DECEMBER 31.....	5,152	5,541	5,650

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)

FOR THE YEARS ENDED DECEMBER 31,

	1996	1995	1994
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net earnings.....	\$ 8,975	\$ 7,632	\$ 6,466
Adjustments to reconcile net earnings to cash provided by operating activities:			
Increase in accounts receivable.....	(199)	(2,203)	(2,342)
Increase (decrease) in advance service fee billings.....	19	(1,213)	2,469
Depreciation and amortization.....	2,020	1,725	1,544
Increase (decrease) in accrued income taxes payable.....	186	(78)	1,372
Increase in other assets and liabilities--net.....	1,982	1,162	787
Cash provided by operating activities.....	12,983	7,025	10,296
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of office furniture, equipment, and leasehold improvements.....	(1,496)	(1,380)	(2,011)
Increase in other long-term investments.....	(380)	(156)	(260)
Cash used in investing activities.....	(1,876)	(1,536)	(2,271)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Dividends paid to shareholders.....	(651)	(674)	(169)
Deferred financing costs.....	30	30	(118)
Issuance of common stock.....	1,141	337	43
Repurchases of common stock and stock equivalents.....	(11,360)	(2,163)	0
Net repayments of long-term debt.....	(500)	(4,000)	(5,000)
Long-term lease payments.....	0	(4)	(7)
Intercompany dividend paid to former parent.....	0	0	(1,557)
Cash used in financing activities.....	(11,340)	(6,474)	(6,808)
Net change in cash.....	(233)	(985)	1,217
Cash and cash equivalents, beginning of period.....	233	1,218	1
Cash and cash equivalents, end of period.....	\$ 0	\$ 233	\$ 1,218

DUFF & PHELPS CREDIT RATING CO. NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 SIGNIFICANT ACCOUNTING POLICIES:

GENERAL

Duff & Phelps Credit Rating Co. (the "Company") is an internationally recognized credit rating agency which provides ratings and research on corporate, structured and sovereign financings as well as insurance claims paying ability. The Company has offices in Chicago, New York, London and Hong Kong and operates with international partners in Latin America, Asia, South Africa and Canada.

On October 31, 1994, the spin-off of the Company from its former parent company, Phoenix Duff & Phelps Corporation, formerly Duff & Phelps Corporation ("D&P"), was finalized. The Company's shares, held by D&P, were distributed October 31, 1994, to D&P shareholders of record October 26, 1994, as a tax-free distribution for which a favorable tax ruling was obtained from the Internal Revenue Service. D&P shareholders received one of the Company's shares for every three shares held of D&P common stock, and cash payments were made in lieu of fractional shares. The distribution resulted in the Company operating as a free standing entity whose common stock is publicly traded on the New York Stock Exchange under the ticker symbol "DCR."

BASIS OF PRESENTATION

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles and include those assets, liabilities, revenues and expenses directly attributable to the Company's operations in the years presented. Certain reclassifications have been made to the financial statements to conform with the 1996 presentation.

#### PRINCIPLES OF CONSOLIDATION

During July 1994, the Company organized a new U.S. subsidiary, Duff & Phelps Credit Rating Co. of Europe, with an office located in London, England. In July 1996, the Company organized a new U.S. subsidiary, Duff & Phelps Credit Rating Co. of Asia, with an office in Hong Kong. The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Duff & Phelps Credit Rating Co. of Europe and Duff & Phelps Credit Rating Co. of Asia. All significant intercompany balances have been eliminated.

#### EARNINGS PER SHARE

Earnings per share were computed using the weighted average number of shares of common stock and common stock equivalents outstanding at December 31 for each of the years presented. Common stock equivalents are based on outstanding stock options under a non-qualified stock option plan.

#### REVENUE RECOGNITION

Rating revenues are typically recognized when services rendered for credit ratings are complete, generally when billed. Revenues are dependent, in large part, on levels of debt issuance. The Company's

#### 1 SIGNIFICANT ACCOUNTING POLICIES: (CONTINUED)

fee schedule depends on the type and amount of securities rated and the complexity of securities issued. Research revenues are billed in advance and amortized over the subscription period.

#### GOODWILL AND INTANGIBLE ASSETS

In 1987, an acquisition by D&P resulted in goodwill and intangible assets allocated to the Company of approximately \$5.0 million and \$6.0 million, respectively. In 1989, another D&P acquisition resulted in a "push-down" of goodwill to the Company of approximately \$24.0 million.

Goodwill and intangible assets are shown net of accumulated amortization. Goodwill is amortized over its estimated remaining life of approximately 31 years, and intangible assets are amortized over remaining lives of 3 through 12 years.

The Company periodically evaluates whether significant events have occurred which may require a revision of the estimated useful life of goodwill and intangible assets or an impairment of the recoverability of remaining balances. The Company uses an estimate of future net income over the remaining useful life of goodwill and intangible assets to measure recoverability. At December 31, 1996, the Company believes that the full amount of goodwill and intangible assets is recoverable.

#### DEPRECIATION

Office furniture and equipment are stated at cost less accumulated depreciation and are depreciated on a straight-line basis over the estimated remaining lives of the assets, which on a composite basis, is 5 years. Leasehold improvements are amortized over the remaining lives of the related leases, which, on a composite basis, is 11 years.

#### 2 RELATED PARTIES:

##### SERVICE FEES PAID TO D&P

Support agreements in effect between the Company and D&P include a name use fee of \$2.0 million per year and actual charges for D&P administrative services which are included in the Company's financial results for the years presented. Effective September 30, 2000, the name use fee reduces to \$10,000 per year.

##### SERVICE FEES PAID TO THE COMPANY

The Company and D&P are party to service and support agreements under which the Company provides D&P with fixed income research services for an annual fee of \$0.9 million and publication printing services for a fee which represents actual expenses incurred by the Company on behalf of D&P. For the years presented, the fixed income research fees are included in revenue and the publication printing support fees offset other operating expenses. The fixed income research agreement expires on September 30, 2000.

#### 3 OTHER LONG-TERM INVESTMENTS:

The Company's long-term investments are composed of investments made in international rating agency partnerships in Argentina, Brazil, Canada, Chile, Colombia, India, Mexico, Peru, South Africa and Venezuela.

The Company accounts for its joint venture investments under either the cost or equity method as dictated by ownership interest.

#### 4 LONG-TERM DEBT:

The Company had long-term debt obligations of \$5.5 million and \$6.0 million at floating annual interest rates of approximately 6.3 percent and 6.9 percent on December 31, 1996 and 1995, respectively.

The \$5.5 million outstanding at December 31, 1996, under the Company's \$10.0 million, four-year revolving credit facility, is due as follows (in millions):

1997.....	\$ .5
1998.....	5.0
	---
	\$ 5.5

The credit agreement contains financial covenants which require that the Company maintain certain ratios and satisfy certain financial tests, including restrictions on the ability to incur indebtedness and limitations on the amount of capital expenditures, common stock dividends and advances to subsidiaries. The Company was in compliance with such covenants, for all years presented.

5 LITIGATION MATTERS: (CONTINUED)

Management intends to vigorously defend these actions, and at this time, cannot make an assessment with regard to such litigation's effect on the Company's financial position or results of operations. The Company is involved in other litigation, which in the opinion of management, would not have a material adverse effect on the Company's financial position or results of operations.

6 INCOME TAXES:

The Company accounts for income taxes under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes."

The Company was included in the consolidated income tax return of D&P until October 31, 1994. Prior to November 1, 1994, a tax-sharing agreement with D&P was in effect which resulted in income taxes being allocated to the Company as if it computed its income tax liability on a stand-alone basis.

Income tax expense was as follows for the years ended December 31 (in thousands):

	1996	1995	1994
	-----	-----	-----
Current			
Federal.....	\$ 5,682	\$ 4,961	\$ 4,613
State.....	812	780	659
	-----	-----	-----
	6,494	5,741	5,272
Deferred			
Federal.....	122	73	(308)
State.....	18	11	(44)
	-----	-----	-----
	140	84	(352)
Total Income Tax Expense.....	\$ 6,634	\$ 5,825	\$ 4,920
	-----	-----	-----

The following table presents a reconciliation from the federal statutory rate to the effective tax rate for the years ended December 31:

	1996	1995	1994
	-----	-----	-----
Federal Statutory Rate.....	35%	35%	35%
State and Local Average Rates, Net of Federal Benefit.....	5	5	5
Goodwill Amortization & Other.....	3	3	3
	--	--	--
Effective Rate.....	43%	43%	43%
	--	--	--

Deferred tax assets and liabilities represent the amount of taxes receivable or payable in future years as a result of differences between the tax bases of assets and liabilities and amounts reported in the

6 INCOME TAXES: (CONTINUED)

financial statements as of year end. The effects of these temporary differences comprised the net deferred tax asset (liability) for the years presented (in thousands):



	1996	1995	1994
	-----	-----	-----
Deferred Tax Assets:			
Long-Term Reserves.....	\$ 280	\$ 385	\$ 400
Allowance for Doubtful Accounts.....	88	86	111
Accrued Vacation.....	7	0	0
Deferred Tax Liabilities:			
Depreciation and Amortization.....	(392)	(348)	(304)
Net Deferred Tax Asset (Liability).....	\$ (17)	\$ 123	\$ 207
	-----	-----	-----

The net deferred tax assets (liabilities) are included in other long-term assets (liabilities). Management has determined that a valuation allowance is not required.

Tax benefits related to the exercise of options were \$830,998 and \$107,304 for years ended December 31, 1996 and 1995, respectively, and are included in the Company's stockholders' equity.

7 LEASES:

The Company leases its existing office space in New York, London, Hong Kong and subleases its existing office space in Chicago. A substantial portion of these leases expire on December 31, 2008. The agreements include escalation clauses, the effect of which cannot be determined at this time. Lease payments for 1996, 1995 and 1994 were \$1.3 million, \$1.2 million and \$1.0 million. Annual minimum lease payments under operating leases for the five years subsequent to December 31, 1996, and thereafter, are as follows (in thousands):

1997.....	\$ 1,671
1998.....	1,704
1999.....	1,591
2000.....	1,293
2001.....	1,365
2002 and thereafter.....	6,167
	-----
Total.....	\$ 13,791

8 OTHER LONG-TERM LIABILITIES:

Other long-term liabilities include a reserve for the litigation described in Note 5.

9 STOCK OPTION PLAN:

The Company's 1994 Long Term Stock Incentive Plan (the "Plan") allows for awards of up to a maximum of 1,450,000 shares of common stock to be granted to key employees, officers and directors. The Plan is administered by a committee of the Board of Directors. As of December 31, 1996, options to purchase 1,085,103 common shares were granted and outstanding under the Plan; 982,464 were held by the Company's employees and directors, and 102,639 were held by D&P's employees and directors. The

options outstanding vest and become exercisable on average in even annual installments over three years at a weighted average exercise price of \$13.26. Options held by participants terminate no later than 10 years from the date of grant.

OUTSTANDING OPTIONS	SHARES	OPTION PRICE	EXERCISABLE
	-----	-----	-----
Balance December 31, 1994.....	960,112		291,013
Granted.....	207,800	\$ 12.13-14.38	
Exercised.....	(46,505)	\$ 1.85-10.00	
Canceled.....	(21,667)	\$ 9.00-16.50	
	-----		
Balance December 31, 1995.....	1,099,740		506,920
Granted.....	229,03	\$ 19.13-22.63	
Exercised.....	(135,605)	\$ 1.85-16.50	
Canceled.....	(108,067)	\$ 1.85-16.50	
	-----		
Balance, December 31, 1996.....	1,085,103		590,817

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for the Plan. Accordingly, no compensation expense has been recognized for its stock-based compensation plan. Had compensation cost for the Company's stock option plan been determined based upon the average fair value at the grant date for awards under the Plan consistent with the methodology prescribed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the Company's net income and earnings per share would have been reduced by approximately \$83,000 or \$.01 per share for 1995, and \$224,000 or \$.04 per share in 1996. The average fair value of the options granted in 1996 is estimated at \$10.19 on the date of grant using the Black-Scholes option pricing model with the following assumptions: dividend yield .45 percent; volatility 18.25 percent; risk-free interest rate of 6.26 percent; assumed forfeiture of 5 percent and an expected life of 10 years. The average fair value of the options granted during 1995 is estimated at \$6.14 on the date of grant using the Black-Scholes option-pricing model with the following assumptions: dividend yield of .45 percent; volatility of 20.95 percent; risk-free interest rate of 5.75 percent; assumed forfeiture rate of 5 percent and an expected life of 10 years.

10 QUARTERLY FINANCIAL INFORMATION (UNAUDITED): (in thousands, except per share data)

The following is a summary of condensed quarterly financial information for years ended 1996 and 1995:

	FIRST QUARTER -----	SECOND QUARTER -----	THIRD QUARTER -----	FOURTH QUARTER -----
Revenue				
1996.....	\$ 12,238	\$ 12,989	\$ 12,184	\$ 15,672
1995.....	10,972	10,995	10,172	13,844
Operating Income				
1996.....	3,696	3,885	3,549	4,609
1995.....	3,204	3,217	3,151	4,360
Net Earnings				
1996.....	2,072	2,203	2,062	2,638
1995.....	1,713	1,769	1,718	2,432
Earnings Per Share				
1996.....	0.35	0.37	0.35	0.47
1995.....	0.29	0.30	0.29	0.40

11 SUPPLEMENTAL CASH FLOW INFORMATION:

For purposes of the consolidated statements of cash flows, the Company considers investments with maturities of three months or less to be cash equivalents.

Cash interest and fees paid were \$0.4 million for the year ended December 31, 1996, and \$0.7 million for the years ended December 31, 1995 and 1994. Income taxes paid were \$6.4 million, \$5.9 million and \$3.6 million in 1996, 1995 and 1994, respectively.

12 SUBSEQUENT EVENTS:

On February 13, 1997, the Company declared its regular quarterly dividend of \$0.03 per share payable March 6, 1997, to shareholders of record February 24, 1997.

ARTHUR ANDERSEN LLP

**END**

Answer/Discussion on next page. Do not read unless you have completed your work on analyzing Duff and Phelps:

The best section is to look at the front section where they summarized five years of financial and operating history.

This is a great business, it is growing, and it requires low capital intensity. Every dollar they make is spent to buy back shares.

You want to see how the management's bread buttered. How much of their salary vs. share ownership? If they are giving themselves egregious option packages then I will take that into account.

Income grew but total assets did not grow. Their incremental return on capital is infinite. They can grow without reinvesting their capital.

Did anyone attempt to value this?

*Duff & Phelps* was spun off at \$7.

EBITDA is 31.25 and EBIT is \$28.8.

EBITDA of \$31.25 minus capex of \$2.5 = \$29.535

EV/(Ebitda – capex).

There are negative working capital businesses like *MacDonald's*.

Anyone see a problem with using a normalized earnings? Look at the fast growth rate of earnings. Do you think that is sustainable?

I took a normal growth rate over five years.

Three different EBIT growth rates: 8%, 13%, 20%. I chose a conservative 8% growth rate.

EBIT of \$43.72 x .6 for taxes = \$26.23 x 13 P/E = \$341. I shrank the number of shares due to the buy backs down to 3.5 million outstanding shares. I assumed that they were buying back shares with the shares increasing in price by 8% a year. Don't forget to make assumptions about what they would do with their excess cash.

\$341/3.5 = about \$95 to \$100 per share.

So at \$52 today at 8% the stock price was \$99; at 13% the price was \$122 and at 20% the price was \$164. If I go out five years expecting to earn 20% per year, how could I earn the return sooner? Time compressed?

How could I make 50% in a year? The market figures it out sooner. I make 76% if pension funds wake up and discount the earnings at 9%.

*Duff & Phelps* was a small cap stock with low liquidity.

**I am always looking at value and where it is now.**

This spin off was a good learning tool for *(The prof's interest and work to analyze and invest in) Moody's*.

*Duff & Phelps* was taken over by *Fitch* at \$100.

Compare the multiple to the bond rate. I will take a 5% earnings yield with a great business and with growth vs. 6% bond yield that is flat.

END