

Defense Never Rests

Investing in many ways comes down to calculated risk-taking, a skill for which Westwood Management's Ragen Stienke has shown particular aptitude.

INVESTOR INSIGHT



Ragen Stienke
Westwood Management

Investment Focus: Seeks companies for which positive internal, secular or cyclical change is so mispriced that share downside is far more limited than the upside.

As much as he talks about managing risk, Ragen Stienke has no illusions that investing is anything but a risk-taking endeavor: "The key is to understand what risks you're taking and their magnitude," he says. "What we don't ever want is to be wrong for reasons we didn't imagine."

Stienke's approach has certainly been in touch with the times. Since taking over Westwood Management's now \$3.2 billion (assets) small- and mid-cap strategy at the beginning of 2005, he's earned for investors a net annualized 13.6%, vs. 6.2% for the Russell 2500.

Looking to capitalize on a steady, if shifting, supply of misunderstood stocks, he's finding mispriced value today in such varied areas as diesel trucks, mobile phones, disk drives and automotive systems. [See page 11](#)

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About Westwood

Westwood Holdings Group, established in 1983, is a highly regarded investment management firm. It provides high-quality, domestic value equity and income investment management services to institutions, mutual funds and high net worth clients. The firm's investment process and philosophy emphasize the use of proprietary fundamental research to construct low volatility, "best ideas" portfolios. The Westwood team is comprised of seasoned professionals with expertise in market strategy, equity research & portfolio management, trading, institutional sales and wealth management.

Westwood offers the following investment strategies:

- | | |
|--------------------------------|--|
| LargeCap Value | AllCap Value |
| MidCap Value | Income Opportunity |
| SMidCap Plus+ | MLP Infrastructure Renewal |
| SmallCap Value | |



WESTWOOD
HOLDINGS GROUP, INC.®

200 Crescent Court • Suite 1200 • Dallas, Texas • 75201
T. 214.756.6900 • F. 214.756.6979 • www.westwoodgroup.com

Investor Insight: Ragen Stienke

Ragen Stienke of Dallas-based Westwood Management explains why he focuses first on how much money he can lose rather than gain, why the input he requires from company management is so narrow, why he's been buying banks for the first time, and what he thinks the market is missing in Motorola Mobility, Western Digital, Navistar and Visteon.

Most value investors claim, as you do, to put great emphasis in their process on downside risk. In what ways do you think your approach is beyond the norm?

Ragen Stienke: The very first thing we do when we start to analyze a company is to ask ourselves how far the stock price would fall if we were wrong. It's not some back-of-the-envelope calculation, but a full assessment looking at liquidation asset values and stressing the business model and valuation levels under any number of bad scenarios. If the downside is more than 30% from today's price, it's unlikely we'll invest, regardless of the upside potential. If we can't establish a concrete downside number – which probably means it isn't far from 100% – we absolutely won't buy the stock.

Going through this first sets the tone we want to set in our research. Rather than start out looking to convince ourselves why we should buy something, we start out trying to prove why we shouldn't buy it. We try to keep that level of skepticism alive throughout the process.

Can you generalize about the types of situations that attract your attention?

RS: We tend to buy companies that are operating fairly well, but that we believe should perform better than the market seems to expect. That can be because of a structural change in the company that isn't well understood. It can be because of a developing but still unproven business opportunity. It can be because of a structural, secular or even cyclical change in an industry with a payoff too far in the future for the market to care.

We own Timken [TKR], the largest producer of bearings in the world. When we first got interested, its returns on invested capital over the previous decade had been materially lower than those of

its largest U.S. competitor, RBC Bearings, which couldn't be explained by obvious differences in product mix or end markets. That interests us and as we looked into it we identified a division serving auto OEMs that was a significant drag on margins and returns, which if sold or fixed would go a long way toward permanently improving profitability. The company sold the business two years ago, but the margin improvement was obscured by the poor economic environment. While the stock has done nicely, we believe that's due more to the cyclical recovery than a recognition by the market of the structural improvement in profitability. That piece is still to play out.

Some of our best ideas combine the expectation of a positive secular change with a cyclical one – at the end of the day it's a lot easier to sail with the wind than against it. In early 2009 we bought a few auto-parts suppliers at a time when U.S. auto production had fallen from a high of 17 million in 2007 to 9 million, an unsustainably low level. With BorgWarner [BWA] – which we still own – we saw it benefiting not only from a cyclical rebound in U.S. car production but also from increased demand for its turbo technology as both consumers and governments sought greater fuel efficiency. With Gentex [GNTX], the leading supplier of rear-view mirrors, there was potential for it to add high-value-add functionality to its mirrors to support a government mandate that all cars by 2014 have back-up sensors alerting drivers what's behind them.

In most cases we're looking for optionality on cash-flow growth that we're not paying for. With Motorola Mobility [MMI] we think that at the current market price, after cash on the balance sheet, we're paying next to nothing for the company's mobile-handset business – which would just have to muddle along to be worth a lot more than that. In the case of



Ragen Stienke

Common Sense

As a freshman at the University of Texas in 1993, Ragen Stienke made a telling discovery about where his innate interests lay: "In engineering we'd observe the rate of air flow into a balloon and calculate how fast it would expand and I just didn't care," he says. "In economics we'd work through a similar problem – this time with money flowing into a bank account – and that made all the sense in the world."

Armed with an economics degree, Stienke spent two years at an accounting firm and five years in equity research at UBS in New York before coming home to Texas to take over Westwood Management's then-\$50 million in small- and mid-cap assets in late 2004. He cites his experience as an analyst and equity strategist during the Internet boom and bust as particularly instructive: "Going through a period like that teaches you very quickly the importance of understanding not just reward, but risk, and of stepping back and asking if all of the individual assumptions being made about companies and industries are feasible in the aggregate. That all falls under the category of common sense, but it's very easy as an analyst to be so focused on the individual brush strokes that the broader picture gets out of focus."

Hologic [HOLX], which makes medical-imaging systems, we believe the company is probably close to fair value on its existing business, but that future cash flows could be much higher from the rollout of a new first-to-market 3D mammography product. In general, low expectations can result in the types of risk/reward imbalances we try to take advantage of.

Do broader themes ever drive your ideas?

RS: Not typically. Over the past year we've built a significant position in banks, but there wasn't a top-down element to that. All the banks we own share some common characteristics: They dialed back on lending as industry pricing and credit standards got silly. They're over-capitalized and in a position to lend profitably as anemic loan demand eventually improves. They're opportunistic and have taken advantage of others' distress to strengthen their competitive position.

East West Bancorp [EWBC] is a good example. It's a commercial lender based in California that doubled its asset base in an FDIC-assisted acquisition of United Commercial Bank in late 2009. The effective price was only 1.1% of the acquired deposit base, while the FDIC gave it significant guarantees against future losses on the acquired loans. While we have no special insight into when loan demand improves, East West has significantly increased earnings power and has unique protection on the downside that we don't believe are reflected in the current share price [of \$18.70].

Describe how Westwood's research operation is organized.

RS: Portfolio managers are also analysts, with all coverage responsibility segmented by industry, up and down the market-cap spectrum. I run the small- and mid-cap strategy and also follow the software and machinery sectors for the entire firm.

Why have you chosen to specialize by industry?

RS: There's leverage in bringing what you already know to an incremental new idea.

If I'm looking at a small-cap software firm, I should have a good sense of the competitive environment, for example, including what Microsoft, Oracle and SAP are doing in the area. If I'm looking at Microsoft, I should know its strengths and weaknesses as well as the new technologies it's up against in any given market. A generalist having to learn things like that for the first time may not recognize change and opportunity as quickly.

We're cognizant of the risk that people lose sight of the forest from the trees, so each analyst covers two very different industries. I cover software and machinery.

ON SPECIALIZATION:

A generalist having to learn things for the first time may not recognize change and opportunity as quickly.

Someone else follows healthcare and energy. This should make us less likely to lock onto one way of thinking and less apt to recommend the best house in a bad neighborhood just because it's where we live.

What are your research "groups"?

RS: These four groups consist of analysts in industries with similar fundamental drivers. The technology and industrials group, which I'm in, consists of industries driven by capital spending. The consumer and healthcare group is driven more by consumer spending. The energy, materials and utilities group is heavily impacted by commodities prices and the financials group is greatly exposed to interest rates and the yield curve.

The second major risk-management step in our process – after the initial downside analysis – is a peer review within these groups. After an analyst works up an idea he or she presents it to the others in the group, who evaluate and challenge all the downside and upside assumptions being made. While they may not know the specific industry or company, they will likely be quite current on the

business models and fundamental drivers of the business. We like to say it's a lot easier to crawl out of hole if you stop digging early – here we're bringing as much collective wisdom to bear as we can to keep us from even picking up the shovel.

Describe your buying discipline.

RS: We model company performance over three years and assign a fair-value price target at the end of that period, applying what we consider the most-appropriate valuation metric – usually P/E, cash flow yield or EV/EBITDA – at a "normal" level. We want the upside we see from today's price to be at least three times the downside we've already calculated. We treat each scenario as equally likely – if we set our targets well, making three times as much money when we're right than we lose when we're wrong will serve our investors very well over time.

How many positions do you hold?

RS: We typically own 45 to 65 stocks, which is fairly concentrated for the small- and mid-cap space. We're concentrated enough to be rewarded when we're right, but by limiting position sizes we feel like we're diversified enough to protect our clients when we're wrong. Our maximum position size is limited to 3%.

We assign a model weight to each stock and want to get to that weighting as soon as possible. Some people work their way into positions, but our feeling is that your purest thinking about value is done at the beginning, before emotion gets involved as you own it. As a stock appreciates or depreciates relative to the rest of the portfolio, we will tactically sell it or buy it to get back to the model weight. A strategic decision, based on an updated assessment of value, would be to actually change the model-weight position.

How do you manage risk at the portfolio level?

RS: We have an internal risk model that allows us to track our exposure to any number of risks, based on geography, end markets, commodities prices, interest

rates, whatever. A retailer, for example, would be tagged for its exposure to consumer spending. We can then aggregate all our consumer-discretionary-spending stocks by their weighting in the portfolio to have a more complete view on what our exposure is. It can be more complicated than that. Our exposure to China would be a function not only of the aggregate Chinese revenues of our companies, but also include things like dependence on iron ore or copper prices, for which China sets marginal prices.

The goal is to understand the risks we're taking and the size of those risks. We've become sensitive to our exposure to China, for example, so have pulled back in certain materials stocks and in some early cyclicals in the machinery sector, both of which would likely suffer were China to go off track economically.

Turning to specific ideas, what caught your eye in Motorola Mobility.

RS: The company has a mobile-handset division and a division that makes the boxes that go on top of your television if you're a pay-TV subscriber. In looking at the downside, you've got \$11 per share in cash on the balance sheet. You've also got a set-top-box business earning good returns on capital and strong cash flow. There's a comp for that business, from Cisco paying a high-teens multiple of EBITDA for Scientific-Atlanta several years ago. I valued Motorola's set-top business at only 6x trailing EBITDA, plus the cash, and got a share price of around \$20, which meant the market ascribed little value to the handset business. [Note: MMI shares closed recently at \$22.90.] That's the type of thing that interests us.

So what can go right? For one, the handset market is growing strongly and the mix is shifting to smartphones, which have significantly higher prices and margins. We're assuming in our model that the smart-phone adoption curve mirrors that of the last big consumer-electronics upgrade cycle, for flat-panel TVs.

In terms of market share, we're assuming Motorola phones can get back to 10% of the market by 2014. That's up from

about 6% today, but well below the mid-20% share the company has had in the past. They've had early success with phones using the Android operating system, and while we aren't making product calls, we think it's reasonable for Motorola to be the 4th or 5th player in the market, which is what a 10% share would imply.

If we're right about share and volume growth, we expect operating margins on the handset business – and for the company overall – to hit 6% by 2014. That's a clear improvement over the tiny margins today, but again not unreasonable given that Motorola has earned 10% margins on handsets when times were good.

How can you imagine all that translating into share upside?

RS: Putting a 12-13x multiple on our 2014 earnings estimate and adding back the net cash, we come to a fair value on the stock in the mid-\$40s.

I would stress that we don't believe we're making a call on consumer preferences. We're assuming Motorola does OK in phones and basically rides the wave of smartphone adoption. If in making conservative assumptions we find a reward-to-risk profile of 100% on the upside and 15% or so on the downside, we take advantage of that whenever we can.

INVESTMENT SNAPSHOT

Motorola Mobility
(NYSE: MMI)

Business: Global manufacturer of wireless communications devices, many running on the Android operating system, and equipment for in-home consumer electronics.

Share Information
(@7/28/11):

Price	22.91
52-Week Range	20.77 – 36.54
Dividend Yield	0.0%
Market Cap	\$6.76 billion

Financials (TTM):

Revenue	\$12.01 billion
Operating Profit Margin	(-0.2%)
Net Profit Margin	0.4%

Valuation Metrics

(@7/28/11):

	MMI	S&P 500
Trailing P/E	145.0	16.5
Forward P/E Est.	14.5	13.4

Largest Institutional Owners

(@3/31/11):

Company	% Owned
Dodge & Cox	9.3%
Icahn Capital	9.1%
NWQ Inv Mgmt	5.8%
Vanguard Group	5.0%
T. Rowe Price	4.3%

Short Interest (as of 6/30/11):

Shares Short/Float	8.1%
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MMI PRICE HISTORY



THE BOTTOM LINE

Ragen Stienke believes the market is ascribing little value to the company's mobile-handset business, which if it "does OK and basically rides the wave of smartphone adoption," will be worth a lot more than that. Putting a 12-13x multiple on his 2014 EPS estimate and adding back net cash, he puts the stock's fair value in the mid-\$40s.

Sources: Company reports, other publicly available information

Do you ascribe any value to the company's patents, which Carl Icahn has been trying to get it to monetize?

RS: They have a broad patent portfolio of 17,000 granted patents and another 7,000 that have been filed. Analysts have made a wide range of estimates on what that's worth, from \$10 to \$60 per share. We're taking no position on that, other than considering it additional potential downside protection.

Are there any spin-off dynamics that might further drive profitability gains?

RS: Possibly, but that's not part of our case. We have a straightforward thesis around the handset business which results in a highly favorable risk/reward profile. These other things – whether management can streamline the company, whether they'll monetize patents, whether they can get their product groove back and take 20% of the market again – are not insignificant, but aren't reasons we own the stock. Were they to happen, it would be incremental upside.

Describe your investment case for disk-drive maker Western Digital [WDC].

RS: The case today centers on how dramatically the disk-drive business has changed. In the 1980s there were maybe 140 different players in the industry, a number that had shrunk to five when we first bought into Western Digital. After its recently announced acquisition of Hitachi Global Storage and Seagate Technology's purchase of Samsung's hard-drive subsidiary, it will be down to three.

The result of that consolidation is that pricing and capacity management within the industry has become much more rational, the effects of which you actually saw during the downturn. WD would historically make decent money in an upturn and then lose money in a downturn, but this time its low EBITDA margin was 8% for a quarter and roughly 14% for a year.

At the same time we're seeing positive structural change, secular demand for disk-drive storage is quite strong. Part of

that is the expansion of data centers, increasingly called upon to store data and information in the "cloud." What impacts WD most directly is the growing demand for consumer storage of photos, music and video – a market in which its cost-efficient drives have leading share.

Finally, there's still somewhat of a cyclical story benefiting WD as well. We're probably halfway through the personal-computer refresh cycle, prompted by companies starting to buy in response to the release of Microsoft's new operating system and by purchases at faster than a replacement rate after cutbacks during the recession.

Are you worried by the company's relative absence from the hottest market segment, making solid-state drives used in smartphones and tablets?

RS: That is a worry, but more out of concern that smartphones and tablets erode desktop-computer sales than that solid-state drives – which are 10 to 15 times more expensive – take share in Western's core markets. On a global basis, we believe the end-market demand for PCs with WD's drives will continue to show at least low single-digit growth.

The story may be different for storage in the data center, where solid-state drives

INVESTMENT SNAPSHOT

Western Digital
(NYSE: WDC)

Business: Designs and manufactures hard disk drives used in personal computers, consumer electronics, enterprise applications and as branded external drives.

Share Information
(@7/28/11):

Price	35.34
52-Week Range	23.06 – 41.87
Dividend Yield	0.0%
Market Cap	\$8.21 billion

Financials (TTM):

Revenue	\$9.50 billion
Operating Profit Margin	9.9%
Net Profit Margin	8.7%

Valuation Metrics

(@7/28/11):

	<u>WDC</u>	<u>S&P 500</u>
Trailing P/E	10.0	16.5
Forward P/E Est.	8.1	13.4

Largest Institutional Owners

(@3/31/11):

<u>Company</u>	<u>% Owned</u>
Vanguard Group	5.1%
Fidelity Mgmt & Research	4.0%
State Street	3.9%
LSV Asset Mgmt	3.3%
First Pacific Adv	2.9%

Short Interest (as of 6/30/11):

Shares Short/Float	2.0%
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WDC PRICE HISTORY



THE BOTTOM LINE

The company is well-positioned to benefit from rising secular demand for data storage, more rational industry competition and its timely acquisition of Hitachi Global Storage, says Ragen Stienke. Putting an 11x multiple on his 2014 EPS estimate and adding back \$8-9 per share in net cash, his target price for the stock is in the mid-\$70s.

Sources: Company reports, other publicly available information

– which produce less heat and have faster input/output speeds – may be more easily cost-justified. One big potential positive of the recent Hitachi Global Storage acquisition is that it has solid-state drive technology it’s just now offering to manufacturers of high-end systems. That could be a real winner for Western, which we believe we’re paying nothing for.

With the shares recently at \$35.30, how are you looking at valuation?

RS: If someone pitched me a stock with trough margins in the mid-teens, peak margins above 20% and an average return on assets over the past ten years of 15% – all of which describes Western Digital – I’d say that sounds like a 10x-EBITDA business. But the stock today, on an enterprise-value basis, trades at only 3.5x trailing EBITDA.

Looking three years out we believe the company can earn at least \$6 per share, well above Street estimates due primarily to upside we see from the Hitachi deal. Put an 11x multiple on that and add back excess cash of \$8-9 per share and our target price on the stock is in the mid-\$70s.

We like situations where we can win both because earnings grow and because the stock can be re-rated to reflect changes in the underlying business fundamentals. That’s certainly the case here.

From disk drives to diesel trucks, describe the upside you see in Navistar [NAV].

RS: Navistar is a leading player with its International brand in Class 8 18-wheelers, smaller delivery-type trucks and school buses. Class 8 trucks account for about 40% of revenues, Class 6 and 7 trucks for 20% and buses for around 10%. Its top competitors include Paccar and Volvo.

What’s primarily behind our interest is the belief that commercial-truck demand is still in the relatively early stages of a positive replacement cycle that will be more robust and last longer than the market seems to expect. In 2005 the EPA issued plans to restrict diesel-engine emissions, setting off a huge pre-buy of diesel

trucks, particularly 18-wheelers, as big fleets tried to buy as many trucks as they could before the restrictions took effect. Tougher emission controls typically mean higher truck prices and higher operating costs. That pre-buy caused demand to fall below replacement levels in both 2006 and 2007.

That weak demand continued into 2008 and 2009 as a result of the recession. So over four years in the U.S. Class 8 truck market, for example, demand averaged 125,000 units or so, versus a normal replacement level – assuming an average four- to five-year fleet age – of 250,000 to 275,000.

With the overall fleet age at all-time highs in 2010, we thought it was inevitable that demand would pick up even if the economy remained sluggish. At some point, trucks become so much more expensive to operate as they get older that it makes more sense to buy a new one than to keep the old one going. We expected that happening over the entire market to prompt some pretty sharp increases in demand.

What’s happened so far?

RS: On a trailing-12-month basis, the order rate is running around 290,000. So

INVESTMENT SNAPSHOT

Navistar
(NYSE: NAV)

Business: Manufacturer of commercial and military trucks, buses, recreational vehicles, diesel engines and chassis. Also provides service parts for trucks and trailers.

Share Information
(@7/28/11):

Price	51.13
52-Week Range	40.58 – 71.49
Dividend Yield	0.0%
Market Cap	\$3.72 billion

Financials (TTM):

Revenue	\$12.69 billion
Operating Profit Margin	4.0%
Net Profit Margin	1.8%

Valuation Metrics

(@7/28/11):

	NAV	S&P 500
Trailing P/E	16.9	16.5
Forward P/E Est.	9.1	13.4

Largest Institutional Owners

(@3/31/11):

Company	% Owned
Fidelity Mgmt & Research	11.9%
Wellington Mgmt	9.5%
Owl Creek Asset Mgmt	5.6%
Vanguard Group	4.2%
Cramer Rosenthal McGlynn	3.9%

Short Interest (as of 6/30/11):

Shares Short/Float	5.7%
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NAV PRICE HISTORY



THE BOTTOM LINE

Ragen Stienke believes we’re still in the relatively early stages of a positive replacement cycle for commercial trucks that will be more robust and last longer than the market seems to expect. At 10-11x the at least \$11 per share he estimates the company can earn by 2014, its shares would trade at more than twice their current level.

Sources: Company reports, other publicly available information

in terms of orders – not yet production – we just went above annual replacement rate. Just to get the fleet age back to normal, we think it's reasonable to assume annual unit production gets back to at least 350,000 and stays there for an extended period.

Are you counting on any upside from the company's defense business?

RS: Navistar has had considerable success selling Mine-Resistant Ambush Protected (MRAP) vehicles to replace Humvees in Afghanistan and Iraq. Management believes defense can be a \$1.5 to \$2 billion business for them on an ongoing basis, down from a peak trailing-four-quarter level of \$3.5 billion.

We don't profess any special insight on military spending or the incidence of war going forward, but our assumption is that they maintain a profitable business at just north of \$1 billion in annual sales. Any upside from there would be a free option.

Another potential positive is that the company has started making its own engines – it had been buying from Cummins – using a unique technology that meets EPA emissions standards by sending exhaust back through the engine so that any leftover diesel is burned prior to the exhaust being emitted. This competes with technology offered by other engine makers that adds urea to the combustion process, the downside of which is that a separate tank of urea needs to be refilled from time to time. We're not counting on it, but there's a possibility the new engines help Navistar gain truck market share, while also capturing incremental margin by insourcing.

What's your estimated fair value for the stock, now trading at around \$51?

RS: We think the Street is underestimating the strength and longevity of the truck-replacement cycle, which pushes our 2014 EPS estimate north of \$11. Using a simple earnings multiple of 10-11x, our fair value on the stock is more than twice the current price. We're trying to be conservative on the multiple, which

you want to do on earnings estimates that are at least approaching peak levels.

Describe the potential you see in refashioned auto-parts supplier Visteon [VC].

RS: This is one of the many auto-parts suppliers – its main business is providing HVAC componentry – that went through bankruptcy and came out with a balance sheet dramatically better than it had ever had. Given how bad their balance sheets were, we historically wouldn't have owned anything like this.

Our work on the downside illustrates how inexpensive the stock is. There are a

few distinct stores of value – a majority-owned Korean company called Halla, a 50/50 joint venture in China called Yanfeng, the core Visteon business in the U.S., and \$1.8 billion in net operating loss carryforwards. To value Halla, a supplier to Hyundai, Kia and Ford Europe that trades on the Seoul exchange, we just use the current market value of Visteon's stake. For Yanfeng, we use a 10x multiple of earnings, the low end of the peer-group range for Chinese auto-parts suppliers who have been growing 30-40% per year. For the NOLs we just take the net present value. To value Visteon U.S. we assume a normal

INVESTMENT SNAPSHOT

Visteon
(NYSE: VC)

Business: Supplier of a variety of climate-control, entertainment, lighting, safety, door and interior-trim systems for original-equipment automotive manufacturers worldwide.

Share Information
(@7/28/11):

Price	64.26
52-Week Range	50.76 – 76.61
Dividend Yield	0.0%
Market Cap	\$3.26 billion

Financials (TTM):

Revenue	\$7.54 billion
Operating Profit Margin	0.7%
Net Profit Margin	11.0%

Valuation Metrics

(@7/28/11):

	VC	S&P 500
Trailing P/E	7.0	16.5
Forward P/E Est.	18.6	13.4

Largest Institutional Owners

(@3/31/11):

Company	% Owned
Cramer Rosenthal McGlynn	5.3%
Cyrus Capital	4.6%
Soros Fund Mgmt	4.2%
Solus Alternative Asset Mgmt	3.0%
Epoch Inv Partners	2.6%

Short Interest (as of 6/30/11):

Shares Short/Float	3.3%
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VC PRICE HISTORY



THE BOTTOM LINE

With key assumptions that U.S. car production returns to 80-85% of its latest cyclical peak, that the company's margins increase by 200 basis points as a result of operating leverage, and that its Chinese joint venture grows at a 30% annual clip, Ragen Stienke's sum-of-the-parts analysis yields a share-value estimate of \$105 to \$110.

Sources: Company reports, other publicly available information

multiple of 6x earnings. The company also net cash of \$250 million, which we just take at face value.

With those assumptions we can isolate the value the market appears to be placing on the component parts. Valuing everything else first, the core Visteon business in the U.S. trades today at less than 2.5x EBITDA. Doing the same to isolate the Chinese joint venture, that business is free.

Is there a positive operating story to tell here as well?

RS: We make three key assumptions in our model. One is that Yanfeng grows at around 30% per year, quite healthy, but a slowdown from its current pace. We also assume a cyclical recovery in U.S. auto production to a seasonally adjusted annual rate of 14 to 15 million per year. That's off the peak level of 17 million in 2007, but well above the recent 9 million trough and ahead of the year-to-date run rate of 13 million. Third, we used a normalized operating margin of 10%, which is 200 basis points above the current level to reflect operating leverage as volumes increase.

How do you see all that translating into share upside from the current price of around \$64?

RS: Applying all the valuation levels we used in our sum-of-the-parts downside analysis, we arrive at a fair value for the shares in the \$105 to \$110 range.

The biggest risks?

RS: The first is that the U.S. car business doesn't continue to recover. We're clearly in an uncertain environment and while we see no reason why auto production won't again hit new highs, the timing is quite unclear.

There is also the risk we never realize full value for the Chinese joint venture, say because it's nationalized or has to be sold for a fire-sale price. That's one reason we did the downside calculations the way we did, to isolate our financial risk in

that business. At today's market price, we think it's close to zero.

You haven't said much about management. Why?

RS: We obviously prefer to invest with good management than not, but our assessment there isn't central to our process. We fully develop our investment thesis before we meet with management and then look to confirm whether their ideas for creating value are aligned with ours. If they aren't, we're unlikely to buy in the hope that they or their replacements eventually come around. Our experience

ON THESIS "CREEP":

One of the best ways to lose money over time is by owning stocks with changing investment rationales.

is that you can wait a very long time for that to happen.

I'd looked for years at BJ's Wholesale [BJ], which we now own, but didn't agree with management's view that value creation would come from aggressively building out the store base. When a new CEO came in and, importantly, was given a compensation package focused not on earnings growth but on returns on capital and improving the performance of the existing asset base, we then got comfortable enough to buy the shares.

You mentioned earlier the importance of not digging deep holes for yourself. Any secrets on doing that?

RS: When we buy a stock we write down exactly why we own it, which we should be able to lay out in three or four sentences. For Hologic, it's that we believe its new 3D technology will allow it to gain market share, grow revenue and expand margins. To the extent that's not happening – say the FDA forces them to recall their product or a competitor comes out


with clearly superior technology – we'll sell regardless of how cheap it gets on the news. We're fighting the natural tendency to come up with new reasons to own something, for the simple reason that we've found in our post-mortem work on mistakes that one of the best ways to lose money over time is by owning stocks with changing investment rationales.

We require a complete review of any stock down 20% over a rolling 30-day period. The analyst has to take it back to the peer-review group to work through the entire thesis and judge whether the assumptions are still valid. The portfolio manager then has to decide whether we sell it, keep it, or buy more.

What have you sold recently because the thesis changed?

RS: We owned Hudson City Bancorp [HCBK] because it was over-capitalized and we thought it was well positioned to take advantage as the government got increasingly out of the residential-mortgage business and as loan demand and pricing normalized in the northeastern U.S. As it became clear to us the government wasn't really pulling back – keeping rates artificially low and increasing the mortgage amount at which Fannie Mae and Freddie Mac would issue guarantees – we concluded our thesis was flawed and sold the stock.

Excellent performance runs like yours have a way of reversing themselves. How do you hope to avoid that?

RS: We're very aware that you can go from hero to zero pretty quickly in this business, and there will certainly be years when the market is running hot and we won't keep up. What we try to do is to stay consistent in our obsession with risk, which I can tell you no one found particularly interesting in 2006. But it's not something we just started doing because it's popular – we believe the best way to make money is by not losing it, and to take advantage when risk becomes mispriced. If we do that, our investors should be well served. 

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