Value Investor INSIGHT
The Leading Authority on Value Investing
July 31, 2012

# At the Extremes

*Taking heed of one of value investing's best aphorisms – to "swing only at fat pitches" – Chris Mittleman has posted a stunning batting average so far.*

**INVESTOR INSIGHT**

**Chris Mittleman**
Mittleman Brothers LLC

**Investment Focus:** Seeks companies that generate strong free cash flow over a complete cycle, when the market's skepticism of that ability appears at its peak.

Chris Mittleman takes seriously his responsibility for open communication with investors through good times and bad, but will admit that certain investors could cut him a bit more slack. "My dad still complains the loudest when we're down," he says.

Mittleman has left little room for investor complaint since setting up an independent investment practice in 2002, which morphed into founding Mittleman Brothers LLC three years later. Since the end of 2002, he's earned a net annualized 20.9%, vs. 6.8% for the S&P 500.

His typically eclectic value approach is uncovering bargains today in such varied areas as car rental, cosmetics, lasers, cable TV and blood plasma. See page 11



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# Investor Insight: Chris Mittleman

Chris Mittleman of Mittleman Brothers LLC explains how he tries to distinguish himself from other value investors, the most important question he looks to answer through fundamental research, the most common mistake he thinks contrarian investors make, and why he sees significant upside in Avis Budget, Revlon, Virgin Media, GSI Group and Biotest AG.

**Are there any ways in which you'd argue your value investing style is unique?**

**Chris Mittleman:** Value investing to me is trying to find companies that have proven over a complete business cycle that they can generate significant free cash flow, and then buying their stocks when the market accords those cash-flow streams a very low multiple. My brother Phil [Mittleman Brothers' chief operating officer] hates it when I say this, but I don't think our strategy is that different from other true value investors. If there is something that sets us apart, I'd like to believe it's that we're more selective. One of my favorite investing quotes of all time is from Joe Rosenberg, Loews Corp.'s chief investment strategist for many years, who said the secret to outperformance is to "have opinions at extremes, and wait for extreme moments." We're willing to wait for the perfect pitch rather than swing at things that look pretty good. It's not that hard to find pretty good values, it's much harder to be patient and only buy the great ones.

**In looking at your portfolio over time, it's difficult to pinpoint a "typical" type of idea. Why do you think that is?**

**CM:** I take that as a compliment. I've never wanted to limit myself by things like business model, industry, cap size or geography. Those distinctions strike me as somewhat artificial and are limiting in a world where great opportunities can be anywhere and are constantly changing.

I would say we've naturally gravitated more to small caps – our current median market cap is $800 million – not by design but for all the same reasons that small-cap stocks tend to outperform over time. They're less followed, less liquid and more volatile, all of which can result in the bigger differences between price and intrinsic value that we try to take advantage of.

We've also from early on had more of a global focus. It's still more likely outside the U.S. to find companies with growth opportunities that are overlooked, or whose businesses in most respects are just like U.S. counterparts but the valuations are much lower. We own a South Korean company, KT Corp. [KT], that is in many respects that country's Verizon, with a fixed-line telephony business in decline and nicely growing Internet-broadband and wireless divisions. But while Verizon trades for 5.8x EBITDA on an enterprise-value basis, KT goes for only 3.4x. Verizon's dividend yield is 4.5%, while KT's is 6.5%. You can come up with reasons – the Korean market is more depressed this year than the U.S. market, KT has been slow in getting its 4G/LTE network up and running – but nothing long-term that we believe justifies that kind of discount.

**What the biggest market-cap company you own today?**

**CM:** It's another Korean company, KB Financial Group [KB], which owns the largest retail bank in South Korea and has a $12 billion market cap. As with KT, part of our interest in KB stems from the fact that we believe Korean stocks in general are trading at an attractive discount, but we also like that the company is the rare bank today with excess capital that it's looking to put to work in higher return-on-equity businesses. If it can't do that through acquisition, the chairman has committed to returning capital to shareholders through dividends or share buybacks – an explicit shareholder orientation that you see less often in Asia. The ADR today [at a recent $31] trades at just 68% of book value, while the company's current ROE of 10-11% would justify a price much closer to book value. And whether excess capital is reinvested or returned, we expect book value per share to grow in the future.

Chris Mittleman

## Natural After All

Adrift and unfocused, Chris Mittleman took a job as a sales assistant at brokerage Shearson Lehman Hutton in early 1990, seeing it as an entrée into a financial world in which he had a budding interest. "I certainly wasn't a natural," he says. "I'm shy and reserved, which isn't conducive to a successful sales practice."

He stuck it out, leaving Shearson for Paine Webber, where over 11 years he developed his research skills and built client portfolios with an eclectic mix of deep-value stocks, many of which were small-caps and traded outside the U.S. This strategy always rankled superiors because it ignored the firm's research and recommended lists, but it wasn't until the early 2000s that his bosses' patience truly wore thin. "I'd say look at the performance. In 2000 and 2001 my client portfolios were up nicely, but had I followed the firm's highlighted buy list, the portfolios would have been decimated. They basically said they didn't care."

Mittleman went out on his own in 2002, first affiliated with boutique brokerage Spencer Clarke and then in 2005 forming Mittleman Brothers LLC. His strategy remains, the conflicts are gone. "Much better for everybody," he says.

**What's your smallest market-cap?**

**CM:** That would be one causing me immense pain lately, LodgeNet Interactive [LNET]. One common reason we find stocks trading at a discount is when the market seems to fear a cyclical issue is actually more secular and permanent. That's what we thought was the case here. The company provides in-room entertainment systems to hotels, and while we were prepared for it to face headwinds from people ordering fewer movies because they were watching stuff on their laptops, we didn't anticipate the rate at which hotels would drop LodgeNet as a service provider altogether and just go with the local basic-cable provider. The market-cap now is almost too small to do anything with, so we're holding it for the time being as sort of an option that the business stabilizes and the new CEO can turn things around.

Another tiny market cap that we're actually excited about is Capital Trust [CT], a commercial-mortgage REIT. The company was left for dead by the analyst community following the financial crisis, but it was able to creatively restructure its balance sheet in a way that offloaded a lot of debt while maintaining assets that we believe have a net liquidation value of maybe $4.50 per share, on a stock today that trades at $2.90. Capital Trust also has $430 million of tax-loss assets that its Chairman, Sam Zell, is unlikely to let go to waste.

**How do you prospect for ideas?**

**CM:** Not to be overly simplistic, but a lot of it comes down to following the news and reading. You never know what might jump off the page and say, "Look at this." As an example, years ago I was reading an article in *The Economist* in which someone was talking about emerging consumerism in Asia and there was a single line saying something about how this company, that company and Lotte Confectionery might be beneficiaries. I had never heard of Lotte Confectionery, but as I looked into it I found out not only that it was a large, global candy and sweets company based in South Korea, but also that it was cash-flow positive and its stock was trading at around net cash per share. You obviously end up hitting a lot of dead ends, but I've found plenty of things no one seems to be paying attention to in this way.

Like a lot of value investors, I also rummage around where there's crisis and scandal. Usually you run away screaming, but the uncertainty surrounding a crisis can create opportunity if you have a different view than what's priced in. One classic example in 2002 was Tyco International, after its CEO and CFO were arrested for stealing from the company and misrepresenting its condition. People thought it was the next Enron, but it owned cash-generating businesses, not mumbo-jumbo trading operations. It made no sense that Tyco's businesses suddenly lost their cash-generating capability just because top management was crooked. The stock went from $70 to $15, at which point I started to buy because I thought the market was panicking rather than behaving rationally. A week later the stock was at $7. When the panic finally subsided – and our average cost got down to $11 – the shares eventually started to reflect the company's value and we ended up selling two years later at more than $30.

**ON MANAGEMENT:**

**I'll tolerate less-than-ideal management way before I'll compromise on the business or the valuation.**

A more recent example is laser-equipment manufacturer GSI Group [GSIG]. The company in late 2009 filed for bankruptcy and the stock continued to trade as competing reorganization plans were being reviewed. Existing management put together a plan that left little for shareholders, but we thought the equity-owner recovery could and should be much better. There was a reason the stock was cheap – that management's plan would win out – but we disagreed with it.

Probably most common on the new-idea front is when something we know well runs into a problem we think is fixable. I remember marveling at how ridiculously overpriced Revlon [REV] shares were when it went public in 1996, but I followed the company over the years because I find the beauty-products business attractive. I wasn't smart enough to buy it when the share price fell close to $2 after the financial crisis, but as new management came in and started to have a positive influence, we saw – and still see – considerable potential upside.

**What do you consider the primary focus of your research?**

**CM:** To understand the business, the company's position in it, and the viability of management's strategy. I spend most of my time reading everything the company has said: How has the business done relative to what was planned? Has management consistently done what it said it was going to do? It really comes down to assessing the durability of the franchise, to make the best judgment on whether the people selling the stock today are right or not.

**How much weight do you put on management acumen?**

**CM:** The ideal situation is a great business, with great management and a great valuation. Usually those three things don't go together, with management missteps often the reason something is cheap. I'll tolerate less-than-ideal management way before I'll compromise on the business or the valuation.

**How generally do you assess valuation?**

**CM:** I try to keep it simple by asking what an informed buyer would pay to have an acceptable cash-on-cash return in owning the whole business. I want to pay no more than 10x free cash flow on a current basis, much less if possible. I will look at "normal" free cash flow if there's a particularly cyclical aspect to the business, but I discount everything back to what it would be worth today. I don't want the thesis to depend too much on my ability to predict this or that happening in the future.

Stress-testing the business is also important. I'm very leery of any business that is so cyclical that it burns cash at or near the bottom. I've concluded there are enough alternatives out there that I don't need to accept that kind of risk.

**You've said you've learned to scale in and out of positions. Why?**

**CM:** I usually own 15 to 20 stocks at a time, so a full position is around 5%. I used to buy full positions right away, but have humbly learned as a value investor that the stocks going down that you're attracted to quite often tend to continue to go down. I won't buy less than a 2.5% new position, but usually leave room to fill out the position at a better price. The same is true on the other end, where in response to far too many premature sales, I will often scale out deliberately as a stock hits my fair value range. The concept of price momentum is real and, within reason, I'll try to benefit from it.

**Do you have any risk-management rules?**

**CM:** The selectivity I spoke of earlier should be our best protection against risk, and cash will build if there are no fat pitches to swing at. That's not fool-proof, however. In the Spring of 2007 a lot of our companies were hitting fair value and cash piled up to about 20% of the portfolio, higher than ever. Unfortunately, as the market started coming down later in 2007 and into early 2008, we put all the cash back to work in what we thought were great values. Through the crash and the ensuing rebound that turned out mostly to be true, but we suffered the full brunt – and then some – of 2008's decline.

We don't have sector limits, but the reality is we rarely own more than one company in an industry at a time. Focusing on 15 to 20 stocks, part of being selective is choosing the absolute best opportunity in a given sector. It's unlikely that the second-best one would make the cut as well.

I'll also limit position sizes when potential outcomes are too binary. We own Penn Virginia [PVA], which because it's a small cap, its cash flow is sensitive to energy prices and its balance sheet is highly leveraged, may be our riskiest position. There's a lot to like about it, but something with this risk profile would almost never be more than 2.5% of the portfolio.

**Walk through the investment thesis for top holding Avis Budget [CAR].**

**CM:** We've owned this in a variety of incarnations, when it was part of the conglomerate Cendant, when we owned the then-separate Avis Europe, and now after Avis Budget bought Avis Europe last year.

We like the travel and leisure space because, though cyclical, the cycles tend to be brief and the growth trajectory is nicely up. Fueling that now is an expanding addressable population coming into the market, with the newly middle class from emerging markets starting to travel in big way. As a trusted, truly global brand, Avis is well positioned around the world to benefit from that.

We consider car rental to be one of the best ways to play travel-industry growth,

**INVESTMENT SNAPSHOT**

**Avis Budget**
(Nasdaq: CAR)

**Business**: Car and truck rental services worldwide; Avis brand focuses on the higher-end and commercial customer, with Budget targeting the value-conscious.

**Share Information**
(@7/30/12):

| | |
|---|---|
| **Price** | **14.77** |
| 52-Week Range | 8.45 - 16.97 |
| Dividend Yield | 0.0% |
| Market Cap | $1.57 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $6.29 billion |
| Operating Profit Margin | 13.3% |
| Net Profit Margin | (-0.9%) |

**Valuation Metrics**
(@7/30/12):

| | CAR | Russell 2000 |
|---|---|---|
| Trailing P/E | n/a | 31.7 |
| Forward P/E Est. | 5.7 | 14.8 |

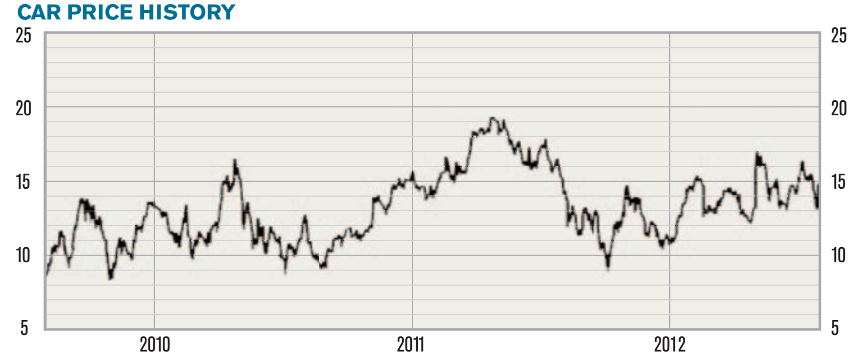
**Largest Institutional Owners**
(@3/31/12):

| Company | % Owned |
|---|---|
| SRS Investment Mgmt | 9.4% |
| Dimensional Fund Adv | 7.4% |
| PAR Capital | 6.3% |
| Columbia Wanger Asset Mgmt | 5.9% |
| Vanguard Group | 5.4% |

**Short Interest** (as of 7/13/12):

| | |
|---|---|
| Shares Short/Float | 12.3% |

**CAR PRICE HISTORY**




**THE BOTTOM LINE**

Following the company's acquisition of Avis Europe, it is now even better positioned to benefit from secular growth in the global travel and leisure industry, says Chris Mittleman, but its shares trade as if its best days are long gone. At even a below-average 6.5x EV/EBITDA multiple on this year's estimated numbers, the stock price would be $25.

Sources: Company reports, other publicly available information

because the companies have much more ability to protect cash flow by pulling back inventory during downdrafts. That was borne out for companies like Avis in the aftermath of 9/11 and the Great Recession, when they sold off excess cars at auction within weeks of the first signs of trouble. Airlines and hotels can't do that.

**Was the acquisition of Avis Europe somewhat ill-timed?**

**CM:** Integration with Avis Europe is going very well, and we expect it to benefit the company significantly for years to come as it brings expanded access to faster-growing markets in Asia, Africa, and the Middle East. The company also believes Avis Europe was neglecting the Budget brand and that it has significant potential to grow in the economy and leisure segments of the market. Budget is already gaining significant traction in Spain, for example, where it hadn't been properly promoted.

We have a lot of confidence in Avis' CEO, Ron Nelson, who has run the company since the Cendant days. He lays out clearly what he plans to do and then executes. Though the business is just getting back to its pre-recession revenue levels, EBITDA this year – including maybe $100 million from Avis Europe – should come in around $850 million. That compares with previous peak annual EBITDA of less than $500 million.

**Is the profit benefit in recent years from strong used-car prices at risk?**

**CM:** That has clearly been a tailwind, and car-rental companies may be somewhat overearning from sales of unwanted inventory into the used-car market at very strong prices since the recession hit in 2008. Avis used to talk about overall peak EBITDA margins of 8-10%, and they're now well above that.

My view is that this is a risk, but that the strength of the economy is not any time soon going to cause people to abandon the used-car market and start buying new cars hand over fist. I also believe the shares trade at enough of a discount that even if used-car prices do come down somewhat, it doesn't materially negate the upside here.

**What upside do you see from today's price of $14.75?**

**CM:** Management has guided to a fairly wide range of free cash flow for this year, with the midpoint at around $400 million, which is $3.75 per share. That makes the free-cash-flow multiple less than 4x, while car-rental companies typically trade for 8-10x. Being conservative because of the potential that used-car prices fall, I'm using just over a 6.5x multiple to arrive at a fair value of $25 per share. I don't believe Ron Nelson would consider selling the company even for that.

I mentioned earlier about scaling into positions. This is one we've built to a 10% weighting over the past three months, a result of seeing the thesis being validated by the company's performance without the stock price reflecting that. That's increased our conviction.

**ON REVLON'S TOP HOLDER:**

**Ron Perelman controls 75% of the stock, a key reason the market hasn't recognized Revlon's transformation.**

**Describe the opportunity you still see today in Revlon.**

**CM:** What we like about the beauty-products business – especially the mass-market end of it in which Revlon competes – is the steadiness of demand and the predictability of free cash flow over time. Even though Revlon for many years was burdened by way too much debt, its market share in its primary cosmetic and skincare areas held up fairly well. Through the latest recession, when the U.S. consumer took it on the chin, company sales went down maybe 5% from 2007 to 2009, but EBITDA and free cash flow actually rose.

On top of that relative stability you have a company that has been transformed over the past three years since Alan Ennis took over as CEO. He had been the CFO, but was promoted to navigate the company through the financial crisis and put it on more solid operational and financial footing. He's done just that, paring the product line-up, refinancing debt and significantly cutting costs, to the point where Revlon's EBITDA margins, at just under 20%, are now on par with much-larger industry peers such L'Oreal and Estee Lauder. Free cash flow, negative until 2009 because the company was burning so much money on interest expense, should be around $100 million this year, nearly $2 per share.

One key reason the market hasn't recognized Revlon's transformation is the fact that Ronald Perelman still controls more than 75% of the shares. He has a deserved reputation for trying to stiff minority shareholders and even attempted to do so here in 2009, trying to steal the company for about $5 per share when the stock was near an all-time low. Shareholders sued and a Delaware court said minority shareholders had to be given the option to decline the offer, which most did. A few months later the stock went way up because of better-than-expected earnings.

Perelman's motives are certainly a concern, but he did help save the company after the crisis by putting in more money, and he played a major role in Alan Ennis taking over as CEO. The discount to fair value here is large enough that we'll accept the illiquidity in the stock and the risk that he acts against our interests.

**At a recent $13.60, how cheap do you consider the shares?**

**CM:** Public peers like Estee Lauder and L'Oreal currently trade for around 12x EBITDA on an enterprise-value basis. Revlon, on the other hand, assuming consensus EBITDA this year of $274 million, net debt of $1.1 billion, $100 million in pension liabilities and 52 million shares outstanding, trades for just over 7x EV/EBITDA. I accept that the ownership

### INVESTMENT SNAPSHOT

**Revlon**
(NYSE: REV)

**Business**: Manufactures and markets beauty-care products, primarily through mass merchants, under brands such as Revlon, Almay, Ultima II and Mitchum.

**Share Information**
(@7/30/12):

| | |
|---|---|
| **Price** | **13.57** |
| 52-Week Range | 11.18 - 17.99 |
| Dividend Yield | 0.0% |
| Market Cap | $710.1 million |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $1.38 billion |
| Operating Profit Margin | 13.9% |
| Net Profit Margin | 3.7% |

**Valuation Metrics**
(@7/30/12):

| | REV | Russell 2000 |
|---|---|---|
| Trailing P/E | 13.8 | 31.7 |
| Forward P/E Est. | 8.4 | 14.8 |

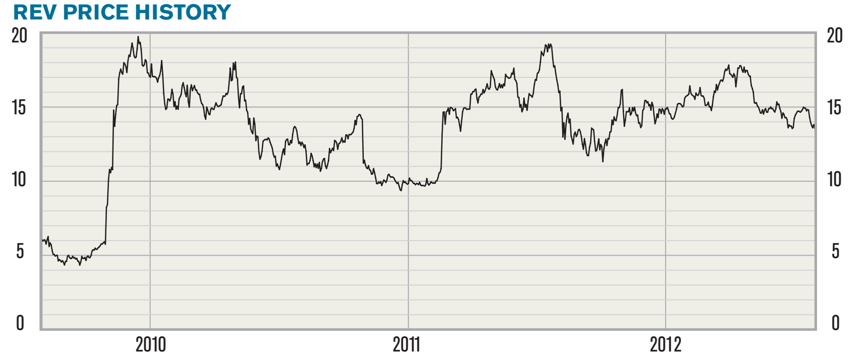
**Largest Institutional Owners**
(@3/31/12):

| Company | % Owned |
|---|---|
| Troob Capital | 4.0% |
| Fidelity Mgmt & Research | 2.1% |
| Vanguard Group | 1.4% |
| BlackRock | 1.4% |
| Dimensional Fund Adv | 1.2% |

**Short Interest** (as of 7/13/12):

| | |
|---|---|
| Shares Short/Float | 3.3% |

**REV PRICE HISTORY**




**THE BOTTOM LINE**

Likely due to the illiquidity of its shares, the market isn't recognizing the company's increased profitability, its revamped balance sheet and its resilient global business model, says Chris Mittleman. He says that at even 9x this year's estimated EBITDA on an enterprise-value basis – larger peers go for 12x – the shares would trade at more than $23.

Sources: Company reports, other publicly available information

structure warrants some discount, but can't imagine why a company with a profitable and resilient business model, backed by a strong global brand with 45% of sales coming from overseas, isn't worth at least 9x EBITDA. I think that's conservative, but even at that multiple the stock would trade for more than $23 per share.

**Key risks?**

**CM:** The company competes with strong players that are much bigger and can spend more money on new-product development and marketing. That's not a new risk, but it poses a constant challenge to Revlon's market share. We take comfort in the fact that share shifts have proven to be fairly glacial over time. Also, now that profitability has improved and the balance sheet is healthier, Revlon should be an even more nimble competitor than it has been in the past.

**You've called cable TV "a basic utility of modern life." Is that part of what's behind your interest in Virgin Media [VMED]?**

**CM:** Virgin by far is the U.K.'s largest cable-TV company, whose major competitor is News Corp.'s BSkyB satellite service. People were worried in the 2008 recession that strapped consumers would cut back sharply on premium pay-TV services, but it didn't happen. Virgin's revenue, EBITDA and free cash flow kept going up through the recession, confirmation to me that people consider pay-TV much less a luxury than a basic utility.

BSkyB is a strong rival, but Virgin defends its position well for two primary reasons. The first is its state-of-the-art broadband infrastructure, which generally allows it to offer better speed and performance than rivals, at comparable cost. The company is currently getting a lot of traction with an ad campaign, featuring Richard Branson and sprinter Usain Bolt, that plays up its network's speed.

Another advantage is its ability to bundle services, now in a "quadruple play" of telephone, TV, Internet and wireless. Something like 65% of subscribers take at least three services, with 15% or so taking all four. Both of those percentages are increasing, which has a positive impact on overall growth and in reducing customer churn. The more services people take, the less likely they are to leave.

**How do you handicap the threat of new competition, namely from British Telecom building out its fiber-optic cable services?**

**CM:** It's clearly an issue, and we can learn a lot about the potential impact from what's happened to U.S. cable companies as Verizon has rolled out its FiOS service in their markets. One mitigating factor is that the U.K. pay-TV market is not as saturated as in the U.S., with Virgin currently passing only 50% of the homes in its market. In addition, partly based on U.S. companies' experience, we believe Virgin has room to expand its average revenue per user [ARPU], which is much lower than it is for comparable companies in U.S.

There are also new Internet-based competitors out there, but we don't consider them much of a threat anytime soon. Virgin has been in the vanguard in delivering all the services its customers would want in the highest-quality form. As evidenced by what happened in the latest recession, people are unlikely to give that up to save a few bucks on an inferior product.

**With the shares at a recent $27.50, how are you looking at valuation?**

**CM:** I look at everything in dollars, so using last year's EBITDA of $2.55 billion, the current EV/EBITDA multiple on a trailing basis is around 6.5x, which is not really an outlier relative to global peers. It gets more interesting when you look at cash flow, given that Virgin has a massive tax-loss carryforward that significantly limits the cash it has to expend on taxes. This year's free cash flow should be around $750 million, while next year's is expected to be closer to $1 billion, as capital spending declines and they continue to have success adding multi-service subscribers. On next year's number, then, the free cash flow yield is over 13%.

Our view is that a business with this kind of market position, resilience and still-decent growth potential could easily trade at less than a 10% free cash flow yield, particularly given where interest rates are today. Using 11x free cash flow, my estimate of fair value is around $40 per share.

I'd add that Virgin has been about as aggressive in buying back stock as I've ever seen, repurchasing about 20% of its shares outstanding over the past few years. As long as the valuation stays low, it's likely to continue to do so at prices that increase the intrinsic value per share for the remaining equity holders.

**You mentioned GSI Group [GSIG] earlier. Now that its crisis has passed, why are you bullish on its prospects?**

**CM:** GSI makes lasers and related products which are sold globally to a variety of customers in the semiconductor, medical-products and other manufacturing industries. It's a cyclical business, but also one that overall has for decades grown faster than GDP. For many applications, lasers can process metals more quickly and efficiently than traditional methods, so as the systems have come down in price they continue to take market share from incumbent machine-tool manufacturers. We consider it an under-recognized area in the world of industrial equipment, with room to grow for years to come.

We also like that GSI has such sticky relationships, as evidenced by the fact that it lost no customers related to its recent bankruptcy. It tends not to sell off-the-shelf products, but systems costing hundreds of thousands of dollars that are fine-tuned to the end customer application. That type of dynamic usually translates into nice margins – EBITDA margins here are 17%.

I mentioned that we were involved through the bankruptcy, which came about because GSI's previous management had disastrously overpaid to acquire a competitor right before the recession hit. Part of our interest came from the fact that another investor, Stephen Bershad, was buying GSI shares even more quickly than we were. He is a former investment banker whom we'd followed as he bought control and then built over several years a defense-electronics firm called Axsys Technologies, which he ended up selling to General Dynamics. We thought this would be his next project, which became clear when he put forward a competing plan of reorganization that ended up winning out over management's plan.

## INVESTMENT SNAPSHOT

**Virgin Media**
(Nasdaq: VMED)

**Business**: Entertainment and communications services in the United Kingdom, including cable television, fixed-line and mobile telephony, and broadband Internet.

**Share Information**
(@7/30/12):

| | |
|---|---|
| **Price** | **27.47** |
| 52-Week Range | 20.52 - 28.14 |
| Dividend Yield | 0.6% |
| Market Cap | $7.52 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $6.39 billion |
| Operating Profit Margin | 15.2% |
| Net Profit Margin | 1.1% |

**Valuation Metrics**
(@7/30/12):

| | VMED | S&P 500 |
|---|---|---|
| Trailing P/E | 116.4 | 15.7 |
| Forward P/E Est. | 11.4 | 13.4 |

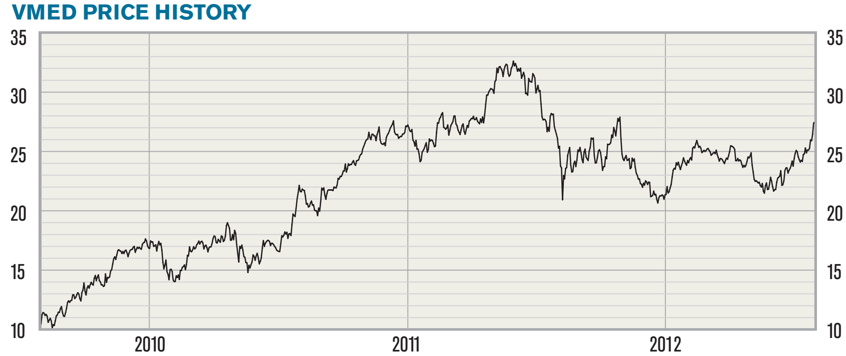
**Largest Institutional Owners**
(@3/31/12):

| Company | % Owned |
|---|---|
| Capital World Inv | 14.1% |
| Capital Research Global Inv | 11.9% |
| Royal Bank of Canada | 7.8% |
| Manning & Napier | 6.2% |
| Goldman Sachs | 5.5% |

**Short Interest** (as of 7/13/12):

| | |
|---|---|
| Shares Short/Float | 20.3% |

**VMED PRICE HISTORY**




**THE BOTTOM LINE**

The company's state-of-the-art infrastructure and "quadruple-play" cross-selling opportunities should allow it to defend and improve its competitive position better than the market seems to expect, says Chris Mittleman. At 11x the $1 billion in free cash flow he believes the company can generate next year, the shares would trade at around $40.

Sources: Company reports, other publicly available information

The story now is about basic blocking and tackling – in a secular-growth business – under CEO John Roush, who was brought in by Bershad in late 2010 after a highly successful career at PerkinElmer. Debt is no longer an issue and Roush is focused on stepping up product innovation and looking for tuck-in acquisitions in what is still a highly fragmented business. We've been impressed by the steps he's taken so far, and think the company is in very capable hands.

**How does your estimate of fair value compare with today's $10.25 share price?**

**CM:** In looking at comparable businesses, we think the stock should trade for a minimum of 7x EBITDA, probably closer to 8x. Using a 7x multiple on the $70 million in EBITDA we think GSI will earn this year, less $5 million in net debt, the shares would go for $14.50. If I do the same math on next year's EBITDA estimate of $79 million, fair value is over $16.

**Is the economy the biggest risk?**

**CM:** The macro drivers of the business are overall industrial activity and capital spending, so another global recession would clearly have a negative impact. We're not macroeconomists or market timers, so that's the kind of thing we just resign ourselves to ride out.

**How did Germany's Biotest [BIO3:GR] get on your radar screen?**

**CM:** This a stock I'd read that Meryl Witmer of Eagle Capital liked, which often interests me because while I don't know her, our ideas have very often lined up in the past.

Biotest is in two businesses. The cash-generating part is in selling products derived from human blood plasma that are used in a variety of healthcare applications, including the treatment of hemophilia, bacterial infections and autoimmune diseases. It's proven to be a steady, profitable business over time, benefitting generally from increased healthcare access and demand worldwide. The biggest part of this business is in Europe, but it's growing faster elsewhere.

The company is also developing its own pharmaceuticals, a development business that is currently a cash drain to the tune of $20 million per year. Its most promising drug is a treatment for rheumatoid arthritis and psoriasis that is in phase-two clinical trials. For that drug, Abbott Laboratories paid Biotest $85 million upfront last summer for a co-development and marketing deal that has milestone payments that could hit a total of $395 million.

Our thesis is pretty simple. On a stand-alone basis, we believe the blood-plasma business is worth far more than the company's current market value. On top of that you have an option on the pharmaceutical business that could be extremely valuable if the marquee development drug makes it to market.

**Walk through the numbers.**

**CM:** At the current share price of less than €41, the company's overall enterprise value, translated into dollars, is just under $700 million. Even including the pharmaceutical losses – which would go away over time if the effort is unsuccessful and

**INVESTMENT SNAPSHOT**

**GSI Group**
(Nasdaq: GSIG)

**Business**: Producer of lasers and laser-based manufacturing systems used by OEMs primarily in the automotive, electronics, semiconductor and medical industries.

**Share Information**
(@7/30/12):

| | |
|---|---|
| **Price** | **10.26** |
| 52-Week Range | 7.03 - 12.58 |
| Dividend Yield | 0.0% |
| Market Cap | $345.1 million |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $353.2 million |
| Operating Profit Margin | 11.5% |
| Net Profit Margin | 6.8% |

**Valuation Metrics**
(@7/30/12):

| | GSIG | Russell 2000 |
|---|---|---|
| Trailing P/E | 14.5 | 31.7 |
| Forward P/E Est. | 7.9 | 14.8 |

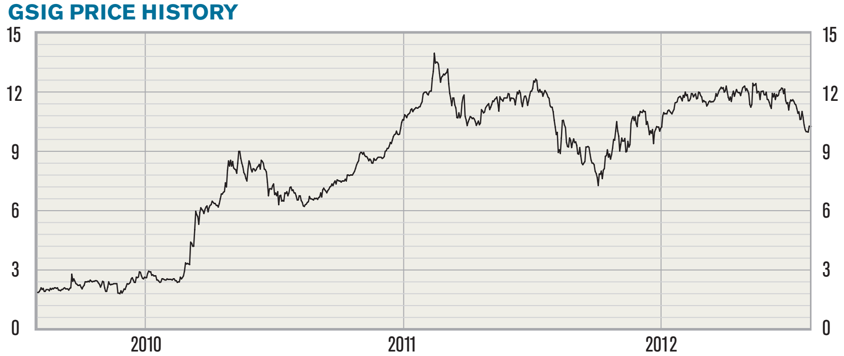
**Largest Institutional Owners**
(@3/31/12):

| Company | % Owned |
|---|---|
| Goldman Sachs | 8.3% |
| Kennedy Capital Mgmt | 4.0% |
| Royce & Assoc | 3.8% |
| Vanguard Group | 3.4% |
| Prescott Group | 2.6% |

**Short Interest** (as of 7/13/12):

| | |
|---|---|
| Shares Short/Float | 4.7% |

**GSIG PRICE HISTORY**




**THE BOTTOM LINE**

Having recast its balance sheet and cost structure, the company is now focused more on product innovation and capitalizing on the ongoing secular growth in laser-based manufacturing systems, says Chris Mittleman. On this year's estimates, at the minimum 7x EV/EBITDA multiple he believes the shares deserve, the stock would go for $14.50.

Sources: Company reports, other publicly available information

**INVESTMENT SNAPSHOT**

**Biotest**
(Xetra: BIO3:GR)

**Business**: Global producer of blood-plasma-derived preparations with uses such as treating autoimmune diseases, bacterial infections and coagulation disorders.

**Share Information**
(@7/30/12, Exchange Rate: $1 = €0.816):

| | |
|---|---|
| **Price** | **€40.45** |
| 52-Week Range | €34.65 - €48.89 |
| Dividend Yield | 1.2% |
| Market Cap | €495.9 million |

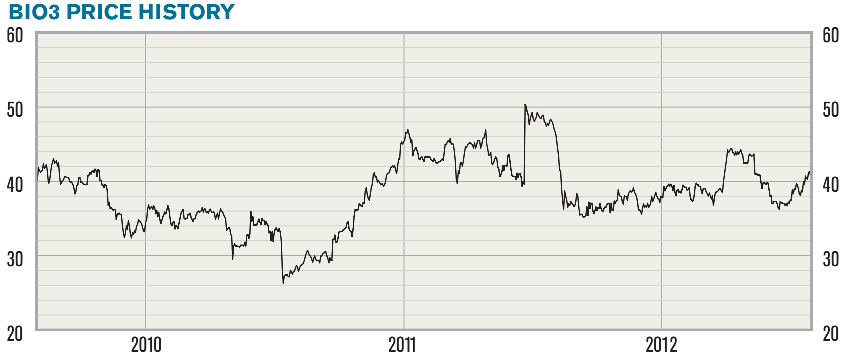
**Financials** (TTM):

| | |
|---|---|
| Revenue | €423.2 million |
| Operating Profit Margin | 10.1% |
| Net Profit Margin | 4.3% |

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

| | BIO3 | Russell 2000 |
|---|---|---|
| P/E | 26.1 | 31.7 |

**BIO3 PRICE HISTORY**




**THE BOTTOM LINE**

The market appears to be mispricing the company's cash-cow blood-plasma business due to losses in its development-stage pharmaceutical operation, says Chris Mittleman. If that wasn't happening, he believes the shares should trade for around €63. If the drug business actually pays off – not inconceivable, he says – the upside is significantly higher.

Sources: Company reports, other publicly available information

turn sharply positive if the effort is successful – the company generates around $100 million in annual EBITDA. That gives you a current EV/EBITDA multiple of 7x. The benchmark peer, Australia's CSL Ltd., isn't a perfect comp because it has already successfully diversified into making its own drugs, but it trades at 12-13x EBITDA.

Using what we think is a reasonable 10x multiple – where deals for comparable companies have been done in the past – we arrive at a current fair value of €63, 50% above today's price. That ascribes nothing to the drug business, which we believe is very likely to have a net present value greater than zero.

**Is illiquidity an issue here as well?**

**CM:** That's part of it – the founding family owns 65% of the company – as is the fact that there's almost no analyst coverage. My view is that none of that matters over time. We like owner-operators, and the family has indicated it would sell at the right price. It was shopping for bidders in 2007 – running the stock price up to nearly €65 – but pulled back when the crisis hit. As for liquidity, if we're ultimately right about the value here, we don't expect a problem in realizing it.

**You mentioned making a secular vs. cyclical mistake earlier with LodgeNet. Is that your most common type of error?**

**CM:** I think it often is for investors who regularly take a contrary point of view.

I'm sorry to say I've even made the same mistake twice with the same company. In 2008 I bought R.H. Donnelley, the big Yellow Pages publisher, because its advertising revenues had historically been incredibly resilient through recessions. While I understood Internet advertising was a threat, I just couldn't see mom-and-pop small businesses dumping the Yellow Pages wholesale in order to promote themselves online. That turned out to be wrong and I lost our entire investment when Donnelley went bankrupt. If that wasn't bad enough, after the company came out of bankruptcy in 2010 as Dex One [DEXO], I thought the pessimism built into the incredibly cheap shares wasn't warranted, given that the economy was picking up, they seemed to have a digital strategy in place and, hey, traditional Yellow Pages weren't going entirely away, right? But the double-digit sales declines just keep coming, and whether the equity [now trading at $1.20] survives or not will probably play out over the next six to nine months.

**Great performance runs are extremely hard to maintain. What do you worry could knock you off your game?**

**CM:** The past ten years has been a period of extremes, so it's hard to say our style has been particularly in fashion and I'm worried that might change. It makes no sense anyway to try to outguess sentiment changes – you start worrying more about what everyone else is going to do, which I consider a waste of mental energy because that's impossible to predict with any useful degree of precision.

For a manager like us with a small-cap focus and plenty of international exposure, 2008 was unthinkably bad. But by sticking to our strategy, the average account we manage has doubled in value since the end of 2007, while the market's still struggling to get back to even. I don't know what's going to happen in the next five years with our performance, but I can say with great confidence that I'm not going to change how I invest. Honestly, I wouldn't know how. VII

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