Eidelman Virant
CAPITAL

Quarterly Letter **March 2011**

Dear Clients & Friends,

The S&P 500 stock market index shot strongly out of the gate, recording a gain of 5.9% for the first quarter of 2011. Along with this tailwind, we benefited from a strong batch of depressed year-ender stocks that were purchased in anticipation of a rebound. Such market resilience occurred in the face of revolutions around the world, rising oil prices, and Japan's largest recorded earthquake and tsunami.

How can the market continue its rise in the face of such turmoil? The key reasons are threefold: 1) companies have gotten more efficient and driven profits back to prior highs 2) inflation and interest rates have remained low, making stocks an attractive alternative to low yielding bonds, and 3) valuations on many great companies have been low and continue to expand.

In the first section of this letter, I will provide an update on some key investment themes we've discussed in the past, including community banks, U.S. multinationals, and small-cap Japanese stocks. I will outline why we still find these areas ripe for superior risk-adjusted returns.

Looking back at this past quarter, our new purchases were not defined by a unifying theme like those listed above, but instead our value approach at work on a case-by-case basis. In the final section, I'll outline two of our latest purchases: an opportunistic investment we made in USEC convertible bonds that sold off to attractive levels due to the disaster in Japan and our purchase of shares in St. Louis-based portrait company CPI Corp (CPY).

Our value-oriented investment approach works best when attention grabbing headlines cloud the favorable prospects of individual investment ideas. We are confident that our latest purchases are examples of this lesson in action. In combination with our investments in the themes listed above, we are optimistic that our clients' portfolios will continue to achieve favorable returns going forward.

Sincerely,

Tom Eidelman, CFA
Vice President

WHERE WE SEE VALUE—AN UPDATE ON THEMES

BY TOM EIDELMAN

Community Bank Stocks

As we outlined in our last quarterly letter entitled "Stan the Man & Community Bank Investing," we are finding great investment opportunities among community banks. Specifically, we are looking for well-managed, asset-clean banks that are trading below book value, with the potential to be bought out at a significant premium. Capitalizing on this theme, we purchased shares in the following companies in the first quarter.

Pulaski Bank (PULB) - $7.50

Pulaski is one of the largest St. Louis-based banks. After meeting with CEO Gary Douglas, we believe Pulaski has a valuable franchise, including a profitable mortgage division, that should be attractive to any acquiring bank looking to expand into the St. Louis market. We estimate 2011 EPS at $0.65 with full earning power around $1/shr and tangible book value of $7.60. We think PULB shares should achieve a total return commensurate with book value growth (estimated at 4-8%) plus its 5% dividend yield. In addition, we think shares have a significant chance of getting bought out at a healthy premium to book value.

First Business Financial Svcs. (FBIZ) - $11.70

FBIZ is a $1.1B asset business bank based in Madison, WI. Due to the passing of the company's founder, his estate offered to sell a block of shares at a significant discount to the prevailing market price. Given the small trading volume of the company, this is common practice when a large shareholder wants to exit a position. For us, it was a great opportunity to execute our strategy of buying a "clean" bank (just 3.7% non-performing loans as a % of assets), in a good location, and trading at a low valuation. Given low loan losses and EPS estimates of $1.80, we think shares are worth tangible book value of $22, representing an appreciation potential of 85%.

Eidelman Virant's relatively small size and flexible mandate enable us to capitalize on opportunities such as these undervalued community banks. We are very pleased with our positions and have high hopes for future returns from this group.

High Quality U.S. Multinationals

Another theme we have discussed is the relative value in high quality US companies. These companies include household names like Wal-Mart (WMT), Proctor & Gamble (PG), IBM, and Johnson & Johnson (JNJ) who have high returns on equity, earnings predictability, dividend growth, and low debt levels. Despite these attractive attributes, shares of such companies have traded at a lower earnings valuation than the market overall.

The absolute performance of these blue chips have been pretty good (+24% on average for the below group) since Sept '09 when we last published a piece outlining these equities. However; smaller, cyclical, and often more speculative stocks have performed even better as represented by the 42% gain in the Value Line Composite index over this period.

Because of lower price appreciation and high earnings growth (>20%), shares of high quality multinationals still represent a compelling value. In fact, the current average forward P/E ratio of 13.6x is even cheaper than when we last reported due to earnings growth.

Blue Chip Valuations (Then & Now)

		Then (9/30/2009)		Now (3/31/2011)		
Company Name	S&P Stock Rank	Div Yield	P/09E Ratio	Div Yield	P/11E Ratio	% Return Since 9/30/09
Coca Cola	A	3.4%	17.2	2.8%	17.4	31.0
Proctor & Gamble	A+	3.1%	14.0	3.1%	15.6	11.7
Exxon	A+	2.5%	16.5	2.1%	10.8	29.9
Johnson & Johnson	A+	3.3%	13.5	3.6%	12.3	2.9
IBM	A	2.1%	12.4	1.6%	12.5	40.9
McDonalds	A-	3.8%	14.3	3.2%	15.1	40.3
Wal-Mart	A	2.3%	14.0	2.8%	11.8	10.5
Average	**A**	**2.9%**	**14.6**	**2.7%**	**13.6**	**23.9**
Value Line Index (Broad Market Index)				**1.9%**	**16.4**	**42.2**

In today's world of inflation fears, sovereign debt issues, high oil prices, and a competitive global market, shares of the world's greatest companies should trade at a premium. We think owning some of these companies at a below average valuation is a great way to position a portfolio to achieve market beating risk-adjusted returns.

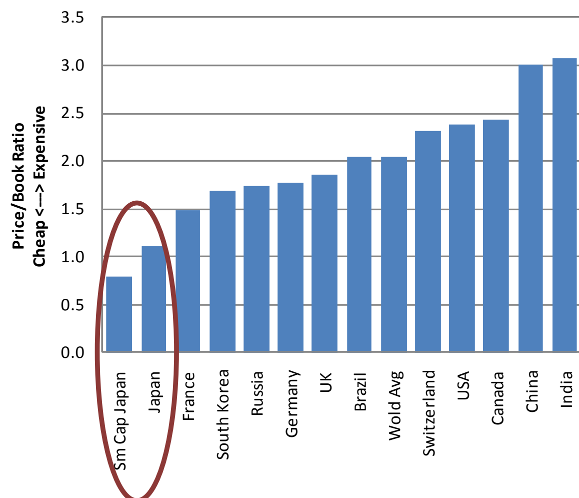
Japanese Stocks and the Tsunami

As I wrote in our March 2010 letter "Land of the Rising Stocks?," Japan's stock market was trading at one of the lowest valuations in the world and thus offered some great buying opportunities. With the Nikkei market down 10% since the earthquake, we believe it to be an even better opportunity now.

Studies have shown that stocks are resilient following disasters. Ned Davis Research studied the results of 50 calamitous events going back to the panic of 1907 and found that investors who bought into the panic gained an average of 3.7% after one month, 9.0% after six months, and 14% after a year. If history repeats, Japanese stocks should rebound nicely as fear surrounding the earthquake and tsunami abates.

Chart A below shows that Japanese stocks (particularly small cap) trade at the lowest price-to-book values in the world. We still think the best ways to capitalize on these opportunities are through buying individual companies trading below their liquidation value or buying an index fund of small-cap Japanese stocks. Our favorite is the WisdomTree Japan SmallCap Dividend ETF (DFJ), where the average company trades at just 80% of book value.

Chart A: Japan vs World Valuations



Investing in Japanese equities presents a great way to capitalize on the temporary fear brought on by the earthquake and Tsunami in Japan. In the next section, I'll describe another investment opportunity which arose from the earthquake and subsequent nuclear meltdown at the Fukushima site in Japan.

NEW PURCHASES

USEC 3% Convertible Notes Due 10/2014 - $79.64

We think USEC bonds have a very attractive risk/reward profile and represent a great way to take advantage of fear surrounding the nuclear power industry.

USEC convertible bonds present an opportunity to earn a 10% yield-to-maturity (YTM) over the next 3 ½ years with the potential for even faster capital appreciation if sentiment surrounding nuclear energy rebounds. USEC is a leading supplier of enriched uranium fuel for commercial nuclear power plants. They operate the only U.S.-owned uranium enrichment facility in the United States and supply more than half of the U.S. market and more than a quarter of the world market.

We find the USEC bonds particularly attractive because of $1.3B of tangible equity ahead of us in the capital structure. In other words, USEC would have to lose $1.3B before our bonds are impaired. We view this as a low probability event given that the company has been profitable every year except one since the US government took them public in 1998. Book value consists primarily of capital expenditures related to a new plant which utilizes the latest centrifuge technology. The company is in the process of securing a long-term government loan from the DOD which would secure financing to complete the plant.

There are two additional items that could make the return on these bonds even higher. The first is that the bonds could appreciate quickly back to pre-earthquake levels, providing the bulk of the return faster than expected. The second potential benefit, albeit a long-shot, pertains to the $12 conversion feature. While the common stock is only $5 per share, if the equity were to gather momentum, these bonds would participate in any gain the common appreciates above $12 per share.

CPI Corp – (Ticker: CPY) - $22.51

CPI is the country's largest operator of professional portrait studios with over 3,000 studios within Wal-mart, Sears, and Babies "R" Us locations. This equates to CPY having nearly 50% of the mass retail photo market. Foot traffic growth remains a challenge due to technology enabling families to capture high quality pictures with affordable digital cameras. However, families are still finding value in professional family photography and for babies in particular. We expect growth to come primarily from two areas. First, Toys "R" Us is retrofitting 40 of its toy stores a year into Babies "R" Us locations with a new CPI photo studio inside. In addition, CPY's recent acquisition of Bella Pictures leverages their stores and technology into the lucrative wedding photography and videography market.

CPY is also hitting a sweet spot of efficiency. The transition to digital photography, debt paydowns, and recent acquisitions are realizing significant cost savings. Adding it all together, we think CPY could earn $4.00 per share this year, placing the shares at 5.5x earnings compared to 16.5x for the market as a whole.

If CPY can hit analyst estimates, we think shares could be worth 10x those earnings, nearly double the current price. Meanwhile, CPY yields a 5% dividend and has a one million share repurchase plan to buy back 14% of the outstanding shares.

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