Eidelman Capital Management

Quarterly Letter June 2008

Dear Clients & Friends,

June turned out to be the worst month for the S&P 500 stock index in 6 years, recording a loss of 8.6%. The Dow Jones industrial average recorded its worst first half performance in nearly 40 years, dropping 14.4%. These declines were due to fears surrounding the US economy due to continued declines in housing prices and rising oil prices.

While no one can predict the short term with certainty, recessions have historically been the best time to buy. As we discussed in last quarter's letter, the stock market tends to do the opposite of what people expect and do well when investor and consumer sentiment is pessimistic. The consumer confidence sentiment index, derived from questionnaires sent to 5,000 families, fell to its lowest level since 1992. Worse, the expectations index which asks people's outlook in six months dropped off the chart to its lowest figure in the 40 years of the survey. The bottom line is that investors are very concerned and they are voting with their dollars by selling stocks and driving down prices. While investor sentiment could get even worse, this low level combined with attractive valuations could prove to be the market bottom.

We constantly evaluate our investment strategies and evaluate what is and is not currently working. It has been a frustrating time for both us and many value investors as we've seen banks, healthcare, retailers, and other more reasonably valued industries underperform while steel, fertilizer, metals, and oil went from high to higher.

While herding into popular areas such as energy and commodities has been what made money this year, our experience and research has shown that certain investment strategies have led to superior investment returns over long periods of time. Our specialty has been focusing on finding value by purchasing securities that trade at a discount to their fair value and we have added more strategies on top of this as we've learned over time. These strategies include selecting companies with high levels of free cash flow, strong balance sheets, and insider buying. We are confident that over time, companies that exhibit these characteristics will continue to outperform and deliver excellent investment returns.

We intend to capitalize on the current market environment. As I will outline in the next section, we believe that like technology stocks in the 90's and housing stocks the last couple of years, oil prices will fall. This could provide a much needed boost to many companies and industries including the beaten down airlines.

Lastly, I would like to thank everybody for the great feedback regarding the last quarterly letter. It is our goal to educate our clients on our latest economic thinking, research ideas, and reiterate our investment philosophy. If there are individual investments or general economic issues you would like me to discuss, please contact me at tom@eidelmancapital.com and I will do my best to incorporate them into future letters.

Sincerely,

Tom Eidelman
Vice President

PAYING MORE AT THE PUMP, BUT LESS FOR STOCKS

BY TOM EIDELMAN

Oil Opportunity

Oil and gasoline prices are hitting record highs. As I write today, oil is a record $144/barrel and the U.S. national average for gasoline is over $4 a gallon. The typical American has seen the average amount they spend on gasoline every year go from 2% to 4% of their gross income. This leaves a lot less money in American pockets for discretionary purchases such as restaurants, automobiles, apparel, and travel.

We see the “Oil Crisis” as an opportunity. Many industries that have been negatively impacted by the quick rise in oil either currently are or will be great buying opportunities for two reasons: (1) Oil may be at an unsustainably high level and should revert to a lower equilibrium price closer to its cost of production, and (2) Most companies will pass on their higher costs in the form of higher prices.

The Oil Bubble

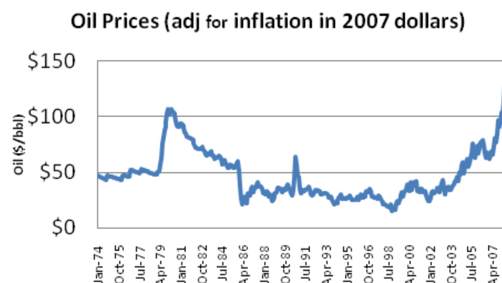
It is our thesis that oil is experiencing a speculative bubble akin to the technology boom (See Exhibit A). Like many historical financial bubbles, this one started with low prices, grew on strong fundamentals, and finally developed into a “can’t lose” new era story. The oil story goes something like this:

The world is experiencing a shortage of oil due to explosive demand from China and India. Supplies of oil are running out as big oil fields in Saudi Arabia and other countries are starting to decline. No new major discoveries have been made in 30 years. Reserve estimates are highly suspect since they come from untrustworthy countries and production has peaked. From now on, every year will experience a production decline until we eventually run out. This supply and demand imbalance justifies an ever increasing oil price.

While it is possible that this thesis is true and oil will continue to go up and stay high forever, it is very unlikely. If it does happen, it would be the first time. Jeremy Grantham, Founder of investment firm GMO, did a study of every stock, currency, and commodity market bubble in history and found that every time one experienced a price bubble (defined as a 2 standard deviation event) they all came back down to their long term average with no exceptions.

This includes oil’s dramatic rise in 1980. Our thesis is also supported by research into the fundamentals including supply, demand, costs of production, and speculation.

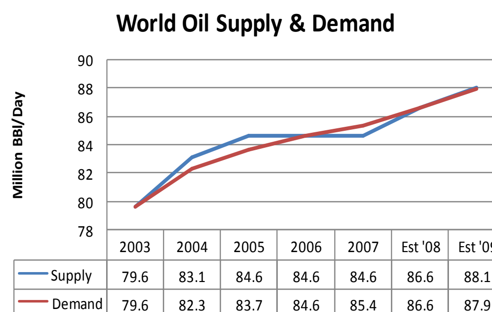
Exhibit A



Supply & Demand

Despite what you may hear in the news, the overall growth in oil supply and demand is surprisingly small. Since 2000, the growth in consumption of oil has increased from 76.6 to 85.4 mil barrel/day, an annual increase of just 1.6% per year and is estimated to grow next year another 1.4% to 86.6 barrel/day.

Exhibit B



	2003	2004	2005	2006	2007	Est '08	Est '09
Supply	79.6	83.1	84.6	84.6	84.6	86.6	88.1
Demand	79.6	82.3	83.7	84.6	85.4	86.6	87.9

Much of this growth has been due to demand from China which has increased demand during this time frame from 4.8 to 7.6 mil barrel/day or 6.8% per year. The US, which constitutes 25% of world consumption, has seen demand grow at just 0.7% per year.

Will Oil Supply & Demand Trends Persist?

As we analyze the supply and demand of oil, one thing keeps nagging at us. Will the supply and demand sustain its current growth path now that oil has skyrocketed to over $140/barrel? Common sense tells us no. People are cutting back. For instance, SUV unit sales are down 36% compared to last year and there are so many SUVs on sale right now that many dealerships won't accept them for trade-ins. On the other hand, unit sales of small cars are up 20% over last year. Public transportation is seeing dramatic increases in ridership. Even the US government temporarily halted their purchases of oil for the strategic petroleum reserve. In other words, people are conserving their money and energy usage and this is driving down the demand for gasoline. MasterCard reported that users of their credit cards purchased 3.8% less gasoline in May '08 versus May '07, a sign record pump prices are prompting drivers to spend less time on the road.

Supply is the other side of the equation. High oil prices motivate corporations to expand drilling and have them working tirelessly to maximize the amount of oil they extract from each well. They will also spend their own money to search and discover new resources even in places that were formerly thought of as being too risky or expensive. In addition, investors are throwing money at new companies to research and develop new alternatives such as wind, solar, geothermal, and ethanol. Due to these factors, oil supply could exceed analyst estimates.

Marginal Cost of Production

So what should the price of oil be? Classic economics teaches us that commodities should trade at their marginal cost of production plus some profit. If a commodity sells too far below a profitable price, companies will exit the business or reduce production. If a commodity vastly exceeds this price, new companies enter and production is increased to satisfy demand until the commodity comes back to its equilibrium around the marginal cost of production.

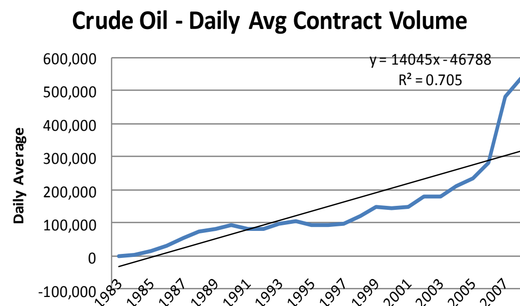
Oil now trades vastly above the marginal cost of production. The most expensive oil in the world to extract resides in the Canadian tar sands and current production cost estimates are approximately $70/barrel. If we add on another $10/barrel for profit to the highest cost of production, then that sets a ceiling on the highest value that oil should trade.

Oil currently trades significantly above this value and is a key reason why oil should eventually revert to this level.

Speculation

The last area that I want to touch on is speculation in the oil markets. While we tend to shy away from blaming speculators and other conspiracy theories for oil's meteoric rise, there is certainly indications of speculation in the oil markets. After about 10 years of averaging around 100,000 oil future contracts per day, the number has exploded up to 550,000. Over just the last two years, the number of contracts has skyrocketed from 280,000 to 550,000, representing a jump of almost 100% (Exhibit C).

Exhibit C



In the long run, high levels of speculation should actually decrease the price of oil. Producers, who worry whether expensive oil projects will be profitable, can lock in their selling price and drill with little risk. This should lead to higher levels of production and lower future oil prices.

Oil – The Bottom Line

It is our thesis that oil is experiencing a speculative bubble. While we do not know precisely how long it will last, the price of oil should revert back to its marginal cost of production around $70. Consumers will continue to cut back their usage and suppliers will crank up the supply and develop substitutes. These market forces should alleviate the oil crisis and provide a lift to the U.S. economy and stock market. In the next section, we will explain how we intend to capitalize on this oil opportunity.

CAPITALIZING ON FALLING OIL: BUYING AIRLINES

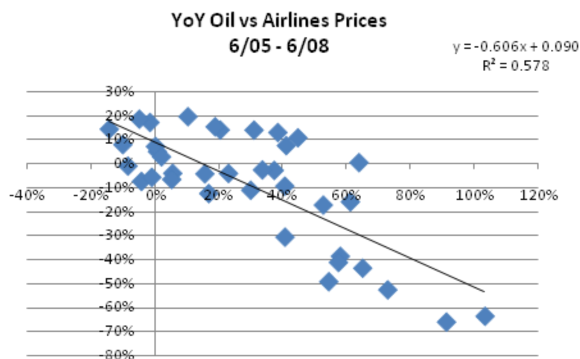
If oil prices decrease, no industry should benefit more than the Airlines. Their currently depressed stock prices could greatly reward investors who invest during a time of such turbulence. As bargain hunters, we have learned that great opportunities arise from investor fear and industry turmoil and our research and experience gives us confidence that the airlines should weather the storm.

Falling Oil Prices Equal Rising Airline Stocks

Falling oil prices would be a short term boon for airlines. As you can see in Exhibit D, for the past 3 years, there has been a very strong negative correlation between the year over year change in oil prices and the Airlines index (AMXEF). This is because jet fuel has grown from 15% of airline operating costs to 35%. A rise in oil prices has resulted in a drop in airline stocks.

When oil prices reverse, the airlines could experience earnings increases even bigger than their declines. They are cutting the number of flights starting with the least profitable routes and trying to get as lean and efficient as possible.

Exhibit A



In the Long Run, Oil Prices don't Matter

It has long been David's thesis that oil prices don't affect the profitability of a company in the long run. This is because companies pass on their increased input cost in the form of higher prices and companies have to increase prices to stay competitive and profitable. To support this, he points to trucking companies and shipping companies that use nearly as much fuel, but haven't been materially negatively impacted by surging oil prices.

The Fundamentals

Airlines are doing everything they can to cut costs and return to profitability. They are merging with other airlines, cutting the number of flights, raising fares, adding fuel surcharges and charging for baggage. Continental, American, United, and Delta airlines have all announced double digit cuts in the number of flights starting after the peak summer travel season. This same group is raising roundtrip fares by $60. Even Southwest Airlines has eliminated its self-imposed cap of charging no more than $299 for any one-way flight. Now it charges close to $400 each way on some routes. US airways and others have adopted a-la-carte pricing where consumers can pay more for window seats or for extra luggage.

Probably the most important element for airlines to weather the storm is their cash positions. Learning from past years, American accumulated a cash cushion of $5.5 billion or $22/share in case they experienced another oil spike or economic slowdown.

Valuation

As recently as last year, American Airlines (AMR) recorded earnings per share of $1.78 and traded at an average price of $25/share. Continental (CAL) earned $4.02 and traded at $35/share. Both of these companies recorded these profits despite average oil prices of $70/barrel in 2007. While both of these airlines will lose money this year, they have the capability to earn at similar levels to 2007 and trade at similar levels if oil prices come back down or if they are able to adequately raise fares.

Summary

While the airlines are facing serious near term difficulties including soaring oil prices and a softening economy; they are aggressively tackling their problems by raising prices and cutting costs. Both American and Continental are trading at very low valuations and have strong cash positions to help weather the storm. They should see the greatest benefit from falling oil prices or an unexpected rebound in the economy.