Eidelman Virant
CAPITAL

Quarterly Letter June 2010

Dear Clients & Friends,

After a 75% gain from the 2009 lows, the S&P 500 experienced a nasty correction of 11.5% in the 2nd quarter. On May 6th, the Dow experienced a “flash crash,” losing and mostly recovering nearly 1,000 points in a single day, the largest intra-day point loss ever. The key reasons for the selloff in the quarter were credit concerns related to European countries like Greece, worries of a double-dip recession, and the news of BP’s offshore oil spill. The good news is that all this uncertainty creates opportunity.

A handful of European countries, now dubbed PIIGS (Portugal, Ireland, Italy, Greece, and Spain), have accumulated huge debt loads from excessive government spending over many decades. The European Central Bank and IMF were forced to announce a $1 trillion bailout package, similar to the TARP bailout of the U.S. banks, to avoid alarm over any individual country defaulting on their sovereign debt. While such uncertainty rattled the U.S. stock market, we see little direct negative impact to U.S. corporate profits. In fact, the resulting decline in the Euro has been a reason for U.S. interest rates falling even further, justifying even higher prices for U.S. stocks.

Later in the quarter, concerns over a double-dip recession drove investor sentiment to their lowest levels since July, 2009. Fortunately, such pessimistic sentiment has historically resulted in good investment returns to come. This same contrarian effect also occurs for individual stocks. In the next section called *A Contrarian's Dream*, I’ll explain why contrarian investing works and how a few of the world’s greatest companies have fallen out-of-favor and now present great investment opportunities.

On May 27th, BP announced that its “top kill” method for plugging the oil spill had failed and it would take months before relief wells could be drilled. Consequently, investors stampeded out of many energy stocks, driving the sector down more than 20% since the spill, with stocks of companies directly related to the accident declining even further. As I’ll explain in the last section of this letter: *BP: The Contrarian Poster Child*, we think that fear and anger have driven the price of BP shares well below fair value and shares will appreciate as the spill is capped and actual cleanup and liability costs are realized to be much lower than expected.

Contrarian investing is one of the many tools that we use as value investors. All of our sub-philosophies attempt to not only provide higher returns than the market, but to do so with less risk. We believe our approach of buying securities at a discount to intrinsic value provides downside protection, with this past quarter being a prime example. Because of pessimistic sentiment over issues discussed and a full portfolio of attractive investment opportunities that meet our value criteria, we remain optimistic towards attaining superior investment returns going forward.

Sincerely,

Tom Eidelman, CFA
Vice President

A CONTRARIAN'S DREAM

BY TOM EIDELMAN

"Buy when there's blood in the streets" – Baron Rothschild, 1894

Contrarian investing uses the idea that stocks hit their lows when people are most pessimistic. Since investors are looking to "buy low and sell high," contrarians are looking to buy when the prevailing opinion is pessimistic and sell when sentiment inevitably swings back to optimism.

David Dreman, author of *Contrarian Investment Strategies*, is an expert on the subject and has made a successful career from profiting from out-of-favor companies. His Dreman Value Fund (KDHAX) has beaten the market by more than 3% annually since 1988. In his book, Dreman conducted several backtests to see how out-of-favor stocks fared relative to the market and glamour stocks. Dreman's findings show that companies investors were most optimistic about, as measured by the price/earnings, price-to-cash flow, price-to-book value, and price-to-dividend ratios, have consistently done the worst. Conversely, stocks believed to have the most dismal futures have done the best.

While Dreman outlines the effectiveness of this strategy for the periods from 1937-1996, Chart A shows an updated backtest. Since 1980, out-of-favor stocks as measured by PE ratio, have returned 16% annually vs. the most loved group of just 4.4%.

Chart A: Out-of-Favor (Low P/E) Stocks

Sentiment	PE Quintile	Annual Return
Out-of Favor	Quintile 1	16.0%
Below Avg	Quintile 2	12.6%
Neutral	Quintile 3	10.8%
Above Avg	Quintile 4	7.7%
Glamour	Quintile 5	4.4%

Source: Ned Davis Research (9/30/80-6/30/2010)

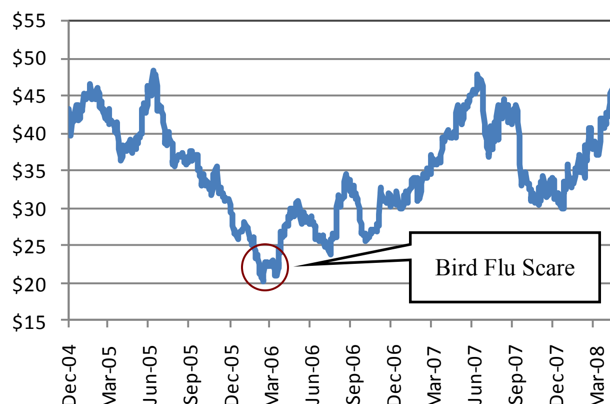
Crisis Investing

While buying out-of-favor companies has produced stellar returns, buying stocks clouded by outright fear have done even better. Crises often present outstanding opportunities to profit, because it lets loose overreaction at its wildest. In a crisis or panic, the typical guidelines of value often disappear. People no longer examine what a stock is worth; instead they are fixated by prices cascading ever lower.

Our studies of investor psychology show that stocks hit their lows when the prevailing opinion is "things are bad and they are going to get worse." While emotionally difficult to implement, we look to keep our cool and benefit from investor overreaction by buying when pessimism has peaked.

Two recent examples involved chicken (Sanderson Farms) and pork producers (Smithfield Foods) surrounding the bird flu and swine flu scares of 2006 and 2009. In March of 2006, with grotesque pictures of dead chickens and workers wearing face masks, it was not a pleasant time to be a chicken farm shareholder. On May 24th, 2006, CNN posted the headline: "Bird Flu Scare: Human Spread?" Chart B shows Sanderson Farms stock price around this time.

Chart B: Sanderson Farms (2004-2008)



In retrospect, it may seem obvious that these stocks would recover when fear abated, but believe me, few wanted to own these stocks when they hit their lows. Both stocks would go on to more than double from their crisis lows.

Finding Out-of-Favor Stocks Now

Three companies that have gone out-of-favor and consequently are trading near historically low valuations are Toyota, Goldman Sachs, and of course, BP. For each, I will give an overview of the company, current crisis, and why we see opportunity.

Toyota Motors (TM) - Price $68.57

Toyota's strength of manufacturing high quality cars people want to buy has stood out in the ultra-competitive auto market. They've done well in the US with their Lexus and Camry brands and are the second largest seller into the booming Chinese market. They've also been at the forefront of technology with their Prius hybrid and their manufacturing operations are best-in-class. While less significant after GM and Ford restructurings, their lower pension and retiree health-care costs give Toyota a cost advantage over the Detroit Big Three. All these characteristics have translated into higher margins than their competitors year after year.

The Crisis

On 1/21/10, Toyota announced it had recalled a total of 8.5 million vehicles for pedal entrapment or unintended acceleration problems. Such recalls and lawsuits resulted in an estimated $2B direct cost to the company to replace the faulty parts in addition to some intangible impairment to their quality brand. On 2/24/10, CEO Akio Toyoda apologized in front of the U.S. congress and pledged to put customer's safety first. Due to the crisis, TM's stock fell 20 points or 20% (See Chart).

Chart C: Toyota Motors (Dec 2009-June 2010)

The Opportunity

Toyota Motor's core business has turned up sharply, with estimates for 2011 rising above $5 per share compared to $1.50 in 2010. Despite the turnaround, TM shares trade near their low historical valuations of 1x book value compared to a 10-year average of 1.4x, implying an appreciation potential of 40%. As outlined in our last quarterly letter *Benjamin Graham in Japan*, we believe buying into Toyota Motor's former parent company Toyota Industries (Ticker: 6201) is an even more attractive way to invest in Toyota.

Goldman Sachs (GS) - Price $131.27

Goldman Sachs is the premier investment bank and financial institution in the world. Their dominant position on Wall Street has improved due to bankruptcies of key competitors including Lehman Brothers and Bear Stearns. They attract the top talent in the industry and have consistently topped the league tables in Mergers & Acquisitions and Debt & Equity offerings.

The Crisis

On 4/16/10, the SEC filed suit against Goldman Sachs, alleging fraud in their role as a market maker in a CDO transaction. Ten days later, CEO Lloyd Blankfein was called to testified before congress. In addition to this suit, financial regulatory reform is being hotly debated in congress, which many fear will have a negative impact on Goldman's business. Between potential penalties, more lawsuits, and impact of regulatory reform, the stock has dropped roughly 50 points or 28% from $180 to $130 a share.

The Opportunity

After thoroughly reading the SECs case and Goldman's response, we find no fraud in the transaction between the sophisticated CDO buyer (Abacus) and seller (Paulson & Co). In addition, while regulatory reform will create some near term uncertainly, we do not see a scenario that would impair Goldman's ability to continue to maintain its dominant position and earn an above average return on capital.

Goldman is estimated to earn roughly $10 billion or $20 per share in 2010, valuing the company at just 6.6x earnings. It now trades just above its tangible book value of $118 vs. competitors like JPM trade at 1.7x book and it has historically traded at 2x. We think shares should appreciate up to our estimated fair value of $200/sh (which would still be just 10x earnings and 1.6x book) when the SEC suit is settled and the fear surrounding regulatory reform dissipates.

Conclusion

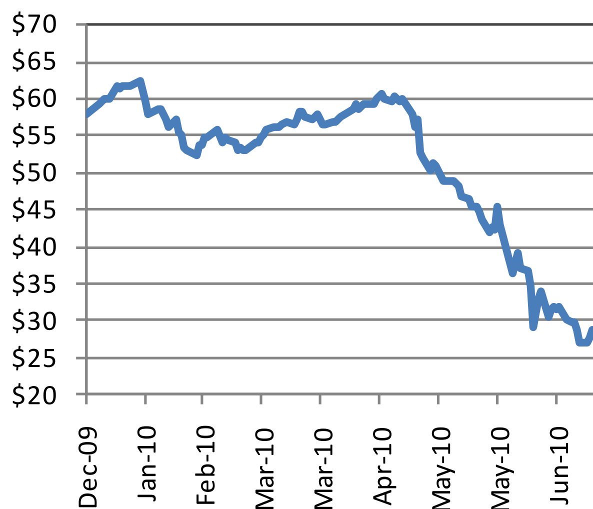
We believe the current crisis and uncertainty surrounding both Toyota and Goldman Sachs presents an opportunity to buy these high quality companies at bargain prices. While these company's shares have suffered from investor fear and anger, perhaps no company is more despised than BP. For this reason, I will highlight our thoughts on this contentious situation.

BP: THE CONTRARIAN POSTERCHILD

BY TOM EIDELMAN

On April 20th, the accident at BP's' deepwater oil well resulted in 11 fatalities and an estimated 50,000 barrels of oil per day leaking into the Gulf of Mexico. This spill has been called the worst environmental disaster in U.S. history. Consequently, BP's stock has fallen nearly 50% from its pre-spill levels (See Chart D) and has come under unprecedented scrutiny by the media and U.S. government. So what's to like about BP?

Chart D: BP Price Chart (Dec 2009-Jun 2010)



BP is the 4th most profitable company in the world. They accomplish this feat by finding and producing energy that fuels our cars, industries, and electricity. This is no easy task. They risk share with foreign governments such as Russia and Angola and develop technology to reach resources more than a mile under sea level.

The Opportunity

Our investment thesis is that the decline in BP shares has been far too severe due to investor fear and anger. As a result, we believe BP's share price is trading at a significant discount to an objective evaluation of the what the company is worth. Here is our analysis:

BP Value = Pre-Spill Value – Spill Liabilities

Figuring out the value of BP excluding oil spill costs and liabilities is pretty straightforward. Evaluating a liquidation value and comparing it's multiples to its competitors, we get an average value around $56 per share. Perhaps the simplest method is to just look at its 6-month average price before the spill, which also suggests $175 billion value or $56 per share.

Trying to handicap the spill liabilities is much more difficult as we need to estimate direct cleanup costs, potential fines, and lawsuits from such industries as commercial fishing and tourism. The latest estimates have a wide range of $20-$90 billion. Taking an average of Deutsche Bank, Oppenheimer, Morgan Stanley, and Morningstar spill estimates, we get a consensus estimate of $35B. Deducting spill costs from BP's pre-spill value implies a current value of $45 per share, roughly 55% higher than the current price (See Chart).

Chart E: BP Share Value

BP Pre-Oil Spill Value ($B)	$	175
All Spill Liabilities ($B)	$	35
BP Net Value ($B)	$	140
Shares Out (B)		3.13
BP Value per Share	$	44.80
Current Price	$	28.88
Upside %		55.1%

Why Cost Impact Could be Less

While consensus spill estimates seem reasonable, there are major factors that could mitigate the impact further. These include: 1) The tax deductibility of the spill costs effectively reduces expenses by their tax rate of 34%. 2) The agreed timing of the payment with the U.S. government over the next few years creates a time-value-of-money benefit of at least 15%, and 3) BP's 65% ownership of the well (Anadarko and Mitsui own 25% and 10% respectively) could reduce BP's liability another 35%. Added together, the current cost of their liabilities could be less than half consensus estimates.

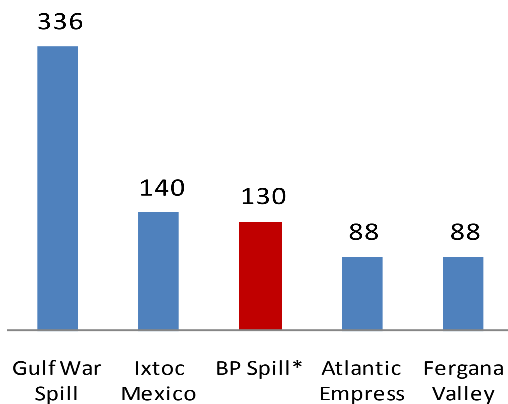
The Moral Argument

Even if the stock is undervalued, is it wrong to invest in BP? We are as outraged as anybody about the disaster; however, we do not believe BP is an evil empire. BP certainly didn't do this on purpose and nobody has a bigger incentive to make sure something like this never happens. While the evidence points to a combination of technical and human error, we believe this disaster was reflective of bad decisions on the part of a few individuals, who will certainly be fired, and not endemic to the roughly 100,000 employees all over the world. This disaster should result in an even more stringent culture of safety and regulation for both BP and the entire industry.

A History of Oil Spills

We studied all the major oil spills historically to look for historical precedent in terms of costs and environmental damage. Assuming the latest 50,000 bbl/day, the BP spill is currently the 3rd biggest oil spill on record (See Chart F).

Chart F: 5 Largest Oil Spills (million gallons)



**Notes: BP Spill assumes 50,000 bbl/day spill until June 30, 2010 from PBS.org Gulf Leak Meter.*

The second largest spill occurred in 1979 when Mexico's PEMEX spilled 140 million gallons into the Gulf of Mexico. While the oil covered Texas's shoreline and hurt tourism, PEMEX spent just $100 million to clean up the spill and the beaches recovered.

The largest oil spill ever occurred in 1991 in Kuwait when Iraqi forces deliberately released an estimated 336 million gallons into the Persian Gulf to slow American forces. Despite a vast amount of oil dumped into a body of water 1/6 the size of the Gulf of Mexico, some experts believe the spill "did little long-term damage." According to a NY Times article in 1993, a study sponsored by UNESCO, Saudi Arabia, the United States and others showed coral reefs and fisheries in "good condition" and described the effects of the spill as "rather cheering" given the amount of oil spilled. With the help of BP's resources, we believe the beaches and Gulf of Mexico will recover.

The Catalyst

We believe the sentiment surrounding the stock will improve dramatically when the relief well is completed, finally stopping the spill. This is estimated to occur in Mid-August; however, BP has announced that it is running ahead of schedule.

Conclusion

We think what's happening to BP right now is similar to the poultry producers during the bird-flu scare and many other instances where negative headlines cloud investor's judgment. In summary, we think the recent market overreaction is a wonderful buying opportunity.