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In Pursuit of Value

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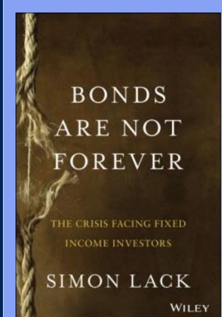


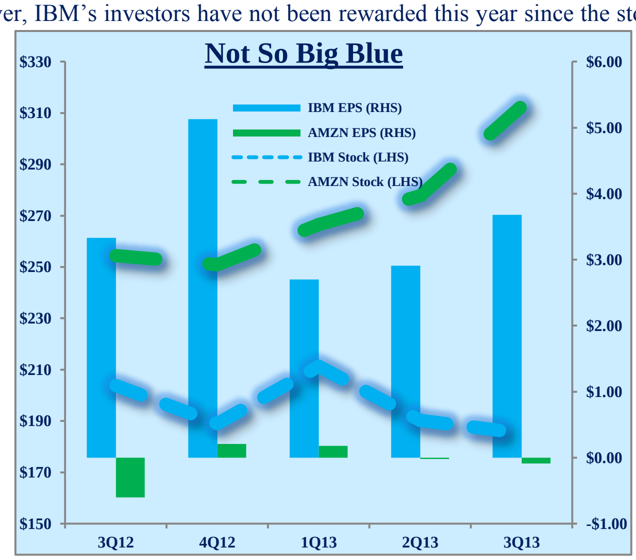
A Tale of Two Stocks

Here's a trivia question for you stock junkies who memorize every number like baseball statistics. Can you identify these two companies before reaching the third paragraph? Company A has for ten years experienced no growth in EPS or Free Cash Flow (FCF) per share, and has experienced declining operating margins over this time from 5.1% to 1.0%. It pays no dividend, yet it has grown revenues 30% annually. Its market cap is $166 billion and its stock is up 45% this year. The enterprise trades at 50x trailing EBITDA.

Company B has grown EPS at 14% for the last decade, per share FCF at 9% , has improved its gross margins from 37% to 50% and doubled its operating margins from 11% to 22%%. Its dividend has grown at 20% per annum. Yet, it's only grown revenues at 1% annually. Its market cap is $198 billion and its stock is down 4% this year. If you're the kind of picky investor that likes to invest in companies that can repay their owners out of profits, you'd own Company B. If you embrace the idea that the absence of profits can be made up with higher sales, you'd own Company A. This enterprise trades at 8.5x trailing EBITDA

Company A, Amazon (AMZN), certainly knows how to grow sales. Despite growing revenues 14 fold from what they were 10 years ago, AMZN isn't making much money. And those of us that remember the internet bubble will recall that AMZN was not exactly a new company in 2003, having already gone through the dot.com bubble years of the late 90s. Back then many "old economy" investors who didn't get the revolutionary change unleashed by Tim Berners-Lee (or was it Al Gore?) questioned whether AMZN would ever make money as the company plowed cash into their business, adding physical distribution centers to support their virtual assets. Here we are in 2013 and the same question may be justifiably asked, but the skeptic is silenced by AMZN'S 45% YTD stock performance. Why quibble about profits when investors have already voted with their brokerage accounts?

Company B is IBM. Revenue growth has been flat for several years, about the only financial yardstick against which they compare poorly. Nonetheless, the measures of business performance noted above as well as others all reflect a company that it executing well, shifting towards higher margin, recurring revenue businesses and returning its profits to shareholders. However, IBM's investors have not been rewarded this year since the stock's return has been around -4% (including dividends), an underperformance relative to the S&P500 approximately equal to AMZN's outperformance.



AMZN's market cap of $166BN has risen to 80% of IBM's, although their FCF is only 2.5% as big. Just 9 days of existence at one company generates the same cash as a year of toil at the other. IBM's annual dividend would cover all of AMZN's *profits* since 2006. Do these companies really both exist at these prices at the same point in time, in the same market? Can a company experience two bubbles? One per corporate lifetime is surely enough. What does the future look like for a company that grows 30% annually, but never seems to be profitable? A more interesting question may be what it means for an investor in a business that doesn't concern itself with making money.

The reader will by now have surmised that SL Advisors does not own AMZN and is invested in IBM. IBM's attractive earnings multiple, operating performance and consistent share buybacks work much better for us than a company where sales and profits have for several years been moving rapidly in opposite directions. Choosing IBM over AMZN hasn't made our clients or us richer, at least not yet. But we believe it will.

At this point many investor letters begin a lamentable monologue on the persistent irrationality of markets and the difficulty of outperforming the indices when mis-pricings such as AMZN's occur. No such apology will be found here though – we're happy with our overall results and you take the opportunities you find rather than wishing for those you'd prefer. We missed AMZN's rise as well as Netflix's, Facebook's, LinkedIn's and other high growth names. We've experienced IBM's stubborn underperformance (it has hardly fallen, it's just been highly sedentary) and we are comfortable in the math that a 10% earnings yield that's growing predictably at 10%+ annually = a very good return.

	IBM	**AMZN**
P/E (Next Years's Earnings)	10	166
Market Cap	$198BN	$166BN
2012 Per Share FCF	$13.42	$0.87
Enterprise Value/2012 EBITDA	8.5	49.5

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

A client/friend (happily in our business the two are often synonymous) asked the other day whether we might build up our exposure to the technology sector. Many of the names we didn't own mentioned above have that in common. Often, extremely high growth rates and valuations accompany a new business whose long term sustainability is unproven and whose competitive position is far from assured. Many IT companies benefit from monopoly positions and the prospect of high operating margins combined with rapid sales growth typically draws competitors (one example is the smartphone business that Apple pretty much invented and whose success has drawn deep-pocketed rivals).

Our fundamental value approach keeps us focused on investing in attractive securities and not speculating on highly unpredictable future profits. Shareholder-friendly managements running businesses with pricing power, high and growing gross margins and a track record of returning substantial portions of FCF to investors (like IBM) are where we focus. Companies that have a strong competitive position as demonstrated via high and expanding operating margins deserve a premium multiple. We are willing to pay more for predictable businesses that are profitable in all environments, and maintain low leverage. The less capital intensive the business the better, and we love businesses that generate incremental cash without incremental cash investments (the General Partners of many MLPs being a good example). Finally, we are price sensitive investors paying particular attention to the initial cash flow yield of a security. These qualities in companies appear throughout each of SL Advisors' strategies although the emphasis on each quality is strategy-dependent. Whereas predictability and stability of cash flows is particularly important to DivCap, discount to intrinsic value is emphasized in Deep Value.

In MLPs, superior governance rights and the ability of General Partners (GPs) to earn a return from the cashflows of Limited Partners (analogous to the position of hedge fund managers) are particularly attractive. The typical MLP is structured as a partnership whose appropriately named Limited Partners (LPs) have far more limited rights than with a conventional business. The GP retains all the power and preferential economics. You won't see an activist hedge fund buying up LP units in an MLP because invariably even if you owned 100% the Limited Partnership Agreement would protect the GP's right to continue running the business. GPs don't get fired. Perhaps most notably, when an MLP raises money through a secondary offering of equity, the LPs run the risk of dilution if the cash raised isn't invested to earn a return above the cost of equity, while the GP simply enjoys a share of the now bigger distributable cashflows. For years very few GPs were publicly traded, but that's begun to change and we've been using the opportunity to incorporate certain GPs into many of our strategies. If the GP's position with respect to an MLP is akin to that of a hedge fund manager with respect to his clients, the author of a book mildly critical of hedge funds might be expected to follow such an approach.