

## Around the Horn

*“Our process points to where the bargains are,” says Polaris Capital’s Bernard Horn, who’s proven quite skilled at choosing the right ones in which to invest.*

Having “overdosed on capital markets theory” during business school at M.I.T., Bernard Horn upon graduation in 1980 decided international value investing was his ticket into the business. “There were enough Boston firms with traditional U.S. strategies,” he says. “I had to distinguish myself.”

He's done just that. Horn's Polaris Capital now manages \$2.8 billion and over the past 20 years its global equity composite has returned a net annualized 9.3%, vs. 5.8% for the MSCI World Index.

Braced for a return to more normal volatility in global equity markets, he's finding opportunity today in such diverse areas as reinsurance, energy infrastructure, healthcare, convenience foods and small U.S. banks. [See page 2](#)

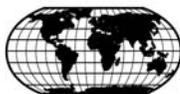
### INVESTOR INSIGHT



**Bernard Horn**  
Polaris Capital Management

**Investment Focus:** Seeks companies worldwide trading at deep discounts to the share prices that would result in an expected 8% annual real return over time.

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# Investor Insight: Bernard Horn

Bernard Horn, Sumanta Biswas and Bin Xiao of Polaris Capital describe the “purist” aspects of their value approach, what they consider one of the most undervalued sectors in the world, why less volatile stocks can often be more mispriced, and why they see upside in Hannover Re, Technip, Greencore Group and Independent Bank Corp.

It takes chutzpah to launch an investment firm, as you did in 1980, straight out of business school. Describe how that came about.

**Bernard Horn:** I worked in the summer of 1979 in Donaldson, Lufkin & Jenrette’s institutional options department for Mike Gladstein, who had written a paper with Bob Merton and Myron Scholes – professors at M.I.T., where I was getting my MBA – about what they called a 90/10 investment strategy. The basic idea was to put 90% of your money in T-bills and the other 10% in a portfolio of call options. It was a nice idea when interest rates were close to double-digit levels. With 90% of your money in T-bills, at year-end you’d pretty much get your money back. If the call-option portfolio did well, you made a lot more, but if it went to zero, your portfolio would still be whole. There was a unique distribution of portfolio returns, with low downside risk and a fair amount of upside potential.

During my second year at M.I.T. I worked on a business plan for a firm that would implement this 90/10 strategy for pension funds. Unfortunately, I figured out the idea wasn’t going to work, given restrictions on pension funds’ ability to buy call options. My plan B was to take the idea of minimizing downside risk while capturing upside potential and applying it to international value investing. It’s all the rage now, but at the time there were only a couple of dozen firms investing globally from a U.S. base, so I saw it as an area where I might stand out. I’ve been applying that strategy ever since.

**The beginning of your investment process is quite quantitative. Explain the mechanics of how you winnow down ideas.**

**BH:** The first step in our process starts with culling a database of 30,000 com-

panies worldwide. We’ve invested hundreds of hours defining algorithms that put the relevant financial information for each company on a more or less comparable basis. That means automatically adjusting for differences in accounting standards, financial statement formats and jurisdictional requirements. The system knows, for example, how to create a relevant cash flow statement for a Mexican company, even though Mexico doesn’t require such statements to be filed. It knows that in the United Kingdom, cash from operations is before interest and taxes, but we want to look at it after interest and taxes in comparing companies.

The next key step in the process is to deduct the appropriate level of capital spending necessary from operating cash flow to arrive at the maintenance level of cash flow, which is the key input we use to value each firm. The system looks at history and ratios of capital spending relative to things like gross property, plant and equipment, for instance, to arrive at the maintenance level of capex.

From there we can screen on any number of variables, but the primary one is maintenance cash flow to market value, where we typically require a yield of at least 8%. We do want companies that are conservatively financed, so we screen for those with total debt as a percentage of total assets of less than 50%. We will also make some more nuanced adjustments – say, requiring a higher cash flow yield for companies with higher exchange-rate risk, or giving greater preference to companies with increasing cash-flow margins over time – but the end result of this screening process is usually a list of 500 or so stocks offering us excellent value at any given time. (As an aside, that list had 2,000 names in the first quarter of 2009, which was one of the classic panic markets of all time.)



**Bernard Horn**

## Man Over Machine

Well versed in the quantitative side of investing – his business school thesis under advisors Fischer Black and Robert Merton was on the pricing of commodity options – Bernard Horn relies heavily on computers to winnow down his investment universe. But his faith in machines as investors goes only so far: “I’ve never been comfortable letting the computer create an optimal portfolio and then investing in it without human intervention,” he says. “It takes judgment to figure out the story behind the numbers.”

Horn’s quant side still informs Polaris Capital’s focus on both minimizing downside risk and keeping portfolio volatility low. To build in a margin of safety, he follows a “purist” quantitative value investing approach, he says. His firm’s global mandate helps limit volatility: “Opening the investment universe to the entire world provides far more opportunity to find low-correlation assets,” he says.

Also inspiring his aversion to volatility: Starting his first investment firm from scratch. “In those days, a bad quarter meant trouble paying the bills. There’s no better lesson on the importance of cash flow and avoiding unnecessary risks.”

We consider this a purist value approach. We don't force the process to point us in any other direction than where the bargains are, regardless of the size of the company, its industry or its home base. The mean real return of stocks over time is about 6%, but the normal standard deviation of that distribution is about 22%. That's actually quite volatile, which almost guarantees that stock prices will often be more volatile than the underlying-company cash flows. Our screening is all about finding those stocks that have gotten pounded on too much, providing us with a prospective rate of return that allows us to outperform.

**Up to this point all the input is backward-looking, correct?**

**BH:** Yes. We're saying that with all the competitive forces in the global economy, this is what the company has been able to actually generate in cash flow, and this is what the market is paying for that. There's no hope being built into the initial valuation.

Once the computer has done its work, humans take over the more strategic tasks of analyzing financials, understanding competitive structures and critiquing management. We will typically discard companies in industries with poor dynamics or facing big secular challenges. When analyzing new companies, we will focus on potential trouble spots, ranging from non-sustainable anomalies in the cash flow to potential share dilution from stock options or convertibles.

For the companies that still make the cut – in healthy industries, with sustainable business models and good management – we'll build a financial model around a five-year forecast of revenues and cash flows. We rarely count on annual growth in real cash flow beyond a couple of percent per year – again, minimizing the extent to which hope is justifying the estimated value.

Our discounted cash flow calculation then produces two prices. Our buy price is the price at which the cash flows are being discounted to produce our required real return of 8%. Basically, the company

is priced low enough to allow us to earn in excess of the market's expected return. Our sell price is the one that discounts future cash flows at 6%, meaning the valuation no longer allows us to earn an expected return greater than the market's. All things equal, the stocks trading at the biggest discounts, or highest expected return, make it into the portfolio.

**Do candidates cluster in particular industries or countries at any given time?**

**BH:** Today it seems to be driven more than ever by industry cycles or sectors going in and out of favor. Last year when

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## ON TECH STOCKS:

**Strong sales growth in cash-rich, well-managed firms trading at single-digit multiples should provide opportunity.**

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investors were ignoring consumer-staples stocks in favor of cyclicals, for example, we found some great values in companies like J.M. Smucker [SJM] and Heinz [HNZ], both of which we still own.

Last year we also bought a lot of small- and medium-sized banks in the U.S. In many cases, their shares got hit with the same credit concerns as bigger banks even though they didn't have comparable loan portfolios. On top of that, as the bigger bank stocks rebounded, smaller-bank shares have lagged on the upside. We still think U.S. small banks comprise one the most undervalued sectors in the world. I'll talk later about one example, Independent Bank Corp.

**You seem to be active in healthcare. Why?**

**BH:** We do think the negativity around healthcare is creating opportunity. For example, insurers like WellPoint [WLP] and UnitedHealth [UNH] have been cast as the villains in the ongoing healthcare debate – not without some reason – but we also see them as central players in the

evolution of the industry. It's easy to place blame for why costs seem to be out of control, but a main reason is that an aging population incurs higher healthcare costs. Any serious effort to make healthcare spending more efficient will require the active participation of viable health insurers, which have the best data and industry experience. As a result, we think the fears that insurers will keep getting squeezed to death are overstated. It doesn't hurt the investment case that at some point over the next five years you could see another 30 million people become insured. Not many industries have the potential for that kind of volume growth.

Another healthcare name that we've been buying is Quest Diagnostics [DGX], the leading test-laboratory company. The stock was already mispriced, in our view, due to general reform-induced margin concerns, but then they very recently reported an off quarter and the stock fell more than 10% over two days. Those are the kinds of opportunities on which we try to capitalize.

**What's your current take on the technology sector?**

**BH:** We haven't been particularly active in IT for several years. For the most part, big tech companies are now largely driven by capital-expenditure cycles – we haven't considered them to be high growth for some time, which has saved the portfolio a lot of money.

That said, we wouldn't be surprised if our technology weighting doubled over the next year. There's evidence that the reinvestment cycle in technology is shaping up to be quite healthy, driven by strong consumer electronics and server sales, a Windows 7 upgrade and excellent memory demand. Strong potential sales growth in cash-rich, well-managed companies that are trading at single-digit earnings multiples should provide us with plenty of opportunity.

It's too early to talk about newer names we're considering, but two that we've owned and still like are Infosys Technologies [INFY], the Indian outsourcing company, and Wincor Nixdorf

[WIN:GR], a German firm which sells ATMs and point-of-sale hardware and software.

**Why does your portfolio tend not to correlate closely with global benchmarks?**

**BH:** We go where the most undervalued stocks are, regardless of market cap or industry. So we're very likely to hold smaller stocks than would be found in most indices, and to overweight versus the index stocks in sectors sporting lots of bargains.

We've purposely avoided basing our bonuses on performance against benchmarks. We're always running into managers who say they're unable to look at certain stocks because they don't fall within a prescribed benchmark. They tell us, "I can't take the risk. If I buy it and it goes down, I'll have to write all sorts of memos explaining it, and I'll get less bonus because my portfolio went down more than the benchmark."

**What are your bonuses based on?**

**BH:** Basically the more money we manage, the bigger the bonus pool and people's individual bonuses. Our ability to attract and grow assets is obviously a function of our performance, but we try not to corrupt our process for the wrong reasons. A company with 200 funds can't reasonably do it the way we do, which we believe gives us an advantage.

**How concentrated are your portfolios?**

**BH:** Our global portfolio usually owns around 75 positions. We could own less than that and have theoretically "proper" diversification, but greater concentration doesn't provide enough downside for me in a volatile market.

The positions tend to be equally weighted. We know there are potential errors in the portfolio, which we'd obviously avoid if we could predict what they were. Since we can't, we assume the future errors are randomly distributed, which is a primary reason we equally weight the positions.

We also try to be well-diversified across industries and countries. It's not a hard-and-fast rule, but we usually try to own a minimum of 15 different sectors and 15 different countries.

**You seem to pay quite a bit of attention to the beta of your portfolio and your individual stocks. Why?**

**BH:** We believe the best values are often in companies with the lowest betas. That's helpful to us, because our objective is to outperform with lower than market risk. If you look at our returns against

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## ON CURRENCY HEDGING:

**Over time, the worst impact of currency movements will be 30-40 basis points. It costs more than that to hedge.**

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global market returns, our beta has consistently been below 0.8. Our screens tend to favor less-volatile stocks, by giving preference to more stable cash flows.

A legitimate case can be made that low-beta stocks are consistently undervalued by the market. Portfolio managers tend to favor high-beta stocks as a way to beat the market. If a portfolio beta is 2.0, the portfolio should double the market returns, right? Of course it can go the other way as well, but with their bonuses dependent on beating the market, many managers are willing to take that risk.

**Do you hedge currency exposure?**

**BH:** No. In any one or two quarters currency movements in a portfolio can have a big effect, however over 10 to 20 years, the worst impact will be maybe 30-40 basis points. It costs more than that to hedge, so we don't do it.

**Describe your selling discipline.**

**BH:** Our valuation methodology tells us what we should pay for a stock assuming

it's priced to give us 2% alpha over the market. When it's no longer priced to give us any of that alpha, we consider it fairly valued and it's time to sell it and buy an undervalued stock. That often means our sell prices are conservative, which is OK with us.

Valuation is a dynamic process, so we very often own stocks for several years. One example is Autoliv [ALV], a Swedish company that is one of the biggest global suppliers of car airbags and other safety systems. After a great run, the stock got hammered in 2008 as the car market turned sharply down. But while its volumes were off more than 25%, Autoliv compensated with aggressive cost cutting. In addition, some competitors were forced out of the business, which indicated that Autoliv was likely to generate more cash coming out of the crisis than we had expected going in. So while the stock price went from \$60 in late 2007 to \$12 in March 2009, our sell price on the stock never went below \$40. We were originally too early in buying more, but it's now come back very nicely and we still own it. [Note: Autoliv shares closed recently at \$57.50.]

**Give an example of something you've sold recently and why.**

**BH:** A good example of what we've been selling is Cargotec [CGCBV:FH], a Finnish cargo-handling company. It's terrifically well-managed and cash flows held up pretty well through the worst of the crisis as it worked off a very healthy order book. However, as we're seeing in many companies like this, the company is having a hard time filling the order book back up again. With demand suspect, we sold out as the stock rebounded earlier this year.

**Describe your investment thesis for German reinsurer Hannover Re [HNR1:GR].**

**BH:** We had historically steered clear of property/casualty insurers because of the unpredictability of their expenses and the opacity of their reserve accounting.

Starting a few years ago we saw reinsurance companies showing up all over our screens, so in the summer of 2008 we decided to take a deeper look at the industry and try to figure how to make money there. We noted that after September 11th, the market seemed to have become more rational, with fewer players willing to lose money on underwriting and then trying to make up for it by taking riskier bets on the asset side of the balance sheet. That made it a better business in general, and while it's difficult to get totally comfortable with reserve accounting, we also identified a few companies – namely Hannover Re, Munich Re and Chubb – that appeared to have consistently taken a conservative approach and done a good job of reserving against unexpected claims.

Because we were new to the sector, we didn't take a rifle-shot approach, instead taking half positions in those three companies, all of which were trading at 7-8x earnings. If we were still comfortable with their ability to weather difficult times, we would increase to full positions if the value was still there. That ended up happening in early 2009.

**How well did Hannover Re come through the crisis?**

**BH:** As we had hoped, the company actually performed quite well. Management is very conservative about the investment portfolio, which meant they didn't get involved in the subprime and other types of paper that hurt so many other insurers. The balance sheet

has always been solid, so they didn't have to raise capital. They have also proven nimble on the underwriting side, moving fairly well from market to market worldwide depending on where they can cherry pick the best business.

This isn't a sexy growth story, but it is indicative of the types of opportunities we find interesting. This is a very solid company in a decent industry that is currently priced well below where we think it should be.

**With the shares trading at just over €37, how are you looking at valuation?**

**Bin Xiao:** We estimate maintenance free cash flow at almost €500 million, so the free-cash-flow yield on the €4.4 billion market cap is over 11%. In our DCF model, we assume premium revenue grows at 2% per year, the investment portfolio generates a 3.5% annual return and that the combined ratios for the property/casualty and life/health lines are 100% and 103.5%, respectively. All of those assumptions are conservative against what they've done in the past, but we still come out with a sell price of €63.

**What are the biggest risks?**

**BH:** The stock got hit a bit in May because Hannover Re has some exposure to European government debt "of concern." But debt holdings in Greece, Spain and Portugal make up only 5-6% of the company's portfolio, so we think it's unlikely they'll end up losing much money on that.

The other big risk is the fact they have a giant bond portfolio. If interest rates shoot up, our yield assumptions could well turn out to be too high. Management is well aware of this and we believe is managing the duration of the portfolio accordingly.

**What interests you about French engineering and construction firm Technip [TEC:FP].**

**Sumanta Biswas:** Technip is one of three major players – the U.K.'s Wellstream and

**INVESTMENT SNAPSHOT**

**Hannover Re**  
(XETRA: HNR1:GR)

**Business:** Germany-based global reinsurer, serving a broad base of life, health, accident, damage, property and high-risk specialty reinsurance markets.

**Share Information**

(@7/29/10, Exchange Rate: \$1 = €0.77):

<b>Price</b>	<b>€37.24</b>
52-Week Range	€26.75 – €38.00
Dividend Yield	5.7%
Market Cap	€4.43 billion

**Financials** (Full-year 2009)

Net Premium Earned	€9.31 billion
EBIT Margin	12.2%
Net Profit Margin	7.9%

**Valuation Metrics**

(Current Price vs. TTM):

	<b>HNR1</b>	<b>S&amp;P 500</b>
P/E	6.6	17.5

**HNR1 PRICE HISTORY**



**THE BOTTOM LINE**

The company's conservative approach to underwriting, reserving and investing may not make for a sexy story, says Bernard Horn, but it does make for a solid investment opportunity. Assuming 2% annual premium growth, a 3.5% annual investment return and combined ratios above historical levels, he believes the shares are worth €63.

Sources: Company reports, other publicly available information

Luxembourg-based Tenaris being the other two – that operate in the high end of the market for designing, engineering, supplying and building energy infrastructure around the world. They build pretty much across the value chain, from piping to entire drilling platforms to refineries. They serve both offshore and onshore markets, and are very well diversified geographically.

**BH:** One long-term trend we see in the oil and gas business is for state-owned companies – which now own 75% of all the world’s reserves – continuing to invest in capturing more of the value attached to their owned reserves. The Middle East has experienced massive spending on refinery capacity and liquid-natural-gas infrastructure. In Brazil, big financial out-

lays have focused on offshore and deep-water exploration. If we can’t invest in the Saudi Aramco-type businesses, we can invest in pick-and-shovel players like Technip that serve them.

**How cyclical is this business?**

**SB:** The business is clearly subject to the capital spending cycles of major oil companies, but Technip’s cash flows have been quite resilient as the oil-price environment has changed dramatically. That’s partly because the production and refining sides of the business often move in opposite directions. It has also been a function of considerable improvement in the company’s project-management skills. When energy prices were at their highest and drilling activity worldwide

was extremely high, Technip’s costs of construction grew very rapidly and, because of some poorly executed contracts, they weren’t able to pass on the rising costs. We believe they now have a much better handle on that, and margins have risen appreciably over the past year as a result.

The big national oil companies are getting back in the market with projects they halted earlier due to prohibitively high costs. On the refinery side of the business the trend is for high-cost refineries to be replaced by low-cost refineries coming online in Asia and the Middle East. That’s positive for companies like Technip, which recently announced a \$1 billion share of a new Saudi Arabian refinery project.

**Technip touts its expertise in deepwater drilling projects. Does the crisis in the Gulf put a cloud over that?**

**BH:** The Gulf spill did appear to impact the share price, but in that same period Brazil’s Petrobras announced significant new projects to develop deepwater oil reserves and Technip is expected to be a major supplier of the flexible pipe to be used. The Gulf crisis will probably prompt more sophisticated technology in production infrastructure, which actually plays into the strengths of high-end players like Technip.

**How cheap do you consider the shares, trading recently at €51.90?**

**BX:** The stock has run up about 10% in the past two weeks, but still trades at a cash-flow yield of about 8%. That’s assuming maintenance cash flow of close to \$450 million over the next few years, which is only about 65% of what they earned in recent years. Our current estimate also gives the company no credit for the Petrobras projects or for the fact that EBIT margins have risen from 5% to 10% so far this year. Our sell price today is only €57, but as the year continues and we get more confidence in the predictability of future cash flows, there’s a strong chance that will be revised upward.

**INVESTMENT SNAPSHOT**

**Technip**  
(Paris: TEC:FP)

**Business:** Design, engineering and construction of industrial facilities used primarily in the worldwide exploration, production, transport and refining of oil and gas.

**Share Information**  
(@7/29/10, Exchange Rate: \$1 = €0.77):

<b>Price</b>	<b>€51.87</b>
52-Week Range	€39.96 – €64.85
Dividend Yield	2.7%
Market Cap	€5.55 billion

**Financials** (Full-year 2009)

Revenue	€6.46 billion
Operating Margin	6.6%
Net Profit Margin	2.6%

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

	<b>TEC</b>	<b>S&amp;P 500</b>
P/E	35.6	17.5

**TEC PRICE HISTORY**

**THE BOTTOM LINE**

Having gotten its operating house in order, the company is well-positioned to capitalize on heavy spending by national oil companies on energy infrastructure, says Sumanta Biswas. Assuming maintenance cash flow of only 65% of what Technip has earned in recent years, he arrives at a fair value for the stock of at least €57.

Sources: Company reports, other publicly available information

Talk about a smaller, off-the-beaten-path idea, Greencore Group [GNC:ID].

**SB:** Greencore is a specialty food company based in Dublin, Ireland that produces and distributes a wide range of ready-made sandwiches, salads, snacks and desserts to grocery and convenience stores. The bulk of their sales are in the U.K. and Ireland, where the ready-made food concept is well established, but they have also been successfully expanding in the U.S. after buying a Massachusetts-based company called Home Made Brand Foods in 2008.

We have owned Greencore shares for several years and have been impressed with how management continues to improve the company. They have divested a decent but volatile commodity malt

business to focus on convenience foods. After some early growing pains, the U.S. business is showing a lot of promise and accounted for €100 million of the €850 million in convenience-food revenues in 2009. They have also maintained excellent relationships and shelf space with their retailer base, and have top market shares for most of their niche products. Finally, they're cost-conscious, which shows up in increasing margins over time.

There are also a couple of external-to-the-company reasons we're optimistic. The value proposition seems in tune with the times. Creating a meal from Greencore's selection of products is cheaper than eating out and is almost as convenient. We also see opportunity for the company to improve profitability in the U.K. – the financial crisis led some

key competitors to close factories and scale back distribution.

**What upside do you see in the shares, now trading at around €1.35?**

**BX:** The yield from our €30 million estimate of maintenance free cash flow at today's price is around 11%. If we assume the company has no revenue growth over the next five years and generates a 6.5% EBIT margin, our DCF model produces a sell price of €2 per share. We hardly think that's aggressive, given that the shares traded at €4.50 two and half years ago.

**BH:** One added margin of safety: Not included in our estimate is the value of real estate the company still owns from from an earlier sugar-processing operation. If that's worth just 25% of what we valued it at the peak of the market, it would add €1 per share in value.

**You mentioned finding opportunity in small U.S. banks. Describe the value you see in Independent Bank Corp. [INDB]**

**BH:** As I mentioned earlier, this is one of the small banks that we believe the market has mispriced by treating it similarly to the big players in the industry.

The story is quite simple. Independent is a no-frills commercial and retail bank with \$4.2 billion in assets operating in southeastern Massachusetts. We first got involved with it after it acquired for stock one of our portfolio holdings, Benjamin Franklin Bancorp, in April 2009.

While Independent's charge-offs as a percentage of total loans were still extremely low last year, 0.38%, they did have several charges impacting earnings that we expect to be temporary. Reserves for loan losses were \$17 million, versus an annual level of \$2 to \$4 million prior to the crisis. Costs related to foreclosed properties – so-called Real Estate Owned [REO] – went from \$1.7 million in 2008 to \$13 million in 2009. FDIC premiums went from almost nothing to \$7 million. The company was also one of the first banks to pay back its TARP money, at a

**INVESTMENT SNAPSHOT**

**Greencore Group**  
(Ireland: GNC:ID)

**Business:** Manufacture and distribution of prepared foods and related products sold to commercial vendors as well as through convenience and grocery stores.

**Share Information**

(@7/29/10, Exchange Rate: \$1 = €0.77):

<b>Price</b>	<b>€1.34</b>
52-Week Range	€1.04 – €1.69
Dividend Yield	5.7%
Market Cap	€272.8 million

**Financials** (Full-year 2009)

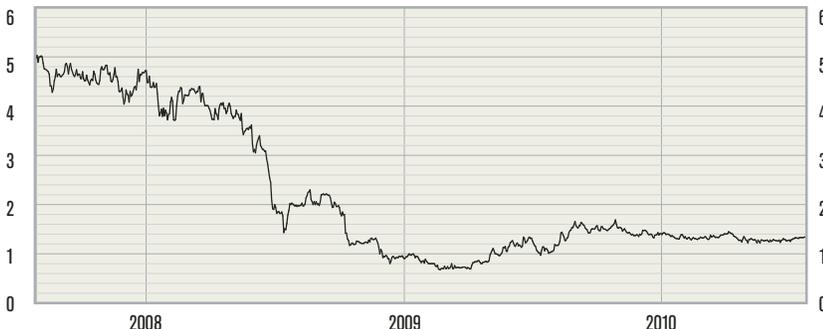
Revenue	€1.10 billion
Operating Margin	6.4%
Net Profit Margin	1.5%

**Valuation Metrics**

(Current Price vs. TTM):

	<b>GNC</b>	<b>S&amp;P 500</b>
P/E	8.2	17.5

**GNC PRICE HISTORY**



**THE BOTTOM LINE**

Structural changes in its home European markets and solid growth prospects for its line of ready-made food products in the U.S. bode well for the company's stock, says Sumanta Biswas. Even assuming no revenue growth over the next five years, his DCF model arrives at a fair share value of €2, 50% above today's price.

Sources: Company reports, other publicly available information

## INVESTMENT SNAPSHOT

**Independent Bank Corp.**

(Nasdaq: INDB)

**Business:** Holding company for Rockland Trust, a commercial and consumer bank operating primarily in southeastern Massachusetts with \$4.5 billion in assets.

**Share Information**

(@7/29/10):

<b>Price</b>	<b>24.43</b>
52-Week Range	19.53 – 28.23
Dividend Yield	3.1%
Market Cap	\$512.1 million

**Financials (TTM):**

Revenue	\$178.0 million
Operating Profit Margin	28.3%
Net Profit Margin	18.6%

**Valuation Metrics**

(@7/29/10):

	<b>INDB</b>	<b>Nasdaq</b>
Trailing P/E	13.6	12.2
Forward P/E Est.	12.6	15.7

**Largest Institutional Owners**

(@3/31/10):

<b>Company</b>	<b>% Owned</b>
BlackRock	7.6%
MFC Global Inv	4.1%
Vanguard Group	4.0%
Columbia Mgmt Adv	3.8%
Delaware Inv	3.3%

**Short Interest** (as of 7/15/10):

Shares Short/Float 11.0%

**INDB PRICE HISTORY****THE BOTTOM LINE**

Bernard Horn believes the market is still penalizing the companies' shares for a variety of what will turn out to be temporarily high hits to earnings. Assuming more moderate but still historically high levels of loan loss reserves, FDIC premiums and costs related to foreclosures, he estimates the price at which he would sell the shares at \$31.

Sources: Company reports, other publicly available information

net cost of \$5.7 million in 2009. Even with all those unusual expenses, it still earned \$17 million in profits.

**How do you “normalize” all that?**

**BH:** If we assume reserves for loan losses at \$10 million per year, \$5.6 million in annual FDIC premiums, around \$2 million in REO expenses, and no TARP-related costs (because they paid it all back), we arrive at a price to sell the shares of around \$31. If we didn't build in such a large margin of safety to the loan-loss number and used a level more consistent with the bank's history, our sell

price would be closer to \$35. [Note: INDB shares closed recently at \$24.43.]

The earnings multiples on these types of banks still look high, because most of them have been continuing to build reserves and some – although not Independent – have reported elevated loan charge-offs. But with even a conservative pass at normalizing earnings, there are a lot of great values out there.

**Has the turmoil of the past few years led to any changes in how you operate?**

**BH:** We haven't changed anything fundamental, however we are working to incor-

porate more non-traditional research into our process. We have maybe focused too narrowly on just the companies we were interested in, not paying enough attention to what was going on elsewhere in a given industry. For instance, we never liked mortgage banking and subprime lending, so we didn't spend a lot of time with companies that were active in those areas and therefore we didn't fully appreciate how crazy it was getting.

One of our biggest mistakes in recent times was holding an Irish bank that ended up being seized by the Irish government. In retrospect, we listened too much to the company and didn't fully hear concerns being raised about it in the industry. We've always tried to tap diverse sources to better understand our companies and their industries, but we can do even more of that.

We're also more actively writing calls on some of our positions, primarily to protect our downside as a stock gets close to our sell price. At the same time, we're observing the implied volatilities. If they're low, that might indicate the market isn't pricing in enough risk. If the implied volatility on a company is high, it might indicate a potential risk that requires more research.

**You've written that you expect markets and business cycles to be “more normally volatile” going forward. How is that changing your behavior?**

**BH:** We do believe the volatility we've seen in recent months will be more the norm. In any given month there will be bouts of good news and bad news and that's going to drive stock prices more sharply up and down. In that environment, the premium will be on being disciplined in selling and de-risking in up periods, and then holding cash for when the market corrects on the downside. We're also trying to pull the trigger more quickly when something appears to be going wrong. We were fortunate to get out of the Spanish banks before the worst headlines hit, for example, because of our heightened sensitivity to risk. Being nimble will be more important than ever. **VI**