

# *Grisanti Brown & Partners LLC*

## *Summary of Investments*

*As of June 30, 2010*

### **Air Products (APD)**

Air Products is a leading seller of industrial gases like argon, helium, nitrogen, oxygen and hydrogen to customers around the globe. The end markets are diverse, ranging from food packaging and healthcare to glass and metals manufacturing, and nearly 75% of APD's sales are in the U.S. (40%) and Europe (34%). We like this business because it produces strong and predictable cash flows owing to its long-term customer contracts. Historically, APD has traded at 16-18 times forward earnings, but earlier this year the stock fell below these levels as a result of a hostile offer APD made to acquire an important rival, Airgas. We believe the acquisition makes economic sense even at a slightly higher price than the current offer. If the deal gets consummated, Air Product's earnings power is likely higher than the street expects, and the shares could trade toward \$100. If the deal falls through, it seems likely the shares will retrace at least part of the decline from when the deal was announced, which could provide for 15% or so upside in fairly short order. Either way, we think the expectations are too low and the valuation gap with history will close over our time horizon. In short, we like the business and are pleased to have this negatively viewed event drive down APD's price to an attractive entry point.

### **Applied Materials (AMAT)**

Applied Materials is the world's largest maker of semiconductor equipment, the machines that make all sorts of semiconductors, from memory chips to microprocessors. Its largest customers are companies like Intel, Texas Instruments and other chip manufacturers. In the first quarter of 2009, orders of semiconductor equipment reached lows not seen since 1984. While many companies have experienced serious sales slumps, semiconductor manufacturing is notoriously cyclical, and a quarter-century low in orders is unsustainable in a world that requires many more semiconductors than it did 25 years ago. Since we purchased the shares, orders and sales have begun to rise, but remain below normal levels. We believe the continued process of normalization of sales levels will drive the shares higher. AMAT is the largest company in the industry, with the best balance sheet (only 3% debt to capital), two criteria that we believe give it the ability to weather the storm. By buying the stock at an 11-year low, we think we have reduced the downside risk should this economic downturn worsen. On the other hand, this is an example where the 2008-09 economic crisis created an opportunity to buy the best company in a growing industry at an attractive price.

### **Bank of America (BAC)**

Our investment in Bank of America is predicated on history repeating itself. When the economy falls into recession, banks increase their provisions for losses, immediately hurting their earnings. Profits drop sharply, but long before the economy is booming again, this loss provisioning peaks. It's important

to note that this peak occurs several quarters before actual losses peak. In other words, the bank may take a provision for a loss in March when a homeowner stops paying his mortgage -- in fact it may write off all or a substantial part of that loan. That provision affects the bank's earnings immediately. Then, in December, when the house is foreclosed upon and the bank actually loses 30% of its mortgage loan, there is no further loss taken unless the provision was inadequate. In fact, if the bank wrote off more than 30% of the loan in March, it may actually book a gain in December. This seemingly semantic distinction between taking a provision and a loss is actually quite important from an investment standpoint, as it means that banking companies typically report terrible earnings at the beginning of the economic downturn, and their earnings start to improve much earlier than other industries. As is typical in this part of the cycle, Bank of America has moved from reporting large losses to modest profits. The current economic uncertainty has brought into question the timing of when modest profits will return to more normal levels, but we do not believe that it has changed the long-term reality that those profits will be earned. We believe over the next three years the provisions will plummet by 90% (and even that would leave provisions above their ten year average), revenue should remain steady or grow, and earnings will rise to more than \$2.00 a share (more than four times their current level). This estimate has been reduced to take into account the almost final version of financial regulation that is poised to pass Congress. There are a lot of obstacles still to surmount, including increasing commercial real estate losses and rising unemployment but, again, we believe that three years from now the economic and lending landscape will be much more beneficial than it is today, creating a meaningfully better earnings profile at BAC. As the economy heals, we believe Bank of America should be a major beneficiary.

### **Charles Schwab (SCHW)**

Charles Schwab provides investment products, advice and services to individuals and their advisors. While the company provides its own product options to customers, it's largely known for its scale in distributing the products of other firms. The firm's focus on transparency and its history of driving costs down for customers has earned Schwab a reputation as a trusted, conflict-free financial company which, especially in this environment, has led to significant share gains. However, these gains have been obscured by low interest rates which affect earnings greatly as Schwab must subsidize its money market funds at current levels, a cost which approached \$350mm or \$0.20 per share over the past four quarters. Our investment thesis hinges on Schwab's continued ability to take market share which, combined with normal interest rates, some recovery in equity market values, and a much lower cost base, will result in dramatic earnings and cash flow growth. Also, the current rate environment has led management to prudently hold cash which, when the trend reverses, will likely be another positive catalyst as management returns to its practice of returning capital to shareholders. Schwab is trading at approximately half its historical valuation range on normalized earnings, a very large gap that we think will close over the next 2-3 years.

### **Chubb (CB)**

Chubb is a large Property and Casualty insurance company that writes personal, commercial and specialty insurance coverage and has one of the best brands in the business. Chubb's business is best known for its personal lines segment which caters to wealthy individuals. It has established a brand that commands a premium in the marketplace by being very liberal on its claims-paying side. Policyholders know that they have a "no questions asked and here is your check" attitude. Coverage is not cheap, but Chubb provides a tremendous amount of 'sleep at night' insurance. The commercial and specialty lines are more traditional and compete successfully in the marketplace. So, the franchise is of high quality and is well positioned to win its share of business. A key reason that the valuation has not moved

dramatically from the bottom is the pricing softness that appeared would reverse in 2009 but which has not. While we don't know what event will drive this change (i.e., catastrophes, some other capital reduction in the industry), we do know that when it happens pricing will move higher, profits will increase, and the premium to book value will move closer to historical norms. In our estimation, this process could deliver as much as an 80% return on our investment over the next few years.

### **Dell Inc. (DELL)**

Dell is the second largest maker of personal computers and servers in the United States. It was a technology darling in the 1990s, rising from (split-adjusted) 10 cents a share to almost \$60 by 2000, when it sold for nearly 100 times earnings. The last decade has brought many changes to the market, not least to Dell. We bought the stock in March for less than \$14, about 11 times our 2011 earnings estimate. We think a corporate upgrade cycle over the next 12 months is highly likely, and this will disproportionately benefit Dell. The majority of Dell's sales are to corporations, where spending on equipment and software in 2009 fell to a 40-year-low relative to GDP, creating strong pent-up demand. When combined with an aging installed base and a new and well-received operating system (Windows 7), this should create a corporate PC upgrade cycle later this year. The corporate market is more important to Dell than to any of its peers, so this cycle will likely stem share losses and perhaps drive hardware share gains for Dell for the first time in years. As always, valuation is key: at 11 times next year's earnings we think there is a lot of upside to the stock on a fundamental basis.

### **Fiserv (FISV)**

Fiserv provides banks and credit unions with processing technology that allows them to deliver everyday capabilities including account processing, online bill pay and other transaction related services. Most customers are medium sized community banks and credit unions in the U.S., although its largest customer -- Bank of America -- is the country's largest bank. Over 90% of the company's revenues recur as a result of five year contracts, and these contracts renew with very high frequency (90%+). After two decades of strong growth and a PE multiple in the mid 20s, the stock traded at 10x forward earnings in 2008 as a result of several cyclical factors. It has become clear that people will continue to use banks to hold money and make transactions, which drives Fiserv's franchise. We believe that once interest rates normalize and temporary headwinds abate, Fiserv's revenue growth will resume and drive faster EPS and cash flow growth. In the meantime, Fiserv is generating strong free cash flow which can be used to buy back stock, pay down debt and profitably reinvest in the business.

### **Goldman Sachs (GS)**

Despite the headlines and the recent stock price performance, Goldman Sachs remains a well-capitalized and dynamic financial services firm. These are two hallmarks of the company that helped it weather the difficult markets of 2008, and why we believed at 70% of tangible book value the shares were so attractive in the darkest hour. Even though the shares are up nearly 100% from our first purchase in December of 2008, the recent uncertainty surrounding an SEC investigation into CDO (collateralized debt obligations) sales practices and the impact of regulatory reform has created extremely negative sentiment that we believe obscures the full value of the franchise. The issues directly at hand are whether the reputational impact of the litigation and the economic impact of increased regulation will reduce the earnings power of the firm and ultimately the value of the franchise. On the first issue, we believe that the issue would be much more significant if Goldman had a strong retail business, which it does not. Instead, it continues to be considered among the best in the business for institutions to rely on for mergers and acquisitions, debt or equity capital raises, and other capital markets businesses among a field of peers that has been decimated. And, relative to financial regulation, while the impact to earnings

is most significant to Goldman among its peers, the shares are still trading at a significant discount to our estimate of post-regulation 2012 book value. Goldman has historically traded at an average of more than twice this valuation. In short, we think that as the issues of the day get settled – whether litigation or regulation – investors will go back to valuing the franchise based on the fundamentals, which are strong and getting stronger.

### **J.P. Morgan Chase (JPM)**

The investment thesis for JP Morgan is similar to that of Bank of America -- i.e., sharply falling loss provisions over the next three years will lead to significantly higher earnings. However, we believe the assets and the management at JP Morgan are of higher quality. For that reason, JP Morgan never declined to the low valuations that Bank of America did, but JPM did fall to 50% of book value, where it became very attractive to us. We believe it has emerged from the 2008 crisis as the leading banking institution in the United States. The relative strength of JPM's balance sheet allowed it to take advantage of opportunities to buy assets like Bear Stearns and Washington Mutual at what we believe three years from now will appear to have been fire sale prices. We believe that JPM will return to normal earning power faster than most financial institutions, and can earn a 15% return on equity by 2012. Thus, we estimate that JPM can earn \$6.20 in 2012 (including the impact of new regulations), and that the stock should sell for 11 times that number, giving us a target price of nearly \$70. Even though JPM has appreciated over 100% since purchase in March 2009, we believe there are still strong gains ahead when earnings rise as losses shrink. The company is now emerging stronger in a competitive landscape that is greatly reduced by the devastation of the past two years.

### **Lear Corporation (LEA)**

Lear Corporation is a leading supplier of automotive seats, electrical distribution systems and electronic products. It was founded 80 years ago and was a well respected company whose debt load forced them into bankruptcy after the catastrophic collapse of U.S. auto sales over the past two years. On November 11, 2009, the company emerged from bankruptcy with a much strengthened balance sheet and stronger operating metrics. Lear ended 2009 with roughly \$500 million in net cash (net cash = cash minus all debt) on its balance sheet, dramatically healthier than the peer group. We expect Lear's operations to get a significant lift from the rebound of the global automotive market over the next few years. Lear's revenue breakdown is: 49% Europe, 36% North America and 15% Rest of World. The opportunity lies in the North American market where production fell by more than 40% from 2007-2009. Assuming a recovery over the next three years in North America (but still 20% lower than the previous peak) and combined with restructuring benefits, we think cash flow (defined as earnings before interest, taxes, depreciation and amortization, or EBITDA) can triple by 2012 to \$1bn. Of course, this assumes that the European market remains on solid footing. Despite broad economic concerns in that region, LEA's strong position in that market gives us some comfort that cash flow will remain consistent with our estimates. Using an Enterprise Value to EBITDA multiple of 4.5x, the low end of its peer group of auto parts manufacturers, we arrive at a target price of \$95. More broadly stated, we like the idea of buying a restructured auto parts maker at a time when auto sales stink and the business is very out of favor. Over three years, we believe sentiment (and results) have very little place to go but up.

## **Mosaic (MOS)**

Mosaic is one of the largest fertilizer producers in the world. Our thesis on Mosaic has both cyclical and secular aspects. From a cyclical perspective, the past two growing seasons have seen a dramatic decline in fertilizer usage worldwide. Farmers can only under-fertilize for so long before soil needs to be replenished with nutrients, and we believe that this “catching-up” is beginning to occur in 2010-2011, driving demand and pricing higher. On a longer term basis, we like Mosaic because the world needs more food but worldwide arable acreage is actually decreasing, creating a greater need for yield enhancements like fertilizer. Emerging market populations are moving up the economic ladder and as they do, consumption moves to more grain-intensive proteins (i.e., beef requires four times more grain feed than chicken). In addition, corn is not only used for food but now also for fuel (ethanol), which is important as it is the most fertilizer-intensive crop. U.S. regulation requires 15 billion gallons of biofuel use by 2015, 25% higher than current levels, which will have a significant impact on the amount of corn grown domestically. Mosaic has a clean balance sheet with a net cash position of roughly \$400 million.

## **Navistar (NAV)**

Navistar is a producer of heavy and medium duty commercial trucks and school buses. The company also manufactures diesel engines for its own use and for sale to third parties. In addition, Navistar has developed a profitable military business over the last three years by leveraging the company’s truck expertise for application into the MRAP platform (Mine Resistant vehicles). Over the past 18 months, heavy truck sales have hit 50-year lows. We expect sales to improve over the next two to three years as an aging fleet requires replacement and new truck emission standards are being introduced in the U.S. as we speak. As business returns to more normal levels, we expect the company’s earnings to increase dramatically to between \$8 and \$10 per share. Assuming the shares sell at 10 times earnings, we believe the stock should appreciate sharply and sell at between \$80-100 per share.

## **Pfizer (PFE)**

How the mighty have fallen. In 2000 Pfizer sold at \$50 a share and earned \$.95 that year. Our earnings projection for 2010 (\$2.20) is more than double the profit the company reported ten years ago, but the stock is down by more than 60%. There are reasons for the market’s now gloomy view of Pfizer. The company has large patent expirations in 2011 and 2012. For example, Lipitor, the best selling drug in the world with over \$11bn in sales in 2009, will go off patent in November 2011. For this reason, Pfizer acquired Wyeth for \$60 billion in 2009. Wyeth’s more consistent consumer businesses (including products like Advil) will enable Pfizer to create a more diversified and stable earnings stream. Thus, instead of Pfizer’s earnings declining in 2012 by 25%, we now expect them to only decline by 5-10%. Meanwhile, that event is still nearly two years away, and there are interesting new drugs in the pipeline of both Pfizer and Wyeth which could soften the impact of the Lipitor patent cliff. This is a classic value investment: While the long term earnings growth is not spectacular, we believe the stock is just too cheap. It is currently trading at six times our expected 2011 earnings with a 5% dividend yield (which may rise) and a AA-rated balance sheet. Also, we think Pfizer and its big pharma peers were smart to be early in the healthcare reform bill concessions, which in the end we think will result in only modest pricing pressure for Pfizer and the industry.

## **Terex Corp. (TEX)**

Terex is a diversified global manufacturer of capital equipment used in end markets such as construction, shipping, mining and infrastructure. The company operates in five segments: Aerial Work Platforms, Construction, Cranes, Materials Processing and Roadbuilding and Utility Products. Terex has been particularly hard hit by the global recession with revenues declining by more than half in 2009.

After having earned over \$5 per share in 2008, Terex lost nearly \$4 per share in 2009. With the shares selling for 75% less than two years ago, we think this is an attractive opportunity. In December 2009, Terex announced the sale of its mining business for \$1.3 billion in cash. While this will dilute Terex's earnings in the short term, the transaction has two strong benefits. First, it will greatly strengthen Terex's balance sheet (the company will have more cash than debt, pro forma). Second, the cash affords management a war chest for possible acquisition at a time when asset values are depressed. Historically, management has an excellent track record of buying assets. Looking forward, we believe the company is well positioned to benefit from improvement in global economies and should be able to earn \$2.75-\$3.00 per share in two years. Assuming the shares sell at 15x forward earnings, this suggests a target price of \$40-45 per share. Longer term we calculate peak earnings power of \$6 by 2013.

### **TEVA Pharmaceuticals (TEVA)**

TEVA Pharmaceuticals is a 100-year old Israel-domiciled pharmaceutical company. TEVA is the largest generic drug manufacturer in the world, with a leading U.S. generic share of 24%. It holds the important position as the industry's low cost manufacturer. The company has compounded earnings at over 25% per year for the last ten years, historically trading at 20x forward earnings and a premium to the market. The stock – along with the entire pharmaceutical industry – has lagged the broader market, and today trades at less than 11 times forward earnings and a 10% discount to the S&P 500. Even after a strong rally since we purchased the stock late last year, TEVA has underperformed its peers since the market bottom in early 2009, despite the largest and most visible product pipeline in the industry. We believe this pipeline, combined with the global secular trend toward generic drug penetration, will drive results at well above market (and industry) average rates, over time resulting in a premium valuation for the shares and significant upside from current levels.

### **Valero Energy Corp (VLO)**

Valero Energy is the nation's largest independent oil refinery. Oil refining -- the business of taking crude oil and turning it into gasoline, diesel and other petroleum products -- has been a dirty, deeply cyclical business for over 100 years. It is currently suffering its worst slump since the late 1970s, when high oil prices forced Americans to use less gasoline. In fact, 2009 was the first year since 1978 that Americans drove fewer miles than the year before. In 2007 Valero sold for \$78 a share, but is now selling at \$18. We calculate the value of the refineries is north of \$50 per share, so we are paying a bit more than one-third of asset value. Valero lost money in the first quarter of 2010, but we expect it to be profitable in the second quarter, which we believe will mark the bottom of the refining cycle. It remains the only independent refinery with an investment grade rating, and it has established a profitable position in ethanol manufacturing. As the economy continues to improve, we believe Valero will anticipate a 2011 turn in refining margins and has the potential to be a superlative investment from current levels, even in a mediocre overall market.

### **Weatherford International (WFT)**

Weatherford is one of the world's largest oil service companies. The company's shares had declined sharply from the high \$40s two years ago to the mid-teens as many large oil companies reduced exploration spending in the economic crisis of 2008 and Weatherford's profits declined sharply. As the

world economies improve, we expect exploration spending to increase over the next several years. Weatherford is well positioned to benefit from this global spending increase with over 75% of its earnings coming from overseas. In 2012, we estimate the company can earn \$2.00. If the shares return to their historical P/E multiple, the shares should trade in the low \$40s, or more than double the current price. While not a part of our investment thesis, we are encouraged by recent industry consolidation, most notably Schlumberger's acquisition of Smith International. In our opinion, this reflects major oil companies' desire to have fewer vendors providing a wider range of services. In this regard, Weatherford could be an attractive take-over candidate.

### **Williams Companies (WMB)**

The Williams Companies is a diversified energy company that operates in three main areas. First, the exploration and production company produces natural gas from several basins in the United States, but the largest resource play is located in the Rocky Mountains. The company also operates a "mid-stream" business. This business gathers and processes natural gas and its related by-products. Finally, the company owns and operates one of the country's premier natural gas pipeline systems in the United States. Given the extremely depressed state of natural gas prices, we believe the shares sell at a significant discount to our estimate of the company's asset value of \$33 per share. As gas prices recover, we expect the shares to trade closer to our asset value estimate. This investment is a good example of the Grisanti Brown philosophy of identifying companies that represent Assets at a Discount. We believe the value of Williams' pipelines, mid-stream refineries and gas fields far exceeds the current share price.

---

*The views presented in the letter were those of Grisanti Brown & Partners LLC as of June 30, 2010, and may not reflect their views on the date this letter is first published or at anytime thereafter. These views are intended to assist in the understanding of investments by Grisanti Brown & Partners LLC and do not constitute investment advice. None of the information presented should be construed as an offer to sell or recommendation of any security mentioned herein.*