September 30, 2009

Value Investor INSIGHT

The Leading Authority on Value Investing

Investor Relations

Companies inevitably face growth-vs.-return inflection points as they mature. Count on Ralph Whitworth to be tracking closely the decisions being made.

Having turned down a job offer out of law school in 1985 from Mesa Petroleum's T. Boone Pickens, Ralph Whitworth was surprised when the Texas oilman called three months later to see if he'd reconsider. "He asked what I was working on, which was some property dispute over a water well," says Whitworth. "I didn't say no that time."

In 1996 Whitworth teamed with former Mesa colleague David Batchelder to form Relational Investors, an activist investment firm that now manages $6 billion. Since inception the firm has earned a net annualized 10.8%, vs. 5.1% for the S&P 500.

Targeting firms whose capital allocation has gone awry, Whitworth is active today in such areas as biotech, medical devices, semiconductors and insurance. See page 2

INVESTOR INSIGHT

Ralph Whitworth
Relational Investors

Investment Focus: Seeks firms whose poor decisions have alienated investors, but with whom active engagement can get such decisions corrected or reversed.

For additional information on Relational Investors LLC, please contact Frank Hurst at (858) 704-3434 or fhurst@rillc.com.

Inside this Issue

FEATURES

Investor Insight: Ralph Whitworth
Looking for opportunity to make a difference for shareholders and finding it in Genzyme, MetLife, Baxter and National Semiconductor. PAGE 1 »

Investor Insight: Eric Sprott
While prepared for the worst, still seeing big upside in Medusa Mining, Corridor Resources, Norseman Gold and Sensio Technologies. PAGE 1 »

Uncovering Value: Healthcare
Consolidation in healthcare is likely to continue – what companies will make attractive targets? PAGE 18 »

Uncovering Value: Liberty Media
A complicated and disparate set of assets, which may also happen to be trading at a bargain price. PAGE 19 »

Editors' Letter
Insight from a surprising source on how to put up barriers to "What was I thinking?" mistakes. PAGE 20 »

INVESTMENT HIGHLIGHTS

INVESTMENT SNAPSHOTS	PAGE
Baxter International	6
Corridor Resources	16
Genzyme	7
Liberty Media Capital	19
Medusa Mining	14
MetLife	8
National Semiconductor	5
Norseman Gold	15
Sensio Technologies	17

Other companies in this issue:
American Dairy, AstraZeneca, Biogen Idec, BioMarin, Bristol-Myers Squibb, Burlington Northern, Carnival, Elan, Eli Lilly, Genzyme, Home Depot, Microsoft, Precision Castparts, Royal Caribbean, Sirius XM, SPDR Gold Shares, Sprint Nextel, Time Warner, Unum, Yahoo

Investor Insight: Ralph Whitworth

Relational Investors' Ralph Whitworth describes how bad capital allocation decisions get "baked into the system," why he expects the technology sector to provide fertile ground for new investments, which regulatory reform he'd love to see enacted, and why he sees significant upside potential in National Semiconductor, Baxter, Genzyme and MetLife.

Your early investment experience was working with Mesa Petroleum's T. Boone Pickens in the "corporate raider" days of the 1980s. How has your activist strategy evolved since then?

Ralph Whitworth: The basics of the valuation model probably haven't changed a lot, but it was a different time. Companies overall weren't as well run and the market even in the biggest stocks wasn't as efficient. October 19, 1987 was the biggest trading day in the history of the New York Stock Exchange at the time, with 187 million shares traded. This morning the market's probably already traded three times that volume.

For Mesa, the investment thesis was usually simple: why pay $10 to find oil in the ground when you could buy it on Wall Street for a fraction of that? The market was right, unless someone with Boone's tenacity came along to uncap the value. Today we start with the proposition the market is right about a company's valuation. We then model the difference between that market value and how it might be valued if composed differently. If these assets, with this management, with this strategy, in this environment are worth $20 per share, can we identify changes in that composition that would make the market value much higher? More traditional investors might stop there, but we then try to figure out how likely the actions we've identified are to be taken and over what time frame, and, most importantly, how capable we are of helping to make them happen.

We typically look for underperforming companies, against their peers and their own history, and then try to understand why that's happening. Sometimes the answer is something we can't do anything about. A chemical company, say, has plants that are 10 years older on average than its peers, so its cost structure is too high in a cyclical business. The company has already decided it can't make the additional investment work, so there's really no opportunity for us there. In another case, though, the underperformance may come from the company having wasted money over the past three or four years on acquisitions and the market is concerned it's going to do it again and isn't assigning full credit to its future cash flows. That's probably an opportunity for us.

We're also active in companies that are otherwise performing comparatively well, but where the market value is still below its potential. Those ideas are harder to identify – you can't just go to Yahoo Finance and screen for return on equity versus the market. In these cases we back out the market's implied expectations for returns and growth and compare those with what has happened and what we believe should happen. When the market's expectations appear a lot lower, we ask the same questions about why that is and what we can do about it. These can be better projects, because you're not trying to dig something out of the mud.

Your investment in Home Depot [HD], where your partner David Batchelder is now on the board, would seem to be a classic example of a situation that attracts you. Describe the conception of that idea.

RW: Here was a company whose cash flow returns on investment had traditionally been 22%. We essentially asked if they continued earning at that rate, assuming only modest growth because the traditional business had matured, what would the stream of future cash flows look like? We then discounted that back to the present and came up with a value far higher than the then-current market value. The market was saying the assumptions we made were not going to happen, which interested us.

Ralph Whitworth

Racing to Win

As a teenager growing up in northern Nevada, Ralph Whitworth often spent weekend nights drag racing on local country roads. "I had a red GTO, the fastest car in town," he says. "I stayed alive and had an incredible amount of fun."

Armed with a law degree from Georgetown, Whitworth's thrill-seeking turned to Wall Street, where he became a fervent advocate of shareholder rights, as a lieutenant to Mesa Petroleum's T. Boone Pickens, president of the lobbying group United Shareholders Association and, since 1996, co-head of investment firm Relational Investors, founded with fellow Mesa alum David Batchelder.

How does racing to win on Nevada country roads compare to doing the same in the stock market? "I spent many a waking hour trying to figure out how to make my car go faster with the least amount of expense and the least risk it was going to break," he says. "I tell our young analysts we're basically looking for the same thing in our companies, how they can go faster with less capital and less risk. If you don't have the passion to stay up until 2 a.m. trying to figure that out, you're probably better off finding something else to do."

All companies at one time or another face a growth-vs.-return tradeoff. Home Depot had grown like mad and became a Wall Street darling, basically taking a powerful store concept and rolling it out everywhere. All analysts ever wanted to know was how many stores they were building and how fast. Then Home Depot got to 2,200 stores and saturated the market. That point in a company's history is as important as the day it goes public, but companies rarely recognize that. All anybody wants to think about, including management, is how to keep growth going.

That mentality is baked into the system. If you look at a graph with growth rates on the X axis and stock multiple on the Y axis – assuming a fixed cost of capital and return – the multiple will be stable until you get to 5% or so annual growth, at which point it starts to turn up at an increasing rate. Everybody wants to be on that upward sloping part of the line, even though the economy is only growing 2-3% per year. So what do mature companies do? They invariably take on more risk as they chase growth. In Home Depot's case, they hired a new CEO out of GE who spends billions to diversify into the wholesale supply business, serving builders and contractors rather than consumers. He maps out how they can grow revenues and earnings for a long time just by rolling up the fragmented domestic wholesale business.

What's less well understood, though, is another graph that tracks the earnings multiple against a company's return on investment. On this one – assuming a typical 9% cost of capital and a 4% growth rate – you've got a nice 20-25x earnings multiple when returns are 22%, but as the returns decline the multiple goes down at an increasing rate, falling off a cliff as you approach 10%. (Markets are forward-looking, so the multiple gets compressed before the dilution fully happens, if that's what's expected.) As it turns out, the supply business Home Depot was counting on to keep revenues and earnings growing was a less-than-10% return business. And everybody was wondering why the stock was going nowhere even though earnings had doubled!

Whether it understood Home Depot was at a growth/return inflection point or not, in 2000 the board saw the core franchise was challenged for growth and brought in Bob Nardelli to address it. The problem was that the incentives they gave him were to increase earnings and revenues, without regard to returns. If he could double earnings and revenues – which he did from 2000 to 2006 – he'd make $350 million. The board got what it paid for, even if shareholders didn't.

Our opportunity comes in trying to correct these strategy mistakes while there's still a way back and before they do too much damage to shareholder value.

ON GOVERNANCE:

We're far more interested in how the board makes decisions than in the tick-the-box corporate governance items.

Are most of your ideas of the capital-allocation-gone-awry variety?

RW: Yes, but I'd say maybe 10% of our ideas fall into a separate category, which are companies that already have weak returns and low multiples, but have the potential to increase those returns and get a big re-rating of their multiple. In other words, climbing up that cliff-shaped curve I mentioned earlier. Fixing these requires a much more operational approach, focused on asset turns and constantly improving productivity.

That may sound kind of boring, but it's actually quite fascinating to see it done well. One portfolio company we believe can pull it off is Burlington Northern [BNI]. Railroads have never earned their cost of capital so the market's perception may be slow to change, but with the right management and the right incentives – which are in place at Burlington – we expect people to start to look at this business in a new light.

I'd also add that our capital-allocation formula is not one-dimensionally focused on just shoveling it toward shareholders. With Precision Castparts [PCP], for example, we're encouraging them to make acquisitions to expand at this point in the cycle. As they look at bigger ones, though, we're trying to make sure they're disciplined in what they pay and fully understand the integration challenges. Most importantly, we are also pressing them to effectively communicate that discipline to the market.

Of the possible uses for excess capital that companies have, do you have a preference?

RW: There are five ways to spend money: dividends, paying down debt, internal investment, acquisitions and share repurchases. When we see excess cash on a balance sheet we don't go in with a knee-jerk response like, "You better buy back your stock," because that's limiting and can be stupid if done at the wrong time or for the wrong reasons. We focus on whether they have clear disciplines and processes for determining which of those five things they choose at any given time, and whether it makes sense in the context of the growth/return tradeoff. It's amazing how often companies say, "We like a balance of each," which is meaningless. Others say, "We buy back enough shares to offset the dilution of our stock-option grants." This betrays a fundamental misunderstanding of financial management. How the shares were issued is irrelevant – you first have to know if the repurchase is attractive in the context of all potential uses of the capital. We have what we consider a best-practice model for making these decisions, which we make a point to communicate early and often.

You haven't uttered the words "corporate governance" yet.

RW: Invariably the companies we zero in on have poor corporate governance, but we're far more interested in how the board makes decisions than in the tick-the-box governance items like whether they have a poison pill or a staggered board. Not enough boards think of themselves as shareholder representatives.

That particularly manifests itself in setting compensation plans, which don't focus enough on return on investment and often just reflect what management wants rather than what true shareholder representatives would require. In virtually all of our companies compensation is a central topic of discussion.

How regimented is your idea-generation process?

RW: The front-end screening is fairly automated, looking at both performance laggards and where implied expectations are pessimistic. We'll dismiss most ideas because we don't think we can make a difference. Of those with problems we think we can help address, we obviously focus on those that are most penalized by the market. As a rule of thumb, we want the potential of at least a 50% return if we can close the discount over two years.

After a potential idea has been identified, we assign an analyst who knows the industry to zero in on what's causing the discount. Up to this point our work is fairly straightforward – any well-trained analyst can identify that a discount exists and why. The next step is more subjective and where our investment committee – which consists of me, David Batchelder and John Sullivan – can hopefully add value. That's in answering how likely it is that things can change, and over what period of time. This depends on a lot of things, including the type of problem, the people involved, the board dynamics and the shareholder base. We've been on a total of 20 corporate boards over the years, so we know a lot of people and how boards work or don't work.

If something passes all the tests, what's a full position for you and do you buy it right away?

RW: We have two funds, one large-cap and one mid-cap, each of which typically has 10-12 positions. So a full position is 8-10% of the fund's assets, but we typically work our way there over three or four tranches. At each step we're either gaining more confidence in the valuation and our ability to make a difference or we're not. For example, we generally don't meet with companies until we own a stake, so that's the first step once we've taken a position. As we gauge their response and validate with them and elsewhere how we're looking at valuation, we'll either sell, buy more, or sit on it to gather additional information. Working into positions this way helps manage risk.

How high do you consider your tolerance for contention?

RW: Pretty high, although that does not define our style. We actually pride ourselves on building consensus without contention. In the first meeting we had several years ago with National Semiconductor, Brian Halla, the CEO, announced after 10 minutes that the meeting was over. At the time they were the leading analog-chip manufacturer, but were spending their excess cash on a dream of becoming a digital-chip maker and competing with Intel. That's a whole different business. We led off by saying they were wasting money on trying to make truffles, when they should be happy earning a nice living making jelly beans. That wasn't something he wanted to hear and he made that very clear. I said, "Well, most people at least hear our presentation and the confident ones, when they think we're wrong, tell us so and why." That got him to let us finish the presentation.

ON CONTENTION:

Most people at least hear our presentation and the confident ones, when they think we're wrong, tell us so and why.

Over a period of about a year and a series of meetings, we concluded that we weren't going to come to consensus. But over that same period we continued to gain confidence in our thesis and increase our position. We proposed that we and management both take our arguments to the board and let them decide, and that we were interested in actually having a seat on the board. We also said if you don't invite us we'll likely run a proxy contest – so you might say it was moving closer to contention, though not publicly.

We met with the board and gave a full presentation, but the key slide was one in which we said if they wanted to double their stock price over the next three years they could do it in a couple of basic ways. The first was to stay on the path they were on, investing in digital chips. This which would require 16% annual growth, faster than the 11% industry growth expected. Or they could follow our strategy to stop spending money in digital, which would mean they'd only have to grow at 10.5% per year. Why take the riskier path? Literally within a week or two the company reversed the strategy and began getting out of digital.

In general, is it tough to give up on something when you get so invested, literally and figuratively, in "fixing" it?

RW: That's true. When we worked for Boone Pickens, he taught us that the most successful wildcat oilmen were not the ones who hit the most gushers, but the ones who knew when to plug a dry hole. I think we're disciplined about ignoring sunk costs. We mark our investments to market every day and say, "OK, we bought this at $25 and it's now at $12, what does the upside look like with this new investment at $12?" If it meets our targets, we'll still own it. If it doesn't, we'll get out. People are afraid to admit to clients that something is a bust, but we're pretty good at just taking our lumps and moving on.

That's one good thing about having more than one person making big decisions, because there can be emotional aspects to all these investments. Our rule is that our investment committee has to be unanimous in order to buy something, but if any one of the three of us wants to sell, we sell it. That way there's never anything in the portfolio that we're not unanimous on.

National Semiconductor [NSM] is in the type of cyclical business you wouldn't really expect an activist to pursue. How do you think through the risk of being right about everything else but then getting the timing of the cycle wrong?

RW: National has been through three industry cycles since we've been in it. What we want to see – and what we have seen here – is increasingly better operating metrics at the cycle bottoms and increasingly higher trough stock prices. We take a long-term view and are willing to absorb cyclical volatility if the underlying business is continuing to improve.

National's expertise is in chips that help manage power in cellphones, solar panels, automobiles and a variety of other uses. Given where the world is going, this leadership position in power management is something that should help them better weather industry ups and downs.

Your National stake also seems like quite a long-term holding for an activist investment. Explain that.

RW: After the initial analog-vs.-digital discussion, the second phase of the conversation centered on margins. National had something like 45% gross profit margins, while its competitors were closer to 60%. The response from the company was, "Well, we have plant capacity we have to fill, so we fill it with lower-margin business to cover our overhead." Our response was, "Or you could rationalize your capacity." We made the point that the market would more highly value a company with higher gross margins because it would be considered safer in the down cycles of a cyclical industry.

That led to our helping them review their product mix, even to sell off some analog product lines and invest in those with more profit potential to fill freed-up production capacity. As they rationalized the mix over the next two or three years, they brought gross margins up to the industry average and beyond.

Are you now on to another phase?

RW: Yes. Because the long-term growth prospects of their industry have declined and we believe the company is ceding market share to tougher competition, we think the highest-return strategy for National would be to pursue consolidation, most likely as a seller.

The company seems to understand the rationale for a merger, which makes both strategic sense and provides a long list of potential cost savings through improved plant utilization, taking out redundant general and administrative costs and streamlining R&D. Despite this, management has dragged its feet. We believe one big impediment is the incentive structure and the change-of-control provisions in top-manager contracts, which essentially create incentives to delay any sale or merger. We want those compensation plans changed and have made a specific proposal to the company to do so.

The stock currently trades around $14.30. How much value could be extracted in some sort of combination?

RW: The level of cost and operating synergies would obviously depend on the partner's product mix and operational and manufacturing footprint. But the upside is real: the way we look at it, we'd

INVESTMENT SNAPSHOT

National Semiconductor
(NYSE: NSM)

Business: Develops, manufactures and markets analog and mixed-signal integrated circuits used primarily in PCs and a wide variety of communication devices.

Share Information
(@9/29/09):

Price	**14.33**
52-Week Range	9.02 – 17.36
Dividend Yield	2.2%
Market Cap	$3.35 billion

Financials (TTM):

Revenue	$1.31 billion
Operating Profit Margin	18.9%
Net Profit Margin	1.8%

Valuation Metrics
(@9/29/09):

	NSM	S&P 500
Trailing P/E	143.3	72.9
Forward P/E Est.	15.9	17.5

Largest Institutional Owners
(@6/30/09):

Company	% Owned
Fidelity Mgmt & Research	13.2%
Relational Investors	9.1%
JPMorgan Chase	7.5%
Vanguard Group	4.4%
Harris Assoc	3.7%

Short Interest (as of 9/10/09):

Shares Short/Float	7.6%

THE BOTTOM LINE

The focus of his activist agenda has changed, says Ralph Whitworth, from concerns over the company's capital allocation, to concerns over margins to, today, a belief that the highest-return strategy for it would be to pursue some sort of business combination. He'd expect a deal to unlock another $5-6 per share in National market value.

Sources: Company reports, other publicly available information

expect something like $5 to $6 per existing National share in additional value to come out in a combination.

Describe the investment thesis today for another long-time holding, Baxter International [BAX].

RW: As with National, the thesis has been iterative. When we first got in, Baxter had the wrong management and terrible board dynamics. The company was hell-bent on growth at almost any cost and had just had some speculative financial investments blow up on them. We pushed for a new CEO who would bring the discipline of a more mature company, and the board in 2004 eventually hired the perfect person, Robert Parkinson, who had spent 25 years at Abbott Labs.

Knock on wood, the company has beaten expectations for 19 consecutive quarters. Their capital-allocation practices, their communication and their executive compensation have all been consistent with what we want to see. We've stayed in this not because we keep seeing new phases to our activism, but because the management is excellent and we really like the asset – a combination that should allow the stock to materially beat the market going forward.

INVESTMENT SNAPSHOT

Baxter International
(NYSE: BAX)

Business: Global provider of treatments and equipment to healthcare providers, with a focus on IV solutions, kidney dialysis equipment and blood-related products.

Share Information
(@9/29/09):

Price	**56.79**
52-Week Range	45.46 – 69.16
Dividend Yield	1.8%
Market Cap	$34.23 billion

Financials (TTM):

Revenue	$12.23 billion
Operating Profit Margin	22.4%
Net Profit Margin	17.5%

Valuation Metrics
(@9/29/09):

	BAX	S&P 500
Trailing P/E	16.5	72.9
Forward P/E Est.	13.3	17.5

Largest Institutional Owners
(@6/30/09):

Company	% Owned
Barclays Global Inv	4.4%
State Street Corp	3.9%
Vanguard Group	3.5%
Fidelity Mgmt & Research	2.8%
Goldman Sachs	2.6%

Short Interest (as of 9/10/09):

Shares Short/Float	0.9%

THE BOTTOM LINE

With excellent management, a record of product innovation, and significant international growth prospects, Ralph Whitworth expects the company to exceed its 7-8% annual revenue-growth goal and steadily improve margins. If it meets his expectations, he says, the company's shares – with no multiple expansion – could hit $100 within three years.

Sources: Company reports, other publicly available information

What do you like about the asset?

Jamison Van Niel: The company's largest division, BioScience, manufactures plasma-based and recombinant proteins used to treat hemophilia and other diseases. They've been innovative in creating products that don't use human or animal proteins, which have been taking market share worldwide.

The company's second-biggest division is Medication Delivery, which sells things like IV solutions, pre-filled syringes and electronic infusion pumps. These products, as well as the plasma-related products, provide some of the basic building blocks hospitals need to provide care. That makes Baxter well positioned to benefit as emerging markets invest in their healthcare systems, which is a continuing trend. Already 60% of revenues come from outside the U.S. and we expect that percentage to increase.

The third business, renal care, focuses on products for what is called peritoneal dialysis, or PD. This is an at-home treatment that replaces the need to go to a hospital or specialized treatment center for traditional hemodialysis. The PD business is growing rapidly outside the U.S. and we think there's a lot of optionality on potential U.S. growth. In the U.S., many doctors own stakes in specialized dialysis centers, so they've been resistant to direct people to use PD. But in 2011, government reimbursements are changing to favor PD, because it's much cheaper. There will be resistance, but what should happen is that PD takes off in the U.S., which would save the healthcare system quite a lot of money and would be great news for Baxter.

What upside do you see here from today's share price of $56.80?

JVN: The company expects to grow revenues 7-8% annually, which we believe is conservative. The BioScience division, for example, has been growing in the mid to high teens and has excellent margins, which is bringing up the company's overall profitability. Based on our DCF analysis, which assumes somewhat faster rev-

enue growth and EBIT margins increasing roughly one percentage point per year over the next few years, we believe the stock can hit $100 within three years. Their earnings multiple is currently compressed by the healthcare debate, so if it expands as well – as it should if they perform as we expect – the upside is higher.

Does the prospect of healthcare reform affect your thesis here?

JVN They've taken that into consideration in their numbers and the impact will likely be a mixed bag. We mentioned the potential positive upside in renal care, but if broad-based Medicare and Medicaid reimbursement cuts are made, that could impact margins. Helping to offset that could be the increased volumes from more people being insured, but precisely modeling any of that right now is difficult.

RW: In general, Baxter isn't like a pharmaceutical company that's dealing to a great extent with patent cliffs and big threats from generic competition. They have been spending more on R&D and have a healthy pipeline, but we see plenty of opportunity in their just selling more of what they already make – particularly outside the U.S., where trends are strongly in their favor and healthcare reform isn't as big an issue.

How does Genzyme [GENZ] fit your profile of an activist investment?

RW: It's in an entirely different industry, but the basic elements of this situation are the same as with Home Depot.

If we do a DCF analysis of Genzyme's existing marketed drug portfolio and the risk-adjusted value of its pipeline, we arrive at an intrinsic value for the shares of around $90. But the shares trade at below $57. As we looked into why that discount exists, we basically concluded it reflects the fact the company has a couple of unbelievably profitable drugs from which it has been using the cash flows to make, by and large, lousy investments. As we calculate it, Genzyme's core genetic-disease business earns a cash return on invested capital of around 26%, while everything else (not including the R&D pipeline) earns less than 9%. It's not a surprise then that the market is anticipating something closer to 9% in the future than 26%.

When we first got involved, the company was telling the Street that it was going to have revenues of $7 billion in fiscal 2011, up from around $5.2 billion this fiscal year, and earn adjusted EPS of $7 by then, up from around $4.70 in 2009. But that was it. Our response to that was, "So what?" Estimates like that mean nothing if we don't understand how they plan to get there and what it's going to cost. We took a sheet of theirs from an investor presentation and added all we'd need to know in order to make an intelligent assessment of what the company was worth. What did they expect the future gross margin percentage to be? What would selling, general and administrative costs be as a percentage of sales? How many shares did they expect to have outstanding? What's free cash flow going to be? The cash return on investment? Our point was not only that investors needed to know all that, but that if the company didn't know it, they might make some big mistakes in shooting for those goals.

INVESTMENT SNAPSHOT

Genzyme
(Nasdaq: GENZ)

Business: Develops, manufactures and markets biotechnology products focused on the treatment of genetic disorders and relatively rare chronic debilitating diseases.

Share Information
(@9/29/09):

Price	**56.95**
52-Week Range	47.09 – 81.96
Dividend Yield	0.0%
Market Cap	$15.39 billion

Financials (TTM):

Revenue	$4.71 billion
Operating Profit Margin	22.9%
Net Profit Margin	12.5%

Valuation Metrics
(@9/29/09):

	GENZ	Nasdaq
Trailing P/E	27.0	45.1
Forward P/E Est.	14.3	20.9

Largest Institutional Owners
(@6/30/09):

Company	% Owned
Legg Mason	5.3%
Wellington Mgmt	4.0%
Sands Capital	3.7%
Barclays Global Inv	3.5%
Vanguard Group	3.4%

Short Interest (as of 9/10/09):

Shares Short/Float	2.7%

THE BOTTOM LINE

Genzyme shares trade at a discount to his $90 estimate of intrinsic value, says Ralph Whitworth, due to recent manufacturing problems, the overhang of potential healthcare reform and worries about how disciplined the company will be in reinvesting cash flows. As those concerns are resolved, he expects the value discount to disappear.

Sources: Company reports, other publicly available information

How receptive has the company been?

RW: We've made a lot of progress, but we recognize that we're speaking a language not typically spoken in the biotech industry. There it's all about your latest trial results or research breakthroughs, not cash flow returns and share buybacks. That applies to management as well as to many of the analysts following the company. One analyst told me recently she had to speak with some of her colleagues to better understand what we were talking about, but assured me that she now recognized how important it was.

Is compensation an issue here?

RW: Without question. The compensation plans haven't focused at all on return on investment, which they attribute to the difficulty in doing that when lead times for their R&D spending are so long. To which our response is, "That makes it all the more important."

The bonus-plan disclosure was almost indecipherable, but what we found out was that management got 80% of their bonus if they hit 86% of their operating-income target. But it turns out that hitting 86% of their target meant the company would earn less in absolute terms than the year before. So they're telling everyone they should grow, but if earnings decrease management still gets 80% of their bonus? For incentives to work, money actually has to be put at risk, which we don't believe this plan sufficiently does. We've had plenty to talk with them about in the area of compensation.

The stock has not participated in the market run-up since March. Why?

RW: The primary issue is manufacturing trouble with their lead product, Cerezyme. They found a virus in some of the work-in-process inventory and had to discard most of it and shut down production to decontaminate everything. This has delayed the result for us, which in economics means less return, but it hasn't changed the fundamental story. The market is worried about the manufacturing problems, about healthcare reform and about how disciplined the company is going to be about reinvesting its cash flow. As those concerns get resolved, we'd expect the shares to close in on the $90 intrinsic value we still believe they have.

Explain your interest in a fairly recent buy, insurer MetLife [MET].

RW: As things started to shake out after the financial crisis, we looked around at opportunities partly just as straight value investors trying to take advantage of what might be overly beaten-up stocks. We looked at banks, but couldn't get comfortable with the level of risk still remaining on their balance sheets and didn't see where we could make a real difference. We then turned to insurers, where we've had success in the past investing in Prudential and in Unum [UNM], which has been a long-term holding. The theme of those investments has been similar to what we do almost everywhere, focusing on risk management, capital allocation and the importance of return on equity.

We're in the early stages of our engagement with MetLife, but have so far been – I don't want to say surprised – but favorably impressed. They have a well

INVESTMENT SNAPSHOT

MetLife
(NYSE: MET)

Business: Global provider of insurance and financial products, including life, auto and homeowners insurance, as well as annuities and other savings products.

Share Information (@9/29/09):

Price	**38.59**
52-Week Range	11.37 – 56.00
Dividend Yield	2.0%
Market Cap	$31.59 billion

Financials (TTM):

Revenue	$46.33 billion
Operating Profit Margin	3.0%
Net Profit Margin	(-0.7%)

Valuation Metrics (@9/29/09):

	MET	S&P 500
Trailing P/E	n/a	72.9
Forward P/E Est.	9.5	17.5

Largest Institutional Owners (@6/30/09):

Company	% Owned
AllianceBernstein	3.8%
State Street Corp	3.3%
Vanguard Group	3.3%
Barclays Global Inv	3.0%
Massachusetts Financial Serv	2.6%

Short Interest (as of 9/10/09):

Shares Short/Float	n/a

THE BOTTOM LINE

Ralph Whitworth has been impressed with the company's strategy to increase return on equity from a depressed 8% to closer to 12%. If it sticks to that strategy, maintains return discipline in pursuing acquisitions and communicates more clearly what it's doing, the company's share price could double over the next few years, he says.

Sources: Company reports, other publicly available information

thought out plan to increase return on equity from around 8% today to at least 12% over the next several years. Their institutional insurance business is highly profitable, where they benefit from scale and a strong brand. We also see tremendous potential for them to grow internationally, where they are already well established in key markets that are demanding more and more of the life and annuity types of insurance MetLife sells.

What's on your activist agenda?

RW: It's fairly modest here at the moment. We're using advocacy to keep them focused on their return on equity goals, particularly as they pursue acquisitions in an attempt to take advantage of weakened competitors. MetLife was early in raising capital and while their investment portfolio has suffered, the damage hasn't been as bad as at several peers. That has made them fairly vocal about their interest in expanding, and the media speculated they would like to buy AIG's international life business, which everyone thought would be scooped up for a song. It hasn't happened and we're working to make sure nothing happens unless they can show it's going to accrete to their longer-term ROE targets.

Their disclosure has been quite good with respect to the investment portfolio – we wouldn't have taken an initial position if it wasn't – but as a next step with them we're going through the entire asset base to make sure we understand what's there and can make a complete assessment of what it's worth.

The last thing I'd mention is a key part of almost all our investments, which is working with companies to improve how they communicate with Wall Street. In general, there's not a good appreciation of how important that is. Investing is all about future expectations, so it's critical that the company be consistent and precise about how they're making decisions and why. If the company has the internal discipline to focus on returns and give the money back if the returns aren't there, it won't get credit for that from the Street if it doesn't make that clear, repeat it often, and point out how its actions are consistent with that discipline.

There's a qualitative premium paid for companies that do that well. The fact that MetLife has proven more focused on returns than we expected tells us there's upside from making that clearer to the rest of the world.

The stock, at around $38.60, has bounced quite a bit from its lows but still trades at half its level of two years ago. What potential do you see?

RW: Because of the operating leverage in insurance companies, if they hit their return on equity targets over the next few years, earnings and the stock price could double. That's particularly true if the operating improvement coincides with decreased risk on the asset side. How vulnerable the investment portfolio turns out to be adds a certain element of uncertainty here, but we're comfortable with that at today's market price.

ON MICROSOFT:

Two things are hitting it: a dilution of returns due to ineffective spending and the decay of core their product lines.

Are maturing technology companies – Microsoft comes to mind – showing up on your radar screen?

RW: The culture I described around Genzyme is the same in the tech industry. These are companies that have gotten used to spending small amounts of money and doing big things and haven't had to think much about returns. We owned Sun Microsystems last year and had people looking for three months into how to roughly estimate its profitability by product line – the company had never done that. How can they know where to invest if they don't really know what they're earning?

Our type of thinking is absolutely going to be more and more relevant in technology companies. When you start out with off-the-charts returns, like a Microsoft, nobody notices for a long time as those overall returns start falling. But Microsoft has two big things hitting it: a dilution of returns because of ineffective spending, and the decay of their core product lines over time. I would say it's not ripe yet as a potential idea for us, but it is getting closer and closer.

Do you still own Yahoo [YHOO]?

RW: No. After the Microsoft deal fell through last year, we got interested as the stock collapsed primarily because we still thought there was value to be realized from some sort of search deal and because we thought the company could just be much more profitably run. We made recommendations for a new CEO, and while Carol Bartz wasn't one we recommended, she seemed to fit the bill in terms of what they needed.

We met with her and she was going along saying all the right things, but then she said in explaining why any search deal with Microsoft was likely to be more focused on future revenue share than upfront cash that, "I'm not interested in cash because I don't have anything to do with it." To us that was like the tuba in the marching band playing the wrong note. What about paying a dividend? What about buying back stock? When the deal was signed with Microsoft that had no upfront cash at all, we took that as a bad signal. Not because we're short-termers, but because of what it said about how she was thinking about risk and capital allocation. Time will tell if she's right, but that made Yahoo not our kind of bet.

What are some mistakes you've made recently and why?

RW: No matter how right we might be from an activist perspective, that can be overwhelmed when big industry or economic changes go against us. We lost money on Sovereign Bancorp last year, for example, and while we can kick our-

selves for a few aspects of it, the biggest problem was that the financial world collapsed before our eyes. Of course we could have been smart enough to avoid exposure to the mortgage market altogether, but in this case we weren't.

One mistake for which we do kick ourselves was Sprint Nextel. The original thesis had three main components: that the merger with Nextel, which was a complete disaster, should be reversed; that they'd be much more profitable if they focused less on adding subscribers and more on keeping the right subscribers; and that they should pull way back on huge investments in building a national WiMax wireless network.

We actually convinced the company of the virtues of all of those things, but we underestimated how weak Sprint's ongoing subscription business was and didn't stress-test well enough the strength of its balance sheet. All that caused problems when the crisis hit, which also nixed any possibility of selling Nextel for a decent price. Compounding our mistake, we jumped into a bigger position more quickly than we usually do. Other than all that, I'd say the project worked out quite well.

Are there any regulatory changes under discussion that concern you?

RW: There's an important proposal before the SEC that, if approved, would allow "access to the proxy," which basically gives investors an easier path to impacting the composition of a company's board. Certain qualified investors would be able to directly put a board candidate into the company's proxy, on which the shareholders would vote. We think that would spur a big self-help movement in boardrooms, which is long overdue.

I've been advocating changes like this for 20 years, because it specifically targets the dysfunctional boards that can do such a disservice to shareholders. The risk today is that the SEC loses its sense of urgency as the markets recover and fails to act. That would be a shame.

One of the biggest problems with boards is that nobody wants to rock the boat. A good director should be likable, but it also should be clear he or she is not there to be liked. I've often said rhetorically that a board should appoint one director every year to be the devil's advocate on everything. That alone would go a long way toward improving board dynamics, which would go a long way toward improving how companies perform.

Without dysfunctional boards, wouldn't you be out of a job?

RW: We screen a universe of 1,000 companies. Given human nature, there will always be a lower quadrant of laggards to choose from. VII