INVESTMENT OUTLOOK

June 30, 2007

LBOs, Mergers, and Beneficial Uses of Corporate Cash

For much of 2007, the financial press has been dominated by the private equity industry and the flurry of leveraged buyouts (LBOs) it has led. Increasingly more and larger public corporations have been "taken private" by shrewd private equity investors employing cheap debt to acquire, reengineer, and eventually sell companies back to the public. With the exception of a brief period in the late 1980s, this frenzy has been unprecedented, with a media fixation on the quantity and size of deals, as well as the lifestyles and dubious taxation levels of the private equity general partners. While the public offering of stock in private equity firm, Blackstone Group, likely marked the peak of recent excesses, this summer's financial crisis and the subsequent end of easy credit may well mark the end of the era.

We admit to a fascination with the LBO phenomenon. Unlike other recent investment styles 'du-jour,' some private equity managers employ some of the same fundamental equity strategies as we do, albeit, by its very definition, magnified with significant 'leverage'. Also, some of our companies have occasionally benefited from "buyout premiums" as investors speculate on their likelihood of being taken over. However, all along we have felt the hype overshadows the far more important reality of how companies themselves are deploying the vast hoards of cash they have generated over the past 4 years of economic expansion. For instance, in the first half of 2007 private equity-led buyouts only accounted for 25% of merger activity, with corporate acquisitions representing the other 75%. It seems that one company buying another (to grow revenues, diversify industries, or lower costs through economies of scale) remains the dominant driver of mergers and acquisitions.

Additional uses of company profits include capital expenditures and research and development. After a slowdown earlier in the decade, such investments have increased, but, as we discussed in last quarter's report, multi-national corporations have focused much of their capital outlay overseas. But perhaps more important and positive for shareholders, the annual amount of cash returned in the form of dividends and buybacks, dubbed the "Corporate Action Yield," has risen to an unprecedented **combined yield of over 5%** (measured by the S&P 500).

Over 60% of this 'yield' is in the form of buybacks, when corporations use much of their excess cash to repurchase their own stock. After the removal of a portion of their shares from the open market, remaining shares effectively 'own' a larger percentage of the company's earnings and market capitalization, presumably increasing the per-share value. Investors smartly view buybacks with a certain level of scrutiny, as some companies have used them to offset stock options exercised by management. Rather than just tracking repurchase announcements, we closely follow quarterly net changes in shares outstanding to see the buybacks' true impact. Other reasons why companies favor buybacks over dividends include uncertainties about cash flows and future tax rates on dividends, as well as management's view (rightly or wrongly) that their stock is undervalued.

The dividend yield on the S&P 500 currently stands at a not-so-impressive 1.75% (up from near 1% in March 2000). Companies are using excess cash to raise dividends, but not nearly to the levels seen during the mid 20th century when stock yields routinely surpassed that of US Treasury bonds. Saybrook Capital does not invest purely for dividend yield, but we consider these quarterly payments an important element of total return (along with earnings growth and multiple expansion). We like steady dividend increases for many reasons, not least of which is the visibility into managements' confidence in their companies' futures. The cliché that "buybacks are like dating and dividends like marriage" stands true, as corporate executives are reluctant to ever put themselves into a position where they may have to decrease or cut the dividend. A review of our portfolio of stocks reveals an average dividend increase of 21% over the past 12 months (versus +12% for the S&P 500), a measure we consider an important indicator of the financial health of the underlying businesses.

Regardless of motive and method, cash is being delivered to shareholders, and we feel it is appropriate to use this "Corporate Action Yield," combining net buybacks and annual dividends, as a building block for future expected returns. The cash generated from companies' operations has to go somewhere, and if a time comes when it is no longer used to enhance earnings per share growth via buybacks (or invested in capital expenditures or acquisitions), then we should witness a re-emphasis on quarterly dividends.

All of these actions, from routine dividend increases to dramatic LBOs, are a natural follow-up to the cash-hoarding of the 2000-2005 period (a reaction to that period's dot-com bust, earnings recession, terrorist attacks, and corporate scandals). Although understandable in such an uncertain environment, this cash stockpiling was ironic in a period where cash was paying record low interest rates (below 1% at one point). The capitalist system does not allow inefficiencies and aberrations to last forever. Microsoft's one-time 10% dividend in late 2004 (from a company that had never paid a dividend until 2003) was an early sign of this change. Good managements, or those pressured by activist shareholders, will use excess cash to invest in their companies' future or return it to shareholders via dividends or buybacks. Companies with weaker leadership (who continue to hoard cash or refuse to to invest in future growth) become targets – either of private equity groups that feel they can financially optimize the business or, more likely, of other companies that are seeking accretive returns through marketing and cost synergies. As with the buyout crazes of the 1980s and 1990s, many of these mergers will fail, but for now current shareholders are beneficiaries.

The recent credit tightening induced by the sub-prime mortgage fallout is tilting the tables toward cash-rich corporations. As bond spreads widen and private equity funds find it harder to borrow funds to buy companies, corporations can make acquisitions with their deep reservoir of "currency": cash and stock. While marginal companies have trouble borrowing cheaply to repurchase their stock, high quality businesses are still generating more than enough cash to fund ample buybacks.

Well-managed "quality growth" companies, such as the ones in which we invest, do not tend to attract LBO buyers interested in financial engineering. Occasionally our businesses are the acquirers of smaller companies in their field, but we seek to avoid the type of hubris often typified by mega-mergers (e.g. AOL/Time Warner). More likely our businesses will continue to reward shareholders by focusing on organic growth, small private acquisitions, buybacks, and dividends – sometimes it is more lucrative to stay out of the financial headlines.