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September 2011 Report

Dear Friends,

This is our second quarterly letter to our clients for the period from July 2011 to September 2011. Global equity markets remained extremely volatile during the period. Events such as the delay in raising the US debt ceiling, speculation about the potential default by Greece, contagion worries in other European countries and a slowing US economy were at the fore front of investors' minds.

Portfolio activity

We made seven new purchases in the quarter – 3 regular positions and 4 merger arbitrage positions. We also added to our position in Vodafone. We closed 2 of the 4 merger positions by the end of the quarter as discussed below.

Big Lots (BIG) is the largest closeout retailer of America. In FY 2011, sales were $4.9 billion generating free cash flow (FCF) of $200 million. BIG had $284 million cash on its balance sheet and an enterprise value of $2100 million. BIG traded at under 10x trailing twelve month FCF.

Vodafone (VOD) is the one of the largest telecommunication and mobile company in the world with more than 370 million customers in 30 countries with annual revenues of 45 billion pounds. We purchased ADRs (1 ADR = 10 shares) listed in the US. VOD owns 45% stake in Verizon wireless (Verizon Communications owns the rest). Verizon wireless produces tremendous cash flows but had not paid a dividend to its owners since 2005 as it was paying down debt from a previous acquisition. As the debt would be paid off, Verizon Wireless would have to pay a dividend to VOD which could be used to increase the dividend to VOD shareholders. Shortly after we made our purchase, Verizon Wireless declared a dividend of $10 billion ($4.5 billion to VOD) that would be payable to its owners in Jan 2012. In turn VOD intends to pay a special dividend of 2 billion pounds ($3 billion of the $4.5 billion) to shareholders in Feb 2012. VOD has an enterprise value of $186 billion. VOD generated free cash flow of $12 billion last year and paid a dividend of $6.9 billion. If we add the $4.5 billion payout from Verizon Wireless, the FCF would amount to $16.5 billion. At our average purchase price $26, VOD was trading at about 11 times FCF. The dividend (9 pence regular + 4 pence special dividend) amounts to a 7.7% yield.

Bolt Technology (BOLT) is a tiny company that makes equipment to conduct seismic surveys for the oil and gas industry. The cost of seismic surveys is a small percent of the exploration and production effort. Bolt had $32 million on its balance sheet in a market cap of $100 million. Our estimate of normalized FCF for Bolt is about $7 million. Bolt was purchased at 10 times our estimate of FCF. We feel that if oil prices remain over $70 a barrel, there would be continued spending on finding offshore oil and gas reserves which should benefit Bolt.

Conrad Industries (CNRD) operates four shipyards and constructs and repairs marine vessels for commercial and government customers. Conrad is operated by the founder family. CNRD had $31 million cash on its balance sheet in a market cap of $83 million. Sales dropped during the recession to $139 million from a peak of $190 million in 2008. Sales and the backlog have since rebounded and CNRD produces good free cash flow. CNRD trades at around 6x 2010 FCF and at 1x tangible book value.

UFP Technologies (UFPT) engages in the design and manufacture of engineered packaging solutions for medical and scientific, automotive, aerospace and defense, computer and electronics, industrial and consumer markets. UFPT also sports a strong balance sheet with $21 million in net cash in a market cap of $105 million. UFPT produced FCF of $9 million in 2010 and trades at sub 10x FCF.

Abbott Labs (ABT) is a large diversified health care company that operates in four segments: Pharmaceuticals, Diagnostic products, Nutritional Products and Vascular products. ABT has made several acquisitions in emerging countries such as India and hopes to increase revenues from these countries dramatically over the next few years. ABT has an enterprise value of $89 billion and produced FCF of $8 billion in the last twelve months. ABT was purchased at 11x FCF and sports a 3.8% dividend yield.

Merger arbitrage: Despite a volatile and uncertain market, merger activity was strong in the quarter. We participated in 4 merger transactions.

Varian Semiconductor (VSEA) is being acquired by Applied Materials. Blackboard (BBBB) and Kinetic Concepts (KCI) are being acquired by Private Equity groups. Motorola Mobility (MMI) is being acquired by Google.

At the time of the announcements for the above deals, the spreads were much narrower and we did not participate in the transactions. However, during the extreme volatility in August and September, the spreads between the market price and the purchase price for these transactions widened considerably (from 3-4% to almost 10%). It was our good fortune that we had considerable cash in our accounts and we opportunistically took 3-5% positions in our accounts. As the spreads reduced below 2%, we exited the positions in VSEA and BBBB for 6% and 5% gains respectively (and a much higher IRR). We deployed the capital into the KCI and MMI transactions as the spreads remained attractive. We find these transactions quite attractive as they have a low correlation with the rest of the market. While each position by itself does not make a big contribution in absolute returns, due to the much shorter holding period, we can cycle many such opportunities to produce attractive returns.

Thank you for your continued support and confidence.

Adib Motiwala
Portfolio Manager
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