Giverny Capital Inc.

Letter to our partners –2nd quarter 2009 (all rights reserved)

Comments

We wrote in our last quarterly letter that the market had sunk to a new bottom when the S&P 500 fell to 677 on March 9, 2009. We also commented that there was no one knew if this new bottom was to be the last. We have no doubt, despite the fact that the market has maintained a higher level to this day, that the majority of the companies in the S&P 500 and the Dow Jones remain significantly undervalued. We are also finding several interesting Canadian companies, though most of them tend to have smaller market capitalizations. We will come back to this later on.

We will use our mid-year report, following in the Giverny Capital tradition, to answers questions from our partners.

Your Questions

We received many questions from you—we have partners who follow their finances closely! It would be unthinkable to answer all of these questions and you will also notice that many of them pertain to subjects we have already addressed in our past annual or quarterly letters and/or at our annual meeting. Nonetheless, we take your questions seriously and will do repeat certain comments from earlier discussions.

Q: The names Bernie Madoff, Vincent Lacroix and Earl Jones all appear in the newspapers for the same reasons. How can we avoid questioning ourselves about our own portfolio manager? Or even better, how can we question our portfolio manager?

Our operating structure at Giverny Capital, since the very beginning, was created to eliminate any possibility of fraud. We wanted our partners to have full confidence in the security of their assets. We use TD as our fiduciary and TD Waterhouse as our custodian which means that TD Waterhouse is RESPONSIBLE for the safekeeping of all of our clients' securities, whether stocks, liquid instrument or bonds. Client assets never pass through the hands of anyone at Giverny Capital. We also have no margin accounts to avoid, as improbable as it is, any risk of insolvency. We never buy options and never sell any securities short.

We have, furthermore, a transparent operating model. At any time, through the Internet, partners can access their accounts at TD. A notice of each transaction is also sent to each account holder directly from our custodian. TD also sends, on a monthly basis, an account statement with detailed information on each security in the account—our team also sends the same account information to each client. TD does not allow transfer of any assets to any bank account that does not have the same address as the account holder. Nothing could be more secure.

In the case of Norbourg, the company acted as both portfolio manager and fiduciary which means that there was no independent entity to protect client assets. This isn't the case at Giverny Capital. With Madoff and Jones, their clients invested directly with them without having any other information. Jones wasn't even registered with the AMF! Giverny Capital is, of course, registered with the AMF. We have audits on a regular basis from the AMF (we had one last year) and, in all cases, we have satisfied all their demands (which have become even more rigorous since Norbourg).

Q: Our most significant investment is Berkshire Hathaway. The stock has gone nowhere for several months now. Do you still believe that this stock is undervalued?

About four years ago, Berkshire Class B shares were trading around $2900 and its estimated intrinsic value was $4200. Today, Berkshire's shares are still trading at $2900 but our estimated intrinsic value is now $5800. So, it seems to us that these shares are more undervalued than before. Our method of evaluating a portfolio holding is always the same: we are satisfied if the intrinsic value of a company increases at a good rate (10% or more). We can furthermore profit from the market's myopic vision in the short term by buying the same companies at better prices. This is exactly what Warren Buffett has been doing with his own portfolio over the course of the last several months!

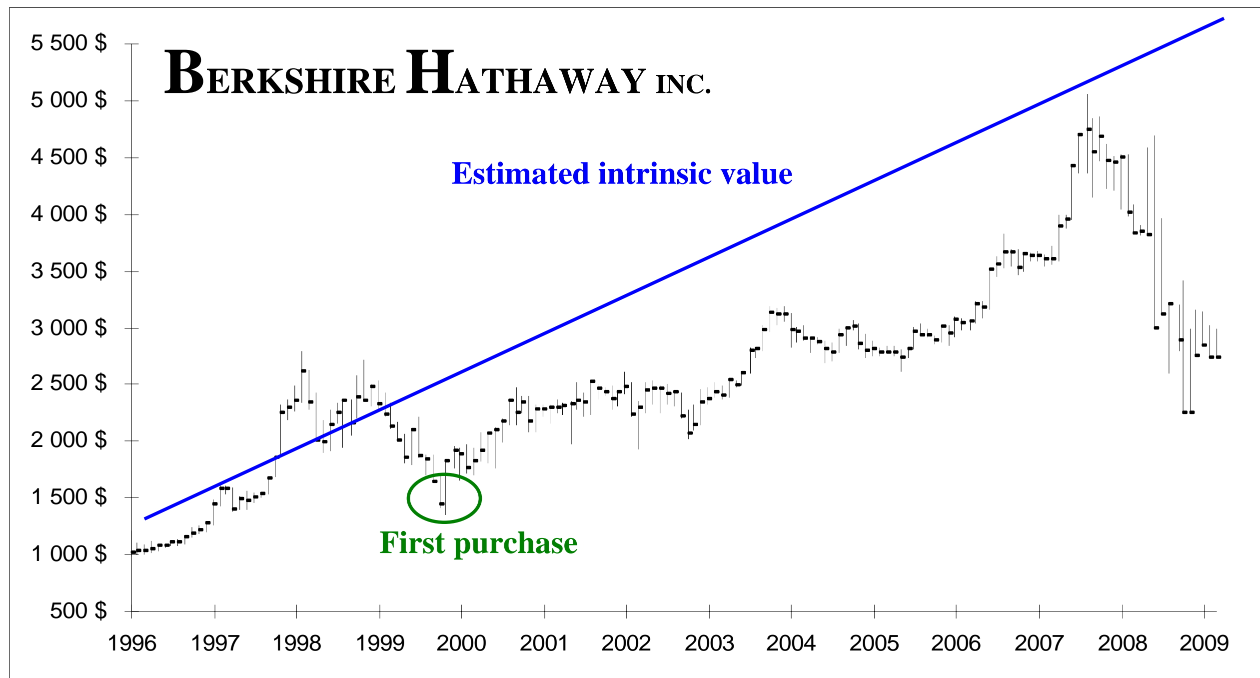


Chart 1: Historical share price of Berkshire Hathaway B relative to our estimate of the company's intrinsic value.

Q: In what ways have you modified the portfolio in order to maximize its future value and profit from one of the "greatest investment opportunities of our generation" (to quote your statement)?

As we explained in our first quarter letter, we sold Walgreen's to buy more M&T Bank. We were confident, based on our estimate, that the value of WAG could double over the next five years and that MTB could triple. So if this scenario occurs, this transaction could increase our annual returns for that portion of the portfolio from 15% to 25%. We also bought shares in Omnicom last year at levels we consider to be about a third of the company's intrinsic value (see our annual letter for more details). We also took advantage of a price drop to buy more shares of Astral Media at excellent valuations. We sold our shares in Brown & Brown to profit from the debacle in the Chinese market and acquire shares in two companies we deem highly undervalued.

We also increased the weight of other holdings as new capital flowed into client portfolios (the majority of our partners add capital to their account). We were able to buy more Disney between $18 and $19, Bank of the Ozarks below $20, and more Berkshire Hathaway at excellent prices.

All in all, we probably changed about 15% of the portfolio by selling undervalued stocks to buy even more undervalued stocks. You can rest assured that we monitor the relative valuation of each of our holdings in order to continuously optimize our use of capital while maintaining a sensible diversification level and reasonable level of transaction costs.

Q: Colabor Income Trust will soon be changing its legal status and become a corporation. Will these shares continue to be interesting?

In this case, the change in legal status will change nothing in the underlying value of the business. Colabor had effectively already lost its fiscal advantage when the company acquired Summit at the end of 2006 (the significant increase in revenue made it no longer eligible for its tax break). We bought these shares at bargain prices because we knew that the company would not be affected by fiscal changes for 2011. Colabor was trading in the stock market at the same valuation as other income trusts while its after-tax profit capacity seemed to us considerably higher.

The company recently announced that it would become a corporation and that its monthly distribution would now become a quarterly dividend of similar levels. So the expected yield remains around 10%. Are the shares still interesting? We believe so. Still, since future growth will most likely be modest, there might be better investment opportunities elsewhere. This changes nothing of our high esteem for this company and of its management.

Q: Is there anything new with Allied Irish Bank? I've noticed that the company's share price has been highly volatile in the last several months.

There is, in fact, some news about AIB since our last update in our annual letter. 2008 was a difficult year, with €1.8 billion in loan losses. 2009 will be even worse with estimates of €4.3 billion in losses. Since this estimate exceeds the income of the company, the Irish government came to its rescue and provided the company with a €3.5 billion capital infusion. This will result in a shareholder dilution of approximately 33%. While we're not happy about this, the company's key competitor, Anglo Irish Bank, suffered an even worse fate and was nationalized by the government in January. There now remains only two private banks in Ireland and AIB is the most dominant.

The situation in Ireland, however, remains difficult. The country's economy shrunk by 8.5% in the first quarter and the still-rising unemployment rate passed through 11%. The country also remains heavily in debt compared with its GDP. The Irish stock market touched a 14-year bottom in February but has since rebounded by 37%. Our estimate is that if, within a few years, Ireland can regain some level of economic growth and AIB can generate only half of the earnings per share (EPS) it had in 2006, then the stock should reach about $30 - a six fold increase. But for the time being, there are very few indicators that the situation is improving.

Q: How do you think the war between Microsoft and Google will end? Do you envision buying shared in Google? (I'm referring to Mr. Munger's response to your question from the Berkshire Hathaway shareholder meeting).

I don't know the future of neither the computer industry nor the Internet (unfortunately, I might add). I believe that these two players will remain dominant in their respective markets and I am skeptical that Microsoft could lose a substantial part of the software application market (Office) or the operating system market (Windows). As far as Google, they dominate by a wide margin the Internet search market. Even after the Microsoft-Yahoo deal.

While Google would love to steal market share away from Microsoft and vice versa, I believe that each company will continue to dominate their respective markets and that each will win a few battles here and there (to stay within the confine of your war analogy). We also must not forget that Apple is becoming more and more of an industry heavyweight. It is also an important part of the equation. So we also follow this company quite closely.

Like Mr. Munger, I'm an big admirer of Google. Their competitive advantage is substantial and, if we look at the company's latest results, revenues still increased modestly despite a very challenging environment. But Google's dominance seems, to me, for the time being, adequately reflected in its current share price (with a P/E ratio of about 20). Microsoft is trading at 12 times earnings which is more attractive even though it has lower growth prospects than Google. We believe that Windows 7 will be a big success. But we are worried about two divisions at Microsoft: Internet products (MSN) and gaming consoles (Xbox). After all these years and billions spent, these two divisions are not or barely profitable and are dragging down the company's overall profits. We would like to see Microsoft free itself from these two divisions and begin aggressively buying back its shares.

Q: What is happening with our small Canadian company MTY Food?

The company's second quarter results are fresh out of the oven (I know, it is an easy pun!!). Revenues climbed 33% and net income rose 24% despite sales comparables which declined 0.5% (not too bad given the current environment). Even after considering the effect of two substantial acquisitions, MTY has maintained a strong balance sheet, with no debt and $6.4 million in cash. We believe that the shares are still a bargain.

Q: What is this new company: China Fire and Security Group?

China Fire and Security Group (CFSG) is a Chinese company specialized in safety and preventative equipment mostly used in steel mills. New safety standards imposed by the Chinese government are a tremendous source of potential profits for CFSG. The company has a high growth rate (25% and more), excellent gross margins (60%), and an immaculate balance sheet.

We took advantage of a drop in the Chinese market to buy shares at attractive prices. Despite that EPS rose from $0.56 to $0.98 between 2007 and 2009, the company's share price declined from $18 to $11. When we adjust for the net cash on the company's balance sheet, the stock's P/E ratio has declined from 30 to 10—a level which we deem very attractive given the company's growth prospects. We may add that CFSG shares have risen 40% since our initial purchase.

Q: How can we hope to make a positive return on our investments if we are buying American companies within the context of an appreciating Canadian dollar?

Your question assumes that the Canadian dollar will always rise relative to the US dollar. If the value of the Canadian dollar simply fluctuates, then the effect will ultimately be modest in the long term. The Canadian dollar is at the same level now as it was 20 years ago while the American stock market (dividends included) has risen by more than 500%. So, the longer the time horizon, the less the impact of the currency on investment returns. If we look in the short term, merely looking at the last year for example, we can see that the Canadian dollar fluctuated between $0.78 and $1.08—an enormous range given the close-knit relationship between the two economies. The only people who lost here were those who sold in a panic (the same thing applies to the stock market, we could add).

We have no ability to predict currency fluctuations. Even Warren Buffett, the greatest investor of all time, cannot make these predictions. He answered a question on that subject at the last Berkshire shareholder meeting by saying: "I don't know how to predict currency fluctuations and we therefore have no contracts on any foreign currencies."

So, to answer your question, we believe that the investment returns we can generate from the aggregate growth of all the companies in our portfolio, along with the rise in P/E ratios we expect in

the future (since we believe that our shares are undervalued), will more than compensate for almost any likely scenario of a rising Canadian dollar.

We arrive at the following estimates if we apply this reasoning to attempt to predict what the years 2009 to 2014 might have in store for us:

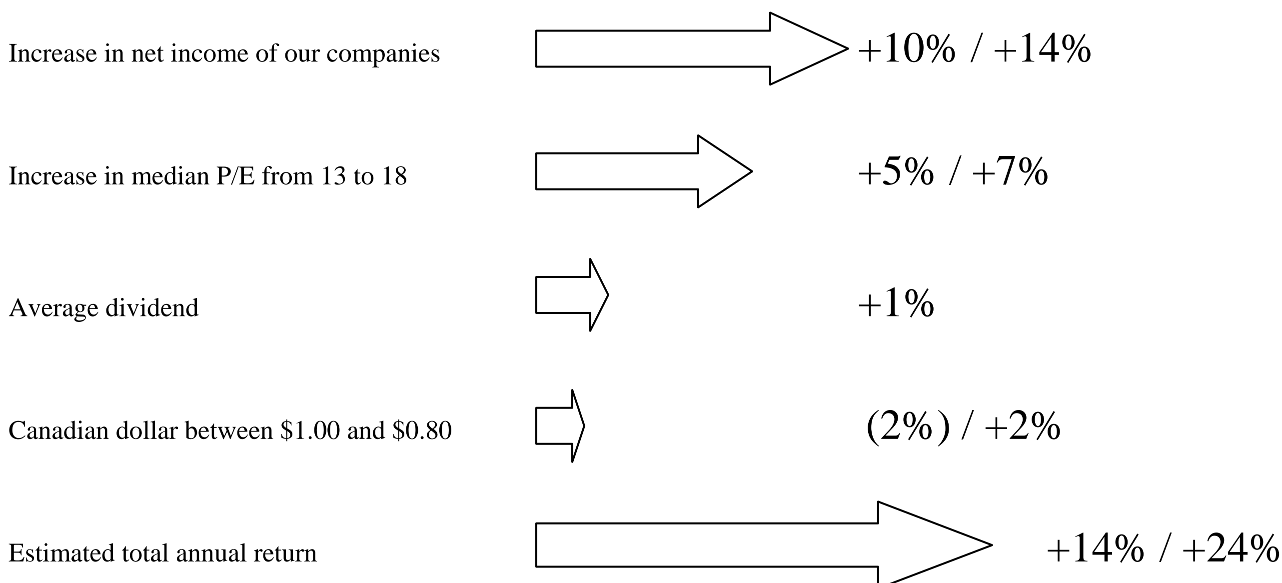


Chart 2: estimated future returns of our portfolio based on its component sources of appreciation.

As you can see on the chart, based on this scenario, our lowest estimate of annual return is 14%, which takes into account both dollars at parity. These estimates are for a portfolio 100% in US assets. In reality, 15-20% of the portfolio is invested in Canadian securities. Another 25% is in other currencies, directly (through the ownership of foreign securities) or indirectly (through the ownership of multinationals like Johnson & Johnson, Procter & Gamble or Omnicom). So the currency effect in this chart is overstated.

Q: Hanfeng Evergreen: you always shied away from buying companies involved in natural resources since they were too volatile. Have you changed your mind on this and why?

The primary reason we avoided natural resources is because we have always wanted to own companies with a significant competitive advantage. This competitive advantage creates a moat which protects its economic castle (to borrow a phrase from Warren Buffett). A large moat allows a business to realize, and even more important maintain, higher returns on its shareholder capital.

It is quite difficult for a business to establish and maintain a competitive advantage when it sells oil, steel, copper, USB flash memory drives, timber, airline flights, general insurance products, computer memory, potassium, etc. A steel beam from Company A is exactly the same as a steel beam from Company B. This is why companies in these sectors often have low margins and, consequently, poor returns on their capital.

A few rare businesses, such as the Korean steel company Posco, have been able to generate good returns for several years due to their exceptionally low cost of production (Southwest Airlines and Ryanair have done also well for the same reason).

It is also possible to create a specialization in niche products that distinguish themselves from those of competitors—such as in the case of 5N Plus. This company purifies telurrium at extremely high levels, which enables 5N Plus to sell a unique product at attractive margins.

I concluded, while studying Hanfeng Evergreen, that its model was similar to that of 5N Plus. The company has technology which allows it to transform basic fertilizer into a controlled-release fertilizer product (Slow and Controlled Release or SCR). This enables farmers to increase crop yield while reducing environmental harm. The company estimates that farmers can realize a 22% saving by using an SCR fertilizer.

The most significant market for fertilizer is China, with 33% of the world's consumption, which is why Hanfeng has built all its plants there. This allows the firm to have better political clout (a factor which cannot be underestimated in this part of the world) and also mitigates currency exposure created by any differences in its cost of production and sources of revenue (i.e. everything is in Renminbi). The potential for growth is substantial, with SCR fertilizer only comprising of 1% of the overall market in China. Since Hanfeng is selling a value-added product which commands a premium price above basic fertilizer prices, the company's margins are more protected when the price of basic fertilizers (like nitrogen) declines.

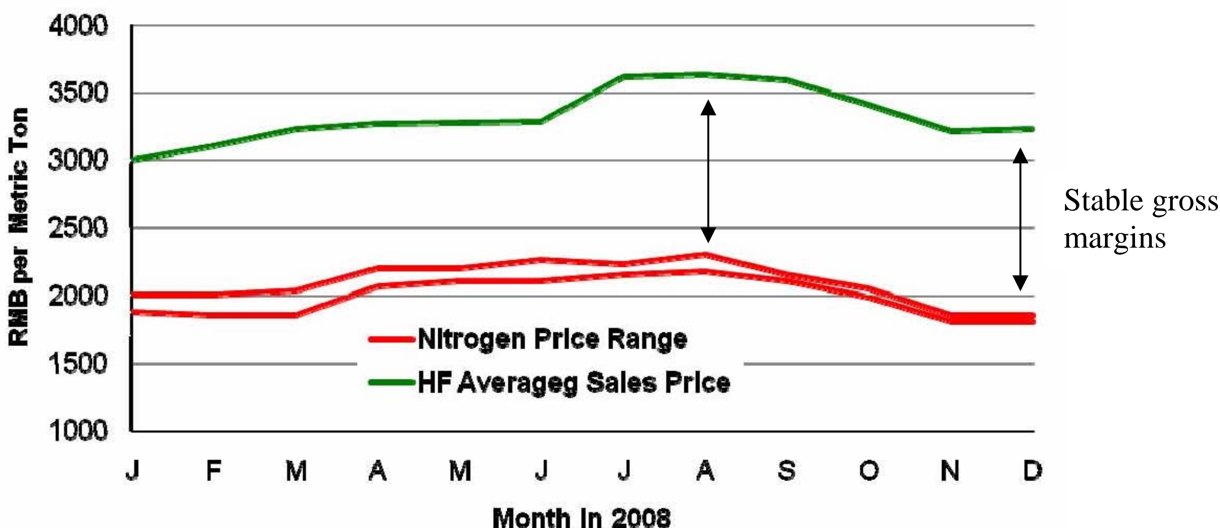


Chart 3: Average price of Hanfeng fertilizers versus base price of nitrogen (Source: Hanfeng).

While this is a Canadian company (it is headquartered in Toronto), Hanfeng is really a Chinese company with almost all of its revenue generated in China. Hanfeng also has an outstanding balance sheet and the company's management owns 21% of the shares (something I always like). After reaching a high of $15 in 2007 (or 44 times that year's earnings), the company is now trading at $7 (or around 10 times this year's estimated earnings). Despite an uninspiring short-term outlook for the industry, most recently evidenced by the weak results at Potash Corp, we believe that Hanfeng will generate great growth in the long term.

Q: What happened at Wells Fargo that the company almost entirely eliminated its dividend? I thought that the bank was well managed and had stayed clear of all the mortgage shenanigans—please explain.

We still believe that Wells Fargo is the best-managed American bank, within the biggest ones. The company stayed away from subprime mortgages from 2003 to 2007. So while competitors had a bloodbath of losses lately, Wells Fargo announced record profits for the first two quarters of 2009.

But we're not completely out of the woods yet with Wells Fargo. Although the Wachovia acquisition was done at a rock bottom price, Wells Fargo was forced to increase its bad debt reserve to account for some of the more toxic assets on Wachovia's books. All in all, we believe that the "pros" will definitely outweigh the "cons". Last May, the American government performed a stress test on all the major banks and recommended that Wells Fargo increase its capital base by $13.7 billion—a number which the government deemed sufficient to cover an apocalyptic scenario for the American economy.

In order to respect the government's analysis (though the bank's President didn't agree with it), the company issued $8.6 billion in stock at $22 per share—representing a dilution of roughly 8 to 9%. In order to avoid further dilution, the company decided to cut its dividend and use this capital to satisfy the government's demands. As of June 30th, Wells Fargo had increased its capital base by $14.2 billion.

I prefer, as a shareholder, to lose a year or two of dividends rather than having further shareholder dilution (which would decrease the intrinsic value of each share). So it's important to see that the reduced dividend is clearly temporary. We believe that the company, in a few years, can generate earnings of $4.50 per share and once again pay out a good dividend. The company's share price, at that time, could well reach the $60 range and if so, we'll be quite pleased that the company didn't further dilute its shares back in 2009.

We continue to have the highest confidence in this excellent bank.

Q: You discussed, last year, the perils of the Canadian real estate market and how this made it difficult to evaluate the profitability of Canadian banks. Where are we a year later? Is there still a wide discrepancy in prices with those of the United States?

Certain Canadian cities experienced a decline in the average price of housing. For example, the average price of a home in Vancouver dropped from $612,000 to $576,000—still far from a bargain. The same happened in Calgary, with a drop from $419,000 to $393,000.

When looking at Canada as a whole, the average price actually increased from $315,000 in June 2008 to $327,000 in June 2009. This is a worrisome price level because it represents 7 times the Canadian GDP per capita. This 7x ratio is the same as that of the American real estate market back in 2005 which was near the height of the speculative bubble.

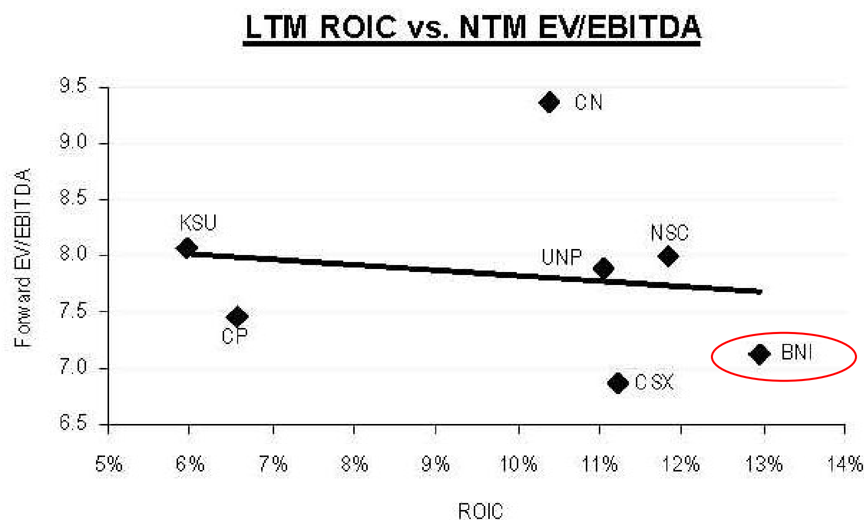
Although I don't predict macroeconomic trends, I find it important to keep our eyes opened to the dangers of high real estate prices in Canada. The highest risk seems to emanate from the CMHC, the federal organization that helps citizens with little cash buy homes. The value of securitization activities at the CMHC has ballooned from $30 billion in 2005 to $167 billion in 2009. It is likely that the CMHC would need an injection of fresh capital from the federal government in light of a significant drop in Canadian real estate prices. While it is difficult to assess the ramifications of a bailout of the CMHC on the Canadian banking industry and on the Canadian government, the impact would most likely not be benign.

In the United States, for the sake of comparison, the current ratio of average housing price to GDP per capita is 5x—helped by a 28% drop in housing prices since 2005.

Q: Why did you decide to invest in Burlington Northern Santa Fe railroad rather than CN in Canada? At least we would have been sheltered from any currency fluctuations.

Our primary reason for choosing BNSF was that it is exceptionally managed. We also believe that the company benefits tremendously from the trade between the US and Asia which will most likely continue to increase once an economic recovery takes hold. We are also impressed by the pricing power the company has exerted over the last several years, which is usually a sign of a significant competitive advantage. BNSF has the best returns on capital in the industry and its market valuation is among the most attractive (see graph below).

I would add that CN, while also an excellent company, is not totally sheltered from currency fluctuations since a substantial amount of its business is tied to exports. So, when the dollar is strong, the company suffers. Still, at a better price, we might be interested in acquiring shares of CN.



Graph 4: Profitability (ROIC) and valuation (EV/EBITDA) of major railroad companies (Source: UBS).

Q: Do you think that the generosity of Warren Buffett in giving a substantial percentage of his estate to charitable organizations will be imitated by other wealthy individuals?

I always end each 2nd quarter letter with a question that is a more philosophical in nature. I would answer that American philanthropy didn't start yesterday. Historically speaking, it's been an inherent part of many of the great American entrepreneurs to return much of their fortunes to society. Andrew Carnegie sold his steel empire for $480 million in 1901—a colossal figure for that time (equivalent to more than $14 billion today). He gave almost all of his wealth to a multitude of foundations and helped build more than 2500 public libraries in the United States. His partner, Henry Clay Frick, gave the city of New York an incredible museum on 5th Avenue, along with a classical art collection that is second to none in the world. We could also cite members of the Guggenheim family (primary Solomon and his niece Peggy) who, for decades, were patrons to a number of avant-garde artists.

At the same time, the fabulously rich John D. Rockefeller gave $600 million to numerous universities and medical institutes. A few decades later, another great oil baron, John Paul Getty, left the majority of his fortune to create the Getty Museum in Los Angeles. Dominique de Ménil, daughter of yet another oil giant, Conrad Schlumberger, became an extraordinary patron of the arts.

Among our contemporaries, to take just a few examples, Eli Broad (founder of Sun America and KB Home) created a number of foundations dedicated to the arts and to medical research (stem cell research, in particular). He gave $600 million to Harvard and MIT between 2003 and 2008. The

widow of Ray Kroc (McDonald's), Joan Beverly Kroc, left $1.6 billion to the Salvation Army when she passed away in 2003.

And the Bill and Melinda Gates Foundation is likely to become the most important philanthropic organization in the history of humanity. So, I think it's fair to say that philanthropy is alive and well in America.

If you like these stories of philanthropy, I've got another one for you. In 1956, Warren Buffett started a small investment fund. One of his first investors was David Dodd, the professor who had co-written the great investment book, *Securities Analysis*, with Ben Graham. He invested a few thousand dollars with the then young Warren. His capital was converted into Berkshire Hathaway shares in 1969 and David left his shares to his daughter upon his death in 1988. Barbara Dodd Anderson recently gave her Berkshire shares to the George School, a small high school in Pennsylvania.

The value of her gift? $128 million.

Best wishes to all our partners for a great quarter.

François Rochon
and the entire Giverny Capital team