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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

# Mid-Cap Equity Investing at Discounted Values

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**SECTOR – GENERAL INVESTING**

**(AAD505) TWST: Would you tell us about Kayne Anderson Rudnick Investment Management and your responsibilities there?**

**Mr. Stone:** Kayne Anderson Rudnick Investment Management is an investment management firm based in Los Angeles. Currently, we manage about $3 billion in assets for individuals and institutional investors through private accounts and a series of mutual funds. Our business was originally formed back in 1984 to manage money for our founders and their business acquaintances who liked the idea of investing side by side with our founders. We manage small cap equity, mid-cap equity, large cap equity and fixed income portfolios. Jon Christensen and I are the portfolio managers for the mid-cap portfolios and we're supported by a team of research analysts.

**TWST: What is your investment style?**

**Mr. Christensen:** We have two specific objectives in our investment philosophy. The first is to build a diversified portfolio, across all economic sectors, of the highest quality businesses that are outgrowing their markets and that we can add to the portfolio at discounted values. Creating a portfolio with superior quality, growth, and value is very important to us and we quantify these characteristics each and every quarter. The second objective of the portfolio is to produce the returns of the asset class, which we have done better than over time, but with less risk. The unique opportunity in mid-cap stocks is to find businesses that have proven themselves over long periods of time, yet still have room to grow. We believe this has a unique appeal since we also manage small cap portfolios. We've known these companies for many years in most cases.

**TWST: How do you define mid-cap and has that definition been slipping a bit during the recent months of economic and market turmoil?**

**Mr. Stone:** We want the weighted average market capitalization of the portfolio to be comparable to the weighted average market cap, on a trailing four-quarter basis, of the benchmark, which is the Russell Midcap Index. In addition, we will not purchase a company that is larger than the largest capitalization of the benchmark, nor would we buy a company that is smaller than the smallest capitalization of the benchmark. As the weighted average market cap changes within an index over time, our portfolio will reflect that as well.

**TWST: Are you fully invested at this time? How many holdings generally do you have in the portfolio?**

**Mr. Stone:** The mid-cap portfolio has about 25 to 35 positions at any given time. Currently we own 26 names. We run a fairly focused portfolio and approach risk management differently than other investment managers. We believe that you can have a lower risk portfolio by investing in companies that have less business risk. We're looking for businesses that can create a sustainable competitive advantage in their markets and generate exceptional returns on capital and strong free cash flow from an underleveraged balance sheet, while at the same time produce industry-leading profitability in good and bad economic times. Now, the source of this comes from the strength of the company's business model, which can take different forms such as a strong brand name that allows for pricing power or a product that is designed into the customers' products making it difficult to replace or switch out, or it can come from dominating a certain niche in an overall larger market.

*Christensen: Our businesses have high returns on capital, which allow them to self-fund their growth and therefore not be dependent on the capital markets. These businesses, with their high returns on capital, should be able to sustain themselves not only in good economies, but in difficult ones like we're seeing now.*

Going back to your question about cash, we intend to remain fully invested at all times. We believe that having too much cash doesn't help our portfolios in that we own exceptional businesses that produce superior returns. Holding excess cash does not give us any sort of benefit over the long term.

**TWST: How has the mid-cap arena in general been doing during this stock market turbulence?**

**Mr. Stone:** Certainly, mid-cap equities have not been immune to the equity market turbulence that we have seen recently. Mid-cap stocks in general are also affected by the slowing global economy. However, if one were to look at the past 20 years, high-quality mid-cap stocks have outperformed lower quality mid-cap stocks as well as larger cap stocks overall. In addition, the outperformance of high-quality mid-cap stocks is achieved with lower risk. So on a risk-adjusted return basis, the outperformance is even more significant.

**TWST: Have you shifted in emphasis the composition of your portfolio to reflect the impact of what has been happening?**

**Mr. Christensen:** Not really. We're not market timers and we're not going to bet on one or two specific sectors. We try to maintain the sector weighting of the portfolio plus or minus 10% of the sector weight of the benchmark. We try to find those exceptional businesses that will grow in good times and bad, and therefore we don't have to worry about trying to time the market, which we think in the end is a losing battle.

*Stone: We approach risk management differently than other investment managers. We believe that you can have a lower risk portfolio by investing in companies that have less business risk. We're looking for businesses that can create a sustainable competitive advantage in their markets and generate exceptional returns on capital and strong free cash flow from an underleveraged balance sheet while at the same time produce industry-leading profitability in good and bad economic times.*

**TWST: You are certainly able to get discounted value in this current environment. What about the other metrics that you look for?**

**Mr. Stone:** The market has given us an opportunity to find quality stocks at very good valuations. If you look at things like free cash flow yield, which is another measure of value for us, the mid-cap portfolio at the end of the year had a free cash flow yield of 7.9% versus the Russell Midcap Index free cash flow yield of 3.4%. Again, our kind of companies generate strong, consistent cash flows that could be used to pay dividends, repurchase stock, or make selective acquisitions.

**TWST: Where are you finding these types of companies that are more resistant to the recession than other companies or sectors?**

**Mr. Stone:** We continue to find opportunities in all sectors of the portfolio — even in these tough times. Our portfolio saw its company earnings grow during the last recession because we look for companies that can prosper in good and bad economic times. It is obviously more difficult today given the severity of this current recession, but we are confident that quality companies have the ability to protect through tough economic times.

**TWST: What is your outlook for 2009? Do you have a macro perspective of how your mid-cap stocks are likely to do?**

**Mr. Christensen:** Obviously, we've been through a very turbulent time, if you want to take December 2007 as the beginning of the recession. We think that we will continue to see a very slow economy with GDP being negative for 2009. One metric we like to look at is consumer debt as a percent of GDP. We had consumer debt as a percent of GDP go from about 60% to 100% from 2003 to 2008. This is a result of home values soaring and the wealth effect that drove consumer spending to unsustainable levels. We know that we are in what many are calling "the great recession," as credit is elusive and consumers' net worths are declining in record numbers; this scenario plays directly into our investment philosophy of focusing on high-quality businesses.

Again, I will reiterate, our businesses have high returns on capital, which allow them to self-fund their growth and therefore not be dependent on the capital markets. These businesses, with their high returns on capital, should be able to sustain themselves not only in good economies, but in difficult ones like we're seeing now. We don't think consumer debt is going to be able to quadruple again and, as a result, we believe that a slower recovering economy continues to favor our types of businesses.

**Mr. Stone:** To add to what Jon just said, we've come through a period where it seems there was unlimited capital, but now we've come to a period where it's difficult to get capital — period. At some point in time, we are going to see liquidity return to the market, but it is clear that we are not going to see another period like what we just experienced where anybody and everybody is able to get capital at very low cost. Near-term funding could be more costly and so it is imperative that companies have the ability to self-fund their own growth. Again, that plays right into the type of companies that we look for.

**TWST: What are some of the companies that you feel will drive and at least survive in this down environment?**

**Mr. Christensen:** One holding we've had in the portfolio for over three years now is **Church & Dwight** (CHD). The company is a leading developer, manufacturer and marketer of well-known brands in household, personal care and specialty products. The company's brands are ARM & HAMMER, Oxi-

Clean, Nair, Orajel as well as Trojan condoms, just to name a few — a pretty well diversified list of brands. The company sells its products to consumers through various retailers, including supermarkets, mass merchandisers and drug stores. While the ARM & HAMMER brand is among the most well-known in the world, it actually dates back to the late 1800s. **Church & Dwight** has built a well-diversified consumer products company with household and personal care as almost equal contributors to revenue.

*Christensen: Strong brands create pricing power and Church & Dwight is no different. The company's ability to take price increases on 50% of their portfolio over the past few years, while seeing strong consumer demand, is a testament to their strong brand equity. This, combined with an ongoing focus on cost optimization and innovative packaging initiatives, such as laundry detergent compaction, has led to consistent margin improvement and a current return on equity of 16%.*

**1-Year Daily Chart of Church & Dwight**

**Chart provided by www.BigCharts.com**

The company has leading rankings in a keen number of categories, including contraceptives, home diagnostic kits, and depilatories. These products not only bring in higher growth, but higher profitability. In the retail channel, for example, the company has brands in the premium category as well as value, with a little more mix toward value, which we believe has benefited in some trade down, given the weaker economy. The company maintains their own inventory at about 60% of their customer sites. This allows for greater controlled supply chain and shrinkage.

Another thing they have done well is brand extensions and new product innovations. In 2006, they brought on a new product development team and, as a result, in 2007, they had a record number of new products introduced. Acquisitions have also played a part in the growth. Normally, we are not fans of companies that are acquisitive. However, this is a company that has been very methodical in their M&A, buying brands that can be incorporated into their existing brands to develop new products. One example of that is ARM & HAMMER Laundry Detergent which has combined with OxiClean to create several new products.

Additionally, when they do acquisitions, they bring manufacturing in house or strategically outsource some of the operations, allowing them to build scale among the existing fixed asset base that, over time, can increase returns on capital. The strength of these brands has been a direct contributor to the company's strong financial results. As we discussed earlier in describing our investment philosophy, strong brands create pricing power and **Church & Dwight** is no different. The company's ability to take price increases on 50% of their portfolio over the past few years, while seeing strong consumer demand, is a testament to their strong brand equity. This, combined with an ongoing focus on cost optimization and innovative packaging initiatives, such as laundry detergent compaction, has led to consistent margin improvement and a current return on equity of 16%. Despite the fact that the stock has fallen roughly 2% in the last year, the S&P has declined over 40% at that same time. Shares are trading at 15 times estimated 2009 earnings and we still find the stock attractive.

**TWST: Do they pay dividends?**

**Mr. Christensen:** Yes, they do.

**TWST: A good staples company. What about another one?**

**Mr. Stone:** Another example is in the energy resource area, and that's **EQT Corporation** (EQT). The company was formerly known as Equitable Resources and just recently changed its name to **EQT**. **EQT** is a fully integrated energy company, focusing on the Appalachian natural gas region. It operates both regulated and non-regulated businesses. The company has three operating segments:

One is the production segment, which is about 57% of operating income; one is midstream, with both regulated and non-regulated transmission pipeline services, which accounts for about 30% of operating income; and the last segment is distribution, a regulated utility that serves wholesale and retail customers in Pennsylvania and West Virginia. We like **EQT** because this is Appalachian's largest exploration and production company and they own about 3.4 million acres of low-risk resource plays in multiple zones. All the acreage is held by the company with no expiring leases. **EQT** has one of the lowest cost structures in the industry. The company's three-year F&D costs (finding and development costs) are some of the lowest in the industry at below $1 per Mcfe (million cubic feet per equivalent) and the company is also a technological leader in air drilling, which over time has helped the company to further lower total operating expenses.

*Stone: EQT is a fully integrated energy company, focusing on the Appalachian natural gas region. It operates both regulated and non-regulated businesses. The company has three operating segments: One is the production segment, which is about 57% of operating income; one is midstream, with both regulated and non-regulated transmission pipeline services, which accounts for about 30% of operating income; and the last segment is distribution, a regulated utility that serves wholesale and retail customers in Pennsylvania and West Virginia.*

**1-Year Daily Chart of EQT**

**Chart provided by www.BigCharts.com**

Additionally, more efficient industry drilling and fracturing technologies have given **EQT** the increased potential to bring down those costs, while at the same time increase reserves and production. There are new technologies, such as horizontal multilateral fracturing, which has replaced vertical drilling wells as horizontal wells with extended reach improve production and help bring per unit cost down as well. If you look at **EQT** today, the company has 3P reserves, which is proved and probable and possible reserves, of approximately 9.5 Tcfe (trillion cubic feet per equivalent). There is the potential of another 15.5 Tcfe that could be added to 3P numbers, particularly as the company is just starting to explore and develop the Marcellus Shale. **EQT** also owns and controls about 11,000 miles of pipeline, which gives the company control of its own takeaway capacity, which is important in serving other wholesale buyers in the Northeast gas corridor.

In addition, controlling its own pipelines gives it the ability to serve its own 275,000 regional distribution customers at a very good price. If you look at the company and its performance over the past 10 years, which includes the 2001- 2002 low commodity price environment, when natural gas was trading at $2 per Mcfe and oil was trading at $10 per barrel, the company over that period still had return on equity that averaged 23%. Despite the shares being down about 50% over the past year, we still like the company due to its balance of midstream and distribution businesses that offer downside protection during cyclical commodity price environments while the acreage position and the low unit per costs of the company's cost structure offers potential upside as production increases over time.

**TWST: Is this a new holding in the portfolio?**

**Mr. Stone:** We have owned **EQT** for over two years now but as the stock price ran up, we trimmed our position early last year. As commodity prices and energy stocks in general fell late in 2008, we brought our position back up.

**TWST: Do you have any other companies you want to talk about?**

**Mr. Christensen:** I've got one more I can talk about. **Choice Hotels** (CHH) is a newer addition to the portfolio, having been added in the last year. The company operates as a hotel franchisor worldwide under the brand names of Comfort Inn, Quality Inn,

Clarion, Sleep Inn, Econo Lodge and Cambria Suites, among others. **Choice** operates a diverse family of brands that address both low and higher ends of the hotel market. The hotels are more focused on the lower end overall, which we believe tend to hold up better in tougher economic times. **Choice** has a very unique business model in the lodging industry by owning the brands and not the properties. This "capital-light model" allows the company to invest in infrastructure, such as sophisticated reservation systems, brand building, and selling franchises. This model has given **Choice** some of the highest returns in the lodging industry. The franchising model has been difficult to duplicate due to the capital required to generate the scale, as well as long-term contracts to create barriers to entry. **Choice** should see promising unit growth potential even in this economy from a combination of new franchisees as well as the conversion of independent hotels into chains. The lodging industry has seen a transformation led by private equity consolidation over the last five years.

*Christensen: The mid-cap portfolio is invested in what we believe are emerging blue chips. These are not only companies that have done well as small cap names, but we think will do well as mid-cap names and will eventually graduate into large cap names.*

**1-Year Daily Chart of Choice Hotels**

**Chart provided by www.BigCharts.com**

This is where **Choice** really has an opportunity, as these systems have been heavily levered and many will be using their cash to pay down debt rather than build out brands or maintain franchise standards, which we believe could help alienate existing franchisees. In addition, as the lodging cycle has slowed, some of these investors may want to exit brands, thus putting **Choice** in a position to acquire some of these brands, especially with their strong track record of integrating and growing other brands.

Lastly, as the economy slows, many operators of independent chains could find an opportunity teaming up with a well-known hotel brand that could allow it to improve overall profitability and thrive in hard times. Again **Choice** fits the bill. With the low capital intensity of the company's model, **Choice** generates strong free cash flow that has been used to pay a sustained and growing dividend, as well as aggressively repurchase stock. Operating margins are in the 30% area and if you look at the peers, such as **Marriott** (MAR) and **Starwood** (HOT), which are both franchisors and operators, their margins are usually in the single-digit to low double-digit area. This is a stock we had on our focus list for many years. We finally got our opportunity when the market declined in the last year and we purchased the shares.

**TWST: In this environment where there are going to be winners and losers, do you see more mergers and acquisition activity in the future for the mid-caps?**

**Mr. Stone:** I would say that every year we see some merger activities among our companies. Today you have quality companies with very attractive valuations, but it would depend on the capital markets and how quickly we come out of this slow environment.

**Mr. Christensen:** I'll also add that this is a good environment for our companies to make acquisitions. They can be more selective, given the fact that valuations have come down precipitously. Remember our companies already generate a lot of free cash. They already have a strong balance sheet so they are in a good position to make selective acquisitions, making sure it is strategic, while not putting any strain on their balance sheet.

**TWST: What about the sell process? What triggers an exit from your portfolio?**

**Mr. Christensen:** We do valuation work to create a price range for the next five years as we are long-term investors. There are three scenarios that would elicit a sale of a stock on our part. The first is, in looking at the overall range I just discussed, we determine a long-term expected return and if for any

reason that five-year expected return drops below the 10-year bond yield, we would then exit out of our entire position.

Another reason we would sell is a deterioration in business fundamentals or changes to the original business model thesis of why we bought the shares initially. The last reason is, as Craig alluded to earlier, we have a couple of stocks per year that are acquired due to their wonderful business characteristics.

**TWST: In this current environment, risk is more of a factor than ever. What risk management techniques have you incorporated within your process to try to control risk?**

**Mr. Stone:** We do that on different levels. First, at the company level, we buy quality companies that have protected businesses, rather than the index which is full of companies that have commodity-type businesses and returns. Second, at the sector level, as Jon mentioned earlier, we won't bet on any one single sector; we give ourselves plus or minus 10% of the sector benchmark weighting and try to be broadly diversified across all industries and sectors. Third, at the portfolio level, we want to buy the highest quality companies that can grow consistently and deliver better values. We believe those three parameters are the risk controls that we have in the portfolio, the sector and the companies.

**TWST: What is distinctive about your mid-cap approach to stock selection? What gives you your edge when compared with other firms?**

**Mr. Christensen:** As we said before, the mid-cap portfolio is invested in what we believe are emerging blue chips. These are not only companies that have done well as small cap names, but we think will do well as mid-cap names and will eventually graduate into large-cap names. But I think the best way to understand the distinctive nature of our portfolio is to quantify the high-quality characteristics that we always talk about.

If you look at various quality, growth and value metrics of our portfolio compared to the Russell Midcap Index, we believe the numbers really bear out the story. For example, the return on equity over the past five years is 24.0% for our portfolio versus 17.5% for the Russell Midcap Index. This says that in a market of commodity businesses, we own proprietary businesses. At the same time, total debt to EBITDA is 1.6 times for our portfolio versus 3.8 times for the Index. Once again, our companies have a lot less leverage on their balance sheets and are less exposed to financial risk.

In terms of growth metrics, our portfolio's earnings per share have increased 14.4% versus 10.8% for the Index. Over a longer period of time, which also incorporates an economic recovery, we have been able to find companies that can grow their earnings faster than the Index. Lastly, we believe we can buy these companies at discounted valuations to the Index.

**TWST: You also seem to invest in what seem to be easily understandable businesses, with solid stories behind them.**

**Mr. Stone:** I wouldn't say they are necessarily easily understandable businesses. It's really the characteristic of our companies, whether it be a brand name, which everybody understands, or niche dominance, a low-cost advantage or superior distribution. The most important thing is to understand the drivers that make these companies quality businesses and how they can sustain those competitive advantages and continue to generate the terrific numbers over time.

**TWST: Looking ahead to the rest of 2009, do you see any more challenges for investors, particularly looking at your mid-cap arena?**

**Mr. Christensen:** As I referred to earlier, we think that the economic recovery is going to be slow and steady, but eventually it should come. However, the facts point to a difficult economy in 2009, and it would be a guess what happens in 2010. For the most part, our businesses are taking share and becoming stronger by taking advantage of their stronger balance sheets, while other businesses are completely imploding — some are even filing bankruptcy. Our businesses, as we stated before, tend to do better than their peers in this type of economy.

**Mr. Stone:** We design our portfolios to weather this kind of environment. In a market where the cost of capital is increasing and earnings growth is going to be hard or difficult to come by, we believe the quality companies will shine through and our portfolio should be well positioned going forward.

**TWST: Is there anything that you'd like to add?**

**Mr. Stone:** One of the things about a difficult market environment like today's is that it gives us much more opportunity to go out and find quality businesses that are trading at a more reasonable valuation than what we have seen in a long time. Again, our portfolios are well positioned to weather this kind of difficult environment and we are excited about our prospects going forward.

**TWST: Thank you. (PS)**

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