

Transcript of David Einhorn's Speech at the Value Investing Congress

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When people ask me what I do for a living, I generally tell them “I run a hedge fund.” The majority give me a strange look, so I quickly add, “I am a money manager.” When the strange look persists, as it often does, I correct it to simply, “I’m an investor.” Everyone knows what that is.

When people ask me what I did on my summer vacation, I generally tell them “I played in the World Series of Poker.” Nobody gives me a strange look.

So I am at the World Series of Poker in Las Vegas and it is time for a break between rounds. A fellow comes up to me as says, “I am from CNBC and we’d like to interview you.” I ask, “About poker or investing?” The fellow looks at me like this is the strangest thing anyone has asked him in a long time; I realize he obviously picked me out due to my large chip stack or, according to my wife, due to my great looks. “About poker” he says as nicely as he can.

Today, I will discuss both. But for this group, who I bet all know what a hedge fund is, I will mostly discuss investing. Investing and poker require similar skills.

Different people approach poker different ways. Loose aggressive types play lots of hands – virtually any two cards – and try to win lots of small pots. They are the day traders of the poker tables. Others play any Ace or any King or any two high cards. They play too many hands, but don’t play them well. These folks can do fine for a while, but get outplayed after the flop by the loose aggressive types who eventually wear them down so that they wind up in a

desperate spot playing a decent hand against a strong hand for the remainder of their chips. I would compare them to long-only closet indexers who trade too much. Then there are the rocks. These folks sit around waiting for premium hands – high pocket pairs or an Ace, King. They fold and they fold and they fold. They are going to wait until they know they have a huge advantage. Then they bet as much as they can. It is very hard to beat a player like this. They can last a long time. Once people figure them out, nobody will play them when they do play. So they don't get the chance to get enough chips in when they have a large advantage. Could this be what is becoming of Berkshire Hathaway?

I will tell you my poker style. It is close to the patient players waiting for a big advantage. I don't play a lot of hands. But I don't just wait for the perfect hand. They don't come up often enough. I try to pick out one or two people at the table I want to play against or who I sense don't want to play against me. When the situation feels right, I put in a big, aggressive raise with a marginal holding. It is very hard to describe how I know the "feel" and sometimes I get it completely wrong. But to do well in a poker tournament, you have to recognize a few non-traditional opportunities and you need to get people to sometimes fold the better hand. I think we invest similarly. By this I mean that most of our investing lines up nicely in the disciplined, traditional value camp – very low multiples of book value, revenues, earnings, etc., but occasionally we are opportunistic and invest in situations that are difficult to justify under traditional criteria but for one reason or another we believe to be better situations than they first appear.

People ask me "Is poker luck?" and "Is investing luck?"

The answer is, not at all. But sample sizes matter. On any given day a good investor or a good poker player can lose money. Any stock investment can turn out to be a loser no matter how large the

edge appears. Same for a poker hand. One poker tournament isn't very different from a coin-flipping contest and neither is six months of investment results.

On that basis luck plays a role. But over time – over thousands of hands against a variety of players and over hundreds of investments in a variety of market environments – skill wins out.

My experience at the World Series of Poker was more like what can happen to a very lucky player in any given tournament. It sure was a blast. If I played a lot of poker, I know that over time the real pros would eat me alive. Personally, I think CNBC would be better served to ask me about investing. I think I have more to contribute in that area.

So let's get to that. How many of you heard me last year? Now how many of you heard someone use the PEG ratio and kind of laughed to yourself when you heard it?

This year, I'd like to talk a bit about ROEs. One of the best investors around, Joel Greenblatt, has written a popular, charming and funny book about investing in great companies at low P/E multiples. To simplify an already simple book, great companies are generally measured as companies that can generate lots of profit without requiring a lot of capital. This means that they have high ROEs.

I recently met a smart hedge fund manager who has built a \$10 billion fund around screening for companies with high ROEs and low P/E multiples for longs and low ROEs and high P/E multiples for shorts. The manager adds human analytical effort to confirm that the screened results are not anomalous accounting figures but instead generally confirm the performance of the business. This has been a successful approach.

My two cents on ROEs is that there are two types of businesses: there are capital intensive businesses and non-capital intensive business. Capital in this definition is both fixed assets and working capital. I define a capital intensive business as a business where the size of the business is limited by the amount of capital invested in it. In these businesses, growth requires another plant, a distribution center, a retail outlet or simply capital to fund growing accounts receivable or inventory. Examples include almost all traditional manufacturing companies, distribution companies, most financial institutions and retailers.

I define non-capital intensive businesses as businesses where growth is limited by things other than capital. Generally, this means intellectual capital or human resources. Examples of intellectual capital are in the pharmaceutical, computer software industries and even some consumer goods like Coke, which rely on brand equity rather than shareholders equity. For example, drug companies are generally limited by the composition of their patent portfolios rather than by their raw manufacturing capacity. Human resource companies are the ones known for the “business going up and down the elevator” every day. Most service companies qualify, including almost any company that sells labor whether it be nurses, construction workers or consultants.

I believe that it is irrelevant to worry about ROE or marginal return on capital in non-capital intensive businesses. If Coke or Pfizer had twice as many manufacturing plants, the incremental sales would be minimal. If Greenlight Capital – and here I mean the management company that receives the fees, and not the funds themselves – had twice as many computers and conference room tables we wouldn't earn twice the fees...in fact, they probably wouldn't increase at all.

When the capital doesn't add to the returns, then ROE doesn't matter. It follows from this that in non-capital intensive businesses

the price-to-book value ratio is irrelevant. The equity of the company in the form of intellectual property, human capital or brand equity is not reflected on the balance sheet. All that matters is how long, sustainable or even improvable the company's competitive advantage is, whether it is intellectual property, human resources or market position.

For these companies the "reinvestment" question becomes what do they do with the cash. Do they return it to shareholders? Or do they do something worse with the cash? Think of all the beautiful non-capital intensive businesses that have either bought or entered capital intensive areas...mostly because their core business generated more profits than they knew what to do with.

A current example is the investment banks. Think about investment banking. It should be a wonderful non-capital intensive business. People go up the elevator and generate fees. Fees for corporate finance advice. Fees for raising capital. The top firms also benefit from their brand equity as companies actually measure their status by the perceived brand value of their financial advisors. They get still more fees for assisting buy-side customers to execute transactions in the capital markets and serving as custodians for their assets. None of this requires a lot of capital. From there, they can generate more revenue by facilitating customer orders, by committing some capital and by lending them money. So the investment banks become a bit more capital intensive. This has evolved.

Next the banks enter proprietary trading and investing – generally in everything from short-term trades in liquid securities to merchant banking or private equity efforts. All that cash flow from the great non-capital intensive businesses gets sucked into ever growing balance sheets. Before you know it, the investment banks are holding on-balance-sheet assets of 30x their equity in addition to tons of off-balance-sheet swaps and derivatives.

What does all this capital-intensive activity do? It drives down the ROEs. Sure the ROEs still seem good at around 15-20%. But when you consider that underneath all the capital intensive stuff is a wonderful non-capital intensive fee-generating business that should have an astronomical ROE, you see that all the proprietary investing and leverage isn't adding much to shareholder returns here. The irony of this is that these are the companies that everyone else comes to in order to get advice on corporate finance and capital allocation.

Why did this happen? They say that the reason is to diversify the business to stabilize the results, as the fee streams are too volatile for the tastes of public investors. In my view that is a lot of value to destroy in order to stabilize results that are still pretty volatile.

I suspect a better explanation is the investment banks are run for their employees rather than their shareholders. They are run so that there is just enough shareholder return left so that shareholders don't complain too loudly and a 15-20% ROE seems to be that level. Of course, the returns could be higher, but around 50% of the revenues go to employee compensation.

Given the risk taking nature of the incremental revenues and the fact that 50% of the revenues go to employee compensation, the investment banks are evolving into hedge funds with...how shall I put this?...above-market incentive compensation fee structures.

We have a company in our portfolio, New Century Financial (NEW), that turned a wonderful non-capital intensive business, the origination and sale of mortgages, and reinvested the cash flows into a mediocre capital intensive business of holding mortgage loans. Worse, they went into the capital markets to raise additional capital to focus on the capital intensive opportunity. I thought this was such a bad idea that I joined the Board with the goal of

unwinding this decision and to free the valuable service business from the investment business. It is too soon to discuss my progress.

One non-capital intensive business we like is Washington Group, which provides design, engineering, construction management, facilities and operations management, environmental remediation, and mining services. Most of Washington Group's contracts are paid on a negotiated cost-plus basis. The plus is either a percentage of the costs or specific performance incentives or milestone payments.

For 2006, Washington Group is guiding to about \$2.50 per share. For 2007, the guidance is \$2.60-\$2.92 per share. The "Street" has taken that guidance at face value and has declared the stock fully valued at \$55.

To us, the shares seem less expensive. There is about \$8 per share in cash and a tax NOL worth another \$7 per share. Backing these out, the business value is about \$40 a share.

We think that guidance is overly conservative. Washington Group's end markets should experience large growth over the next few years. In 2006, Washington Group will grow backlog more than 16%. The estimates imply earnings growth of about the same percentage.

Until recently, Washington Group also participated in "Rip and Read" bidding for government infrastructure projects. Those projects are contracted based on sealed bids from contractors, all ripped open at the same time. The lowest bid wins the contract. This has not worked out very well for them.

When the customers on those contracts request changes or expansions, Washington Group incurs increased costs.

Washington Group will file a claim for the increased expense with the customer, and it is either paid out or litigated in a process that can take several years. Washington Group has historically recovered money on a good percentage of its claims.

Washington Group accounts for these loss-generating contracts with cost overruns by taking a charge for the expenses expected to be in excess of revenue going forward. Future revenue on the contract is recognized at a 0% EBIT margin. Claims are not recognized in earnings until the cash is received, no matter how far along in negotiations Washington Group and its customer are, or how reasonably claim recoveries can be estimated. In effect, Washington Group will have charges in early quarters, followed by quarters with revenue at 0% EBIT margin, and then later quarters with claims revenue at 100% margin. Washington Group does not include claims recoveries in its guidance.

Lately Washington Group has had three particularly difficult contracts with cost over-runs. This has resulted in repeated charges over the past few years. The 2006 guidance includes \$32 million in pre-tax charges that have reduced earnings by about 60 cents per share.

There are other accepted ways to account for cost overruns on government contracts. The largest of these contracts, for which Washington Group has recognized \$122 million of the losses, is done through a joint venture for which Washington Group has a 50% share. Washington Group's publicly traded JV partner estimates \$57 million of claims recoveries that it has recorded on its books as an offset to the losses. As I mentioned, Washington Group doesn't book the recovery until it collects the cash.

I believe that a more reasonable estimate for 2007 starts with 2006, adds back the 60 cents of charges and grows the core business by 16%. That puts me at around \$3.60 per share or about 11x

conservatively stated earnings that give no credit for claims recoveries. I do not believe this is a peak result. This seems pretty cheap for a non-capital intensive business with above average growth prospects and a history of using excess cash flow to buy back stock. For what it is worth, the peer group trades at 20x more aggressive earnings.

Coming back to my main theme. I believe it is very important to analyze ROE and marginal returns on capital...but only in capital intensive businesses. It may surprise you, but I prefer at the right price capital intensive businesses with low ROEs, where I think the ROE will improve, to high-, or at least medium-ROE businesses.

The problem with high ROEs in capital intensive businesses is that it is hard to sustain the ROEs. Here, high returns attract competition both from new entrants that come with new capital and existing competitors that try to see what the better performing competitor is doing to copy it. The new capital and the copycats often succeed in driving down the superior ROEs. Really bad things happen to earnings when a 25% ROE turns into a 10% ROE.

This is why I prefer the low ROEs. Great things happen to earnings when a 10% ROE becomes a 15% ROE. ROE can improve three ways: better asset turns, better margins and by adding financial leverage. I like to look for companies that can expand the ROEs in as many of these levers as possible.

This brings me to my second investment idea, which is, I hope, a good example of what I am talking about.

Arkema is a diversified generic and brand name chemicals company that was created in 2004 by the French oil & gas giant TOTAL following the reorganization of its chemicals portfolio. Arkema consists of three divisions: Chlorochemicals, which is a

mature and cyclical segment; Industrial Chemicals, which is growing and moderately cyclical, and Performance Products, that occupies high-value-added non-cyclical niches. Arkema's products are used in automotive, electronics, hygiene & beauty, construction and chemical industries. Almost half of Arkema's revenue comes from outside of Europe and about two-thirds of its employees and capital employed are located in Europe, primarily in France.

Arkema was spun off and started to trade in May 2006 on the Paris Stock Exchange under the ticker AKE FP. TOTAL management, more focused on its highly profitable oil and gas businesses, had under-managed the "non-core" Arkema segments that have generated margins considerably lower than its pure-play peers.

Arkema currently trades at €38 per share, which translates into a market cap of €2.3 billion and reflects a valuation of 1.2x book value, which was almost halved by a slew of write-downs and provisions in the three years preceding the spin-off. Arkema currently trades at 38% of revenue and 4.9x our estimate of 2006 EBITDA, representing an industry low multiple of a depressed EBITDA result, caused by an industry low 7.7% margin.

We like Arkema because it has a great opportunity to improve its ROE through improving asset turns, margins and, if it is inclined, by adding leverage.

Arkema was spun off with working capital of 23.6% of sales. Industry peers operate in the mid-teens. If Arkema can shrink this number to 17% over time it will free up cash in excess of €6 per share or alternatively, it could grow revenues by 39% without requiring working capital. Arkema should also be able to expand asset turns as it holds €220 million or almost €4 per share of construction projects that are not yet producing. As these come on line, Arkema will get the revenue and income benefits from these investments that have already been made.

Additionally, Arkema has a good opportunity to expand its margins, as Arkema's recent "recurring" operating results had significant embedded undisclosed one-off costs depressing these results. The Industrial and Performance Chemicals divisions, Arkema's two largest, which account for 75% of revenue and all of EBITDA, have had average margins over the last eight years that were significantly higher than recent levels. Arkema's most comparable company, Degussa, has operating margins almost three times Arkema's recent results.

We believe that just with the return of Arkema's two largest divisions to their historical long-range profitability and a modest fixing of its troubled Chlorochemicals division, Arkema should be easily able to expand its EBITDA margin to 10% which would imply only 3.6x "reasonably achievable" EBITDA. After executing an authorized buy-back for 10% of its shares, such results would demonstrate €5 in EPS, implying a 7.6x P/E, and a 12% ROE. This is a dramatic improvement from what we think this year will be €2.50 in EPS and a 7.6% ROE. As I dream into the distant future of possibilities, if Arkema achieves Degussa's margins, they would earn €8.60 per share, implying a 4.4x P/E, and a 20% ROE.

So I went back to the CNBC reporter and asked him to read my speech and summarize it with a title. He read it, thought long and hard, and came up with Winning Poker Strategies from an Investor. I looked at him in the same confused way he had looked at me back in Vegas. So I've come up with an alternative title for today's talk: Financial Learnings for Make Benefit Glorious Wiseguys.