April 30, 2013

ValueInvestor INSIGHT

The Leading Authority on Value Investing

Pushing an Agenda

While the companies that attract his attention may lack a certain pizazz, Alex Roepers' success in investing in them has resulted in quite exciting returns.

In his first job out of business school, Alexander Roepers went to work in corporate development for a European industrial conglomerate that was dramatically overhauling its portfolio of businesses. "Value investors talk about buying and selling with a business-owner mentality," he says. "That's exactly what I was doing."

Roepers launched Atlantic Investment Management in 1988 and has skillfully applied that nuts-and-bolts mentality to public equity investing. His flagship hedge fund has earned a net annualized 12.4% over the past 20 years, vs. 8.6% for the S&P 500.

Making outsized bets when the valuation and his ability to affect change warrant it, he sees opportunity today in such areas as glass containers, oil services, chemicals, IT services and auto parts. See page 2

INVESTOR INSIGHT

Alexander Roepers
Atlantic Investment Management

Investment Focus: Seeks out-of-favor companies best poised to create shareholder value through an earnings turnaround, restructuring or takeover.

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	STRATEGY	2013 YTD	3 YEARS	5 YEARS	10 YEARS	SI
			ANNUALIZED			
Cambrian Fund	**US Activist**	**+20.4%**	**+17.2%**	**+4.8%**	**+9.0%**	**+19.3%**
AJR/Quest	**US Long/Short**	**+10.0%**	**+8.8%**	**-0.9%**	**+5.1%**	**+12.5%**
S&P 500 TR		+14.9%	+16.7%	+5.3%	+7.5%	+8.9%
Cambrian Global	**Global Activist**	**+11.8%**	**-**	**-**	**-**	**+20.1%**
MSCI AC World TR (USD)		+11.2%	-	-	-	+19.8%

Note: Figures are as of May 9, 2013. Returns are net of all fees and represent Class A Series 1 shares of the AJR/Quest and Cambrian Fund offshore funds. For purposes of reporting Cambrian Global we are using a representative class based on a hypothetical return for a new investor coming in on the inception date of January 1, 2012. Returns for the Limited Partnerships and other classes may vary. Inception of the Cambrian Fund is October 1, 1992 and performance prior to June 1, 1996 is based on the audited record of a managed account with a similar strategy and fee structure as Cambrian Fund. S&P 500 inception figures are from October 1, 1992. Inception of AJR/Quest is February 1, 1993. Cambrian Global Fund and MSCI AC World TR (USD) are from January 1, 2012. All indices are with dividends reinvested. All returns are audited through 2012 and unaudited thereafter. **Past performance may not be indicative of future results.**

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Investor Insight: Alexander Roepers

Alexander Roepers of Atlantic Investment Management describes why he maintains such a tight circle of competence, the key differentiator between his core and non-core positions, how he's been refining his portfolio-management process, and why he thinks Owens-Illinois, Oil States International, Ashland, Atos and Koito Manufacturing are mispriced.

We were struck when we last spoke [*VII*, February 28, 2007] by the extent to which you limited your investment universe. Is that as true now as it was then?

Alexander Roepers: We continue to believe in concentrating our time and capital on our highest-conviction ideas. Our long-only funds typically have six or seven positions, while our hedge fund on the long side has those same core positions plus another eight or nine long holdings. Concentration brings the opportunity to dramatically outperform, which is what we're after, but it also comes with risk. Our risk control starts with universe definition.

That means investing only in areas we know well, typically industrial, consumer-products and services companies. The more predictable and reliable the earnings the better, so we prefer companies that offer consumable, non-discretionary products supported by a large installed base. A classic example – which I believe we spoke about last time – would be Goodrich, which among other things makes landing gear and brakes for aircraft. Every time an aircraft touches down, that is logged by the FAA and the airline, which has to replace the brake pads and wheels on a predetermined schedule. The extent of Goodrich's market share and installed base meant that its earnings and profitability were far more predictable than you might expect for a business tied to the aerospace cycle. That's why United Technologies, in a deal that closed last July, paid 11.4x EBITDA to acquire it.

Another example would be Secom [9735:JP], a Japanese residential/commercial security company that's like ADT in the U.S. It has an unassailable franchise with 70% market share, contract retention rates of 99% and a huge net-cash position on its balance sheet. What's something like that worth? According to the market today, 8-9x EV/EBIT. We think the valuation should be 11-12x EBIT. In comparison, ADT trades at 15x.

Describe what you tend to avoid?

AR: We won't invest in areas we consider unanalyzable. That would include anything high-tech or biotech, where we think it's too difficult to predict the next product-development success – yours or someone else's – that can kill your traditional business. A consumer-technology company like Apple needs to come up with product innovations all the time to stay ahead of competitors and the price degradation of its products. To predict its success in doing that is just very difficult.

We avoid companies with inadequate transparency and an overreliance on leverage, such as banks, insurance companies and brokerage firms. We've seen too many cases where a rogue trader or a set of poor deals can wipe out the equity of a financially levered firm. We can't take that type of risk with our degree of concentration.

We're also averse to anything that might be considered faddish or trendy, where the fortunes of the business can turn quickly. We'd be unlikely to invest in retailers or restaurants for that reason.

Looking at your portfolio over time, you appear far more likely, say, to invest in an auto supplier than an automaker. Why?

AR: I'd never say never to us owning shares in a car manufacturer, but you're right, we prefer the suppliers to the original-equipment manufacturers. For instance, we have owned both Koito Manufacturing [7276:JP] and Valeo [FR:FP], which dominate the global market for vehicle headlights. Given their market positions and diverse customer bases, they generate solid and predictable returns and are not as susceptible to new entrants and large market-share swings as the OEMs are. Carmakers operate in a more competitive and fashion-conscious environment that is less appealing to us.

Do you always have an activist agenda?

AR: For our core longs, most of the time we do. In those positions we're typically taking a 2% to 7% stake in companies with market caps of $3 billion to $20 billion. That gives us access to management and the ability to advance our agenda for enhancing shareholder value, but with reasonable liquidity to trade around the positions and scale in and out.

While we're attracted by the quality of the business, we're going in when it's undervalued for reasons we believe are temporary and fixable. The "fix" may have to do with any number of things, including operational execution, changing the business mix, capital allocation or corporate governance. We're not just hoping for management to put things right, we want to engage with them in a constructive fashion to make things happen.

Rockwood Holdings [ROC] is a fairly typical example. It's a diversified specialty chemical company operating five divisions, focused on lithium, advanced ceramics, titanium dioxide, surface treatments and performance additives. Through a combination of operating missteps, worries about Europe and commodity-price volatility, particularly in titanium dioxide, the stock at around $45 last year was trading at what we thought was a significant discount to its sum-of-the-parts valuation.

Our message to management focused on the wide discrepancies in how the individual businesses could be valued versus the overall company valuation at the time of 6x EBITDA on an enterprise-value basis. The lithium business had high organic growth that hadn't yet really benefitted from the increasing prevalence of hybrid and electric cars using lithium batteries.

Based on comps, it deserved a 12-13x EBITDA multiple. The surface-treatment business, based on recent transactions, was likely worth 9x EBITDA. Our view was that there were plenty of options at management's discretion that could unlock those types of values.

The company has taken action. It's selling the advanced-ceramics division. It decided to merge the titanium-dioxide and performance-additives units, which will generate $30 million in synergies and should attract greater buyer interest when that entity is sold, as is planned. Rockwood stock now trades at $65 and we believe is worth $85-90 one year out as asset-sale proceeds are used to repurchase shares. We don't take all the credit, but think we've played a constructive role so far and we will continue to do so.

What keeps a non-core holding from becoming a core one?

AR: We've been adding to our non-core position in Agco [AGCO], a pure play on the increasing mechanization of global agriculture through the sale of tractors and other related equipment. We recently met with the CEO in Atlanta and believe he has a credible plan – through higher value-add products and broad-based cost savings – to increase operating margins by 2015 to 10%, from just over 7% today. Our price target on the stock is $77, 9x estimated 2014 EV/EBIT, versus a $51 share price today at a 6x multiple.

For this to become a core position, I need to see multiple ways for value to be unlocked, from earnings recovery, to restructuring, to even the takeover of the whole company. Today it is mostly an earnings and re-rating story.

Cardinal Health [CAH] seems like something a bit different for you. Is it another activism-light holding?

AR: Yes. Cardinal is one of the three major U.S. drug distributors and the stock took a hit in March on the news that Walgreens was taking its business to a competitor. For a number of reasons we don't see this having much of an impact on near-term forward EPS, while in the long term we like the earnings-growth potential from brand-to-generic conversions, an aging population, upside in China, expanding healthcare coverage in the U.S., and shareholder-friendly capital allocation. We think it's a compelling value play, but it won't be a core holding unless we see additional catalysts and an opportunity for constructive shareholder activism.

ON ACTIVISM:

We are counting on higher cash-flow multiples. But we don't just wait for the market to see things as we do.

Is there ever a thematic element to where you're finding ideas?

AR: Sectors go in and out of favor just as companies do. For example, we've recently gotten quite interested in the oil-services space, which has been weak for some time and where the share prices of several quality companies are not far from financial-crisis lows. We have recently scaled into a few stocks, like Baker Hughes [BHI] and National Oilwell Varco [NOV], as they came into our buy-in valuation range. We recognize the short-term issues at Baker Hughes – from acquisition-related stumbles to commodity-price impacts on drilling activity – but at the end of the day it's hard to deny that it has a phenomenal worldwide franchise that will benefit from activity in oil and gas exploration anywhere. The stock trades at less than 8x EV/EBIT on our 2014 estimates and at half the price of two years ago.

Describe generally what you're looking for in terms of valuation.

AR: We are cash-flow oriented, focusing on our EBIT and EBITDA estimates for the next couple of years. Most of the companies that interest us trade in a forward EV/EBIT range of 7-8x at the low end and 11-12x at the high end. We obviously seek to buy in at the low end of the range and sell at or near the high end.

People have said, "So you're just counting on the market paying you a higher multiple of cash flow?" At a basic level, yes, but these ranges aren't uncharted territory. Over any 12-month period, most of the companies we own hit the high-end of their historical trading range at least once for a while, which is all we need.

Again, we're not just waiting for the market to see things as we do. We identify multiple catalysts for a company to achieve better-than-consensus earnings, an upward re-rating or to unlock value through corporate actions, and we drive them as hard as we can.

You tend to trade actively around positions? Why?

AR: I look at managing individual positions as if I'm driving a car on a racetrack. There are curves, there are wet spots, and there are other cars around you. You can't go the same speed all the time – sometimes you have to let up on the gas and sometimes you should push down on it.

We don't try to be too cute about our trading and try to keep it as mechanical as possible, based on the position size in the portfolio and where the stock is in its valuation range. Take Energizer Holdings [ENR], for example, which has been a core position in our activist/event fund for the past three years. As the stock has moved up and down it has gone from 8% of capital to 15% and back several times. Given the more pronounced move up in the share price over the past nine months, we've trimmed along the way to keep the position size in check. Now at $95-96 per share, we see the upside and downside as fairly equal and have been scaling out of the position.

Walk through the investment case for your largest position, Owens-Illinois [OI].

AR: This is the largest glass-container manufacturer in the world, with about

a quarter of the global market. OI and Saint-Gobain of France are the only two producers with a global reach that has allowed them to foster long-term customer relationships with the world's blue-chip brewers, wine makers and consumer-products companies, and which also serves as a significant competitive barrier to entry. You can spend up to $150 million to build a new glass-bottle plant in the U.S. and then go to Coca-Cola to ask for business and they'll say, "That's great, guys, but you'd need a lot more plants like that in the U.S. to work with us." OI has 81 glass plants around the world and enjoys monopoly or duopoly positions in most of its key countries.

The story here is to get earnings power up through operational execution and focus. Last August we urged management and the board to focus on core regions of Australia, Europe, Latin America and North America, to de-emphasize Chinese investments, to refrain from acquisitions, to prioritize debt repayments, and to lay out a three-year roadmap to achieving full earnings potential, which we believe is $4 per share.

We've been pleased with the response and actions taken so far. In February the company announced a roadmap targeting at least $3.50 in EPS and more than $400 million in free cash flow by 2015. It has instituted a three-year plan to rationalize and restructure its European operations. There have been several management changes, including a new CFO and new presidents for North America, Europe and Asia-Pacific. Free cash flow, an estimated $300+ million in 2013, is being used to pay down debt. The benefits of all this may not show up right away, but we believe the company is very much on the right track.

Is the replacement of glass by plastic and aluminum still a secular threat?

AR: That substitution largely played out through the 1980s and 1990s. It set off a dramatic consolidation in glass packaging, which is now mostly over as the number of credible players in most markets is down to no more than two or three. Wine is overwhelmingly packaged in glass and it's hard to imagine people in large numbers drinking it out of a plastic bottle. In the U.S. beer industry, glass has actually taken share from cans in the past two decades and it is clearly the premium package. The focus on the environment and rising incomes globally are also long-term positives for glass. So we're not talking about the Polaroid camera here.

OI shares have gone nowhere since recovering after the recession. At today's $26, how are you looking at valuation?

AR: As the company makes progress toward its EPS goals and uses cash to pay down debt, we believe the stock will re-rate from the current 9x forward P/E to something closer to 12-13x, which is in the middle of its typical historical range. On a 2014 earnings per share target of $3.20, which we consider quite achievable, we're looking at a share price of close to $40. Once they get net debt below $3 billion, which should happen within the next 18 months, they're going to start buying back shares, accelerating EPS growth and the revaluation.

INVESTMENT SNAPSHOT

Owens-Illinois
(NYSE: OI)

Business: Global manufacturer of primarily glass containers used in the packaging of beer, wine, spirits, non-alcoholic beverages, condiments and packaged foods.

Share Information
(@4/29/13):

Price	**25.94**
52-Week Range	16.82 – 27.79
Dividend Yield	0.0%
Market Cap	$4.27 billion

Financials (TTM):

Revenue	$6.90 billion
Operating Profit Margin	10.3%
Net Profit Margin	1.9%

Valuation Metrics
(@4/29/13):

	OI	S&P 500
P/E (TTM)	32.3	18.5
Forward P/E (Est.)	9.3	14.2
EV/EBITDA (TTM)	6.9	

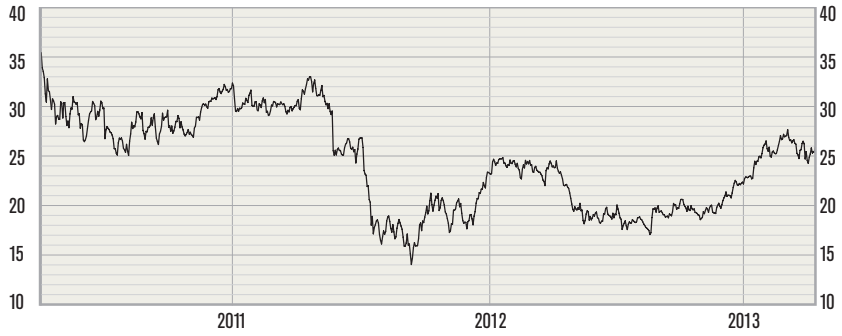
Largest Institutional Owners
(@12/31/12):

Company	% Owned
Atlantic Inv Mgmt	6.8%
Vanguard Group	6.3%
Sasco Capital	4.7%
BlackRock	4.7%
State Street	4.4%

Short Interest (as of 4/15/13):

Shares Short/Float	2.2%

OI PRICE HISTORY



THE BOTTOM LINE
The market isn't giving the company credit for progress toward meeting newly articulated earnings and cash-flow targets, says Alex Roepers. As that progress continues, he expects a re-rating of the shares to at least 12-13x forward EPS, the middle of their historical valuation range. At that level on his 2014 numbers, the shares would trade at $40.

Sources: Company reports, other publicly available information

One can't talk about OI without mentioning its ongoing asbestos-related liability. How are you assessing that?

AR: The company is still liable for claims made on products that included asbestos made by a subsidiary before 1958. So to file a new claim means someone had to be old enough to have been in the workforce in 1958, which means the youngest of those are probably 75 years old. So while claim payments are still high – probably $155 million this year – they are actuarially destined to come down. As that happens, OI's free cash flow increases incrementally as a result of the asbestos liability slowly ebbing away.

Why do you consider Oil States International [OIS] a "special-situation" energy-services idea?

AR: The company operates in more traditional areas of oil services, such as providing riser and pipeline connectors for offshore drilling rigs, leasing out onshore drilling rigs and distributing a wide range of casing and tubing products. The special-situation aspect is that its largest business – accounting for 55% of EBITDA – is in providing accommodations for workers at remote drilling and mining locations. It's basically the Marriott of the energy-services sector, mostly active in oil-sands areas of Canada and in coal-mining regions of Australia.

While the accommodations business is under some pressure for macro reasons – namely depressed coal prices worldwide and the cost advantage today of U.S. oil over crude coming out of the oil sands – we believe the intermediate- to long-term prospects for it remain solid. The number of rooms probably won't keep growing at the 10%-plus annual rate its has been, but billions and billions of dollars have been invested in both of these key regions by operators who will continue to take material out of the ground. Oil States' accommodations contracts typically run from one to five years, and something like 80-90% of the 2013 and 2014 capacity is already locked in.

What's the focus of your activism?

AR: We have recommended that management seriously review the feasibility of a REIT or REIT-like structure for the accommodations business. As growth slows down, the business should throw off a lot of cash as they throttle back on capital spending. Given REIT valuations that are much higher than where Oil States trades today, some sort of transaction would unlock considerable shareholder value. We're optimistic that management will actively look at the available alternatives to achieve this.

Do you have to be bullish on energy prices to want to own this now?

AR: If you believe as we do that 3% annual global GDP growth is in the cards over the next five years, we think energy prices today are closer to the bottom than the top. That said, we see Oil States as a low-beta derivative play on energy prices, including oil sands and met coal. Low prices impact it much less substantially than they affect the actual producer. The possible unlocking of the value of the accommodations business is a bigger part of the story here than the energy-price cycle.

INVESTMENT SNAPSHOT

Oil States International
(NYSE: OIS)

Business: Provider of a range of specialty products and well-site services used by large customers in the exploration and production of oil and gas worldwide.

Share Information
(@4/29/13):

Price	**76.54**
52-Week Range	60.03 – 87.63
Dividend Yield	0.0%
Market Cap	$4.21 billion

Financials (TTM):

Revenue	$4.38 billion
Operating Profit Margin	14.7%
Net Profit Margin	9.5%

Valuation Metrics
(@4/29/13):

	OIS	S&P 500
P/E (TTM)	10.2	18.5
Forward P/E (Est.)	9.4	14.2
EV/EBITDA (TTM)	5.7	

Largest Institutional Owners
(@12/31/12):

Company	% Owned
Fidelity Mgmt & Research	8.1%
BlackRock	5.3%
Royce & Assoc	5.1%
Vanguard Group	4.8%
State Street	3.3%

Short Interest (as of 4/15/13):

Shares Short/Float	3.7%

OIS PRICE HISTORY

THE BOTTOM LINE

While a "low-beta derivative play on energy prices," the crux of the thesis for the company rests on the possibility of unlocking value in its unique accommodations business, says Alex Roepers. His sum-of-the-parts analysis – assuming a 10x EV/EBITDA multiple for accommodations and 6.5x for the rest – yields a share-price target of $120.

Sources: Company reports, other publicly available information

What upside do you see in the shares, now trading at around $76.50?

AR: We're now using a sum-of-the-parts valuation for our price target. With a 10x EV/EBITDA multiple on the accommodations business and 6.5x multiples on the rest, after subtracting the debt we arrive at a share-price target of around $120. That translates into approximately an 8x multiple on our 2014 estimates for the entire company, which is reasonable relative to where the stock has traded in the past.

Turning to Europe, describe your thesis for French IT-services firm Atos [ATO:FP].

AR: Atos is the largest European provider of IT outsourcing and services, with a makeup similar to an Accenture or the services side of IBM. Over 70% of the business is tied to long-term contracts, producing a high share of recurring revenues. While this might appear a bit "techy" for us, it's not about inventing technology, just effectively applying what's out there.

Our thesis has two primary components. The first has to do with the ongoing profitability improvement in core IT services, starting with a rigorous restructuring plan implemented when the current CEO took over in 2008, and now more from integration synergies following the 2011 acquisition of Siemens' IT-services business. That deal provided Atos with critical scale while locking in a €5.5 billion long-term contract with Siemens, which now owns 15% of the company. Even in a no-growth European environment, earnings per share have gone from €3 or so pre-deal to closer to €5 this year, with almost €4 per share in free cash. As the three-year integration plan wraps up, we expect greater emphasis on bolt-on acquisitions to consolidate market positions.

The second component to the thesis involves the company's end-to-end payments processing business that accounts for 15% of total revenues and more than 25% of profits. Multiples paid for such businesses in Europe have been high, so we believe an obvious way to unlock value would be to IPO or to sell this business outright. We think a conservative valuation for this business would be closer to 14x EV/EBIT, while the company overall trades at around 6.5x. Management has taken the necessary steps to legally separate the division, which suggests to us that something will eventually happen.

What impact do you see that all having on the share price, now around €53.50?

AR: Given the improved profitability of the core IT business, we're assuming a 9x EV/EBIT multiple on our 2014 EBIT estimate of €535 million. There's a small business-outsourcing division, on which we're putting an 11x EV/EBIT multiple on estimated EBIT of €65 million. For payments processing, as I mentioned, we're using 14x and a 2014 EBIT estimate of €200 million. Add that all up, divide by 98 million fully-diluted shares, and we arrive at a 12-month target price of €82.

If it plays out as we expect, the company will have over €1 billion in cash by the end of 2014 and will be in a position to continue to invest in growth and return capital to shareholders. That's additional support for our making this our largest European position.

Chemical company Ashland [ASH] has already been a big winner for you. Why do you still find it interesting?

AR: This has been a core long for us since mid-2011, run by a management team that has been skilled in restructuring the

INVESTMENT SNAPSHOT

Atos
(Paris: ATO:FP)

Business: IT consulting and outsourcing, with particular expertise in such areas as managed services, transactional services, healthcare and systems integration.

Share Information
(@4/29/13, Exchange Rate: $1 = €0.76):

Price	**€53.49**
52-Week Range	€41.34 – €59.22
Dividend Yield	1.1%
Market Cap	€4.60 billion

Financials (2012):

Revenue	€8.84 billion
Operating Margin	6.6%
Net Profit Margin	2.5%

Valuation Metrics
(Current Price vs. TTM):

	ATO:FP	S&P 500
P/E	20.0	18.5

ATO:FP PRICE HISTORY

THE BOTTOM LINE
Alex Roepers says the market isn't adequately recognizing either the ongoing profitability improvement in the company's core IT-services business or the obscured value in its lucrative payments-processing division. Based on his sum-of-the-parts valuation, using 2014 estimates, he believes the shares over the next 12 months can trade above €80.

Sources: Company reports, other publicly available information

company's business mix through M&A. You may remember Ashland as a big player in refining and asphalt, but those businesses are gone and the company is now focused on specialty chemicals with consumer, healthcare and industrial applications, chemicals used in water treatment, and Valvoline-branded motor oil.

When we bought in 2011 we were expecting one of three things to happen: they would make a transformational acquisition, be bought themselves, or do a large buyback to propel the share price. Within a month of our getting involved they announced a deal to buy International Specialty Products, which provides intermediate chemicals used in a variety of pharmaceutical and consumer products. It was a big deal for Ashland – the purchase price was $3.2 billion – and in one fell swoop repositioned the company as having more of a consumer/health focus, which could earn a higher valuation. The market loved it and the stock went up 10% the day the deal was announced.

What wasn't so universally clear at the time was how good this deal actually was. By late 2011, management had closed the deal and laid out a credible plan for achieving substantial earnings growth, following the standard acquisition-integration playbook – cutting overhead, taking advantage of supply-chain, marketing and sales synergies, paying down debt.

That appears to have gone fairly well.

AR: The shares rallied from the mid-$40s to over $80 in the past eighteen months. But the current fiscal year, which started in October, got off to a weak start. There were headwinds from destocking, weaker than expected international markets and continued underperformance in water chemicals. None of that was dramatic or changes our long-term outlook, but it was the first time since the ISP acquisition that things weren't great. The stock went from $85 to less than $75 from the end of January to the end of March.

It popped back earlier this month when JANA Partners announced it had taken a 7.4% stake. How attractive do you consider the shares now at $85.50?

AR: We're always pleased when other prominent investors see value where we already have.

Estimates have come down a bit, but we're expecting EPS to increase from $6.75 or so in fiscal 2013 to around $9 in 2015. With that kind of growth, reduced debt and a realization by the Street that earnings are more recession-resistant than commonly believed, we also expect a gradual re-rating. Either on a sum-of-the-parts basis or assuming an overall 10x fiscal-2014 EV/EBIT multiple, our 12-month price target is $106.

Are you pushing any activist agenda?

AR: Our discussions with management are primarily around fixing or selling the water-chemicals division, divesting or re-segmenting parts of the performance-materials division, and more aggressively repurchasing shares. We continue to have an open and active dialogue.

The last thing I'd add is that a credible case could be made that the entire company is a takeover candidate. A large

INVESTMENT SNAPSHOT

Ashland
(NYSE: ASH)

Business: Producer of specialty chemicals through four operating units: Specialty Ingredients, Water Technologies, Consumer Markets and Performance Materials.

Share Information
(@4/29/13):

Price	**85.48**
52-Week Range	58.96 – 90.21
Dividend Yield	1.0%
Market Cap	$6.84 billion

Financials (TTM):

Revenue	$8.04 billion
Operating Profit Margin	4.9%
Net Profit Margin	0.4%

Valuation Metrics
(@4/29/13):

	ASH	S&P 500
P/E (TTM)	221.4	18.5
Forward P/E (Est.)	10.4	14.2
EV/EBITDA (TTM)	12.1	

Largest Institutional Owners
(@12/31/12):

Company	% Owned
Fidelity Mgmt & Research	14.5%
BlackRock	4.8%
Vanguard Group	4.8%
TIAA-CREF	3.3%
Atlantic Inv Mgmt	3.0%

Short Interest (as of 4/15/13):

Shares Short/Float	4.4%

ASH PRICE HISTORY

THE BOTTOM LINE
Having shed its grittiest roots, the company now has a more consumer products/health focus and a higher earnings-growth profile – neither of which the market has fully appreciated, says Alex Roepers. Either on a sum-of-the-parts basis or assuming an overall 10x fiscal-2014 EV/EBIT multiple, his 12-month price target for the shares is $106.

Sources: Company reports, other publicly available information

strategic buyer would find a lot of value in Ashland's specialty-chemical lines and could pay down some of the purchase price through an immediate sale or IPO of Valvoline, which would be quite attractive on a stand-alone basis.

Like most Japanese stocks, Koito Manufacturing has had a great recent run. What potential do you see in it from here?

AR: As I mentioned earlier, Koito Manufacturing and Valeo are the biggest and most-successful manufacturers of auto headlamps in the world. Koito is #1, with 20% of the global market, and is consistently highly regarded for its technology and product quality. The customer base is relatively well diversified, although Toyota – which owns 20% of Koito – accounts for approximately 30% of total sales.

The stock has done well lately, but only after two years of misery since we bought it. Toyota had its quality and product-recall issues. There were also the earthquake in Japan, the floods in Thailand, the Japan/China diplomatic dispute and the unrelenting strength of the yen. There was even a scandal with a separate company called Koito Industries, which is still partly owned by Koito Manufacturing, which was being sued by customers for late delivery of airplane-seating systems.

Things seem to have turned for the better across the board. Toyota has righted itself and the Koito Industries issues are being worked out with little lasting damage. Time has healed the more practical impacts of the earthquake and the floods. From a headwind, the yen has turned into a tailwind, and we believe its depreciation is bound to continue.

More on the company-specific front, we expect Koito's top line and margins to grow faster than global automotive production as it gains market share and benefits from a product-mix shift toward higher-margin LED headlamps. It has had a higher-than-normal win rate in recent new-model supply competitions and visibility on order growth for the next three years is quite good.

How do you see that translating into share-price upside from today's ¥1,900?

AR: Even after a sharp rise, the shares still only trade at a 5.7x EV/EBIT multiple on our estimates for the fiscal year ending in March 2015. That's roughly in the middle of what we're considering a normal valuation range of 4-8x, but the stock in the past has traded many times above 10x EBIT. Using 8x, on our fiscal 2015 numbers, our price target one year out is ¥2,600, 35-40% above the current price.

You had very tough 2008. Did that cause you to rethink any aspects of your strategy or process?

AR: Our strategy in terms of universe definition, due diligence, valuation and activism hasn't changed at all. What we did refine were certain aspects of managing exposure. In our long-only U.S. fund we were able to use leverage and were caught at 115% long going into the teeth of the crisis. That was an unforced error that we won't make again, as that fund will no longer use leverage.

In our hedge funds we have also more formally tightened the net-exposure range to the 30% to 60% band in which we've typically operated. One of the biggest mistakes we made with the hedge fund in the fall of 2008 was to let the net exposure get up to 75%, as we didn't replace covered shorts and as we started buying into weakness thinking the worst had passed. We reviewed our long-term performance

INVESTMENT SNAPSHOT

Koito Manufacturing
(Tokyo: 7276:JP)

Business: Global manufacturer of automotive lighting products and accessories as well as lighting, electrical and hydraulic equipment used in commercial aircraft.

Share Information
(@4/29/13, Exchange Rate: $1 = ¥97.96):

Price	**¥1,903**
52-Week Range	¥832 – ¥1,930
Dividend Yield	1.1%
Market Cap	¥305.98 billion

Financials (FY2012):

Revenue	¥218.29 billion
Operating Margin	7.2%
Net Profit Margin	3.2%

Valuation Metrics
(Current Price vs. TTM):

	7276:JP	S&P 500
P/E	18.4	18.5

7276:JP PRICE HISTORY

THE BOTTOM LINE
Things have turned for the better at the company almost across the board, but its stock still trades below the midpoint of its normal valuation range, says Alex Roepers. He expects that to change as the company leverages its global position in automotive headlamps to gain market share and increase margins. His one-year share-price target: ¥2,600.

Sources: Company reports, other publicly available information

attribution of that fund and found that our best returns have been at low-to-medium exposure levels, not when we're trying to time the market by going beyond that.

We're also generally paying more attention to volatility when sizing positions. While we look for companies with muted cyclicality, we do often find opportunity in those that go in and out of favor due to more macro influences. Joy Global [JOY] is an example, a mining-equipment company that has an excellent service and consumables business, but can't help but be impacted when order flow dries up on the new-equipment side. Our timing in Joy last year was less than ideal, as the weakening economic outlook in China weighed heavily on the stock. Still, the impact on the portfolio was quite a bit less than it likely would have been in the past, primarily because we sized the position smaller due to the stock's high beta.

You've said you were unhappy with your short performance in 2012 and made some changes as a result. What were those?

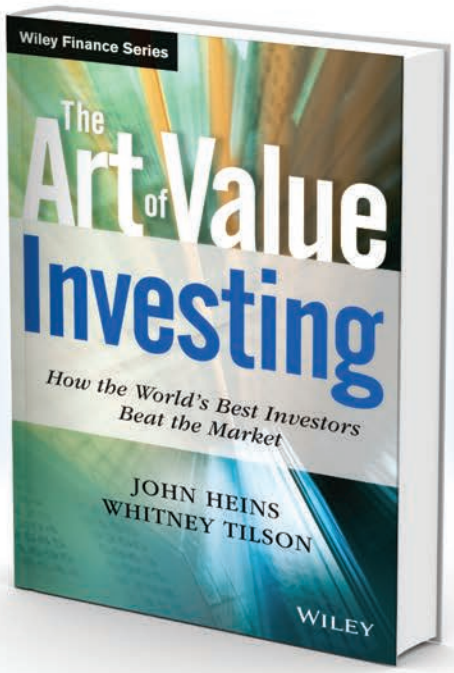
AR: In looking at our shorting history, one conclusion we've made is that the further we stray from our long universe, the lower the chances of success have been. We also changed our process to slow us down a bit on the short side. In the past, one of our analysts and I would discuss a short idea and if we agreed on it, it would go into the portfolio. Now the respective regional research directors get involved and have to sign off on short ideas in their region before they enter the portfolio.

You started Atlantic in 1988, at age 28, without any classical equity-investing experience. How has and hasn't that benefitted you?

AR: After business school I spent four years at Thyssen-Bornemisza Group, a large European industrial conglomerate that was transforming its portfolio of businesses. I worked in corporate development, so I spent a lot of time visiting manufacturing facilities and interacting with both top-level and line management. That helped me understand the daily challenges of dealing with unions, with distribution, with product development – all the nitty-gritty aspects of running a company. Appreciating what actually goes on inside a company has always been a benefit to me as an investor.

What I lacked going in was experience in managing a portfolio when the market made things challenging. I didn't know much about the importance of sizing positions, about holding cash when it made sense to do so, about shorting to mitigate risk. I've learned a lot over 25 years, but I'm still learning every day.

What keeps you sane in this business is staying within your area of competence and sticking with the strategy and discipline that you've proven works. That's not at all an argument for complacency or for being stubborn. But it means that once you can say you've done all your work, that you understand something very well and that you are convinced the value will come out, then you can stand there and say, "Bring it on, market." VII



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