October 2008

Our letter to you this July discussed Avenir Corporation's core investment principles as they related to the extraordinary turbulence we were experiencing. As we are all aware, economic conditions have continued to deteriorate, resulting in stresses to the financial system not seen since the 1930's. The trust you have placed in us is one we take with utmost seriousness. We are therefore providing you with this update discussing how recent events affect your portfolio and what we are doing in response.

Current Environment

While the current financial crisis has elements common to all credit crunches, the erosion of confidence in our financial system is without modern precedent. Bank customers fear for the safety of their deposits and money market investors wonder if their fund will 'break the buck.' Iconic American financial institutions have been forced to consider their own mortality and Blue Chip industrial companies have felt compelled to raise fresh equity capital. To date, taxpayer-financed government interventions have failed to cheer markets. In this environment, *nothing* seems safe and therefore a flight to cash is to be expected. It is understandable why some investors believe the system upon which they relied is no longer worthy of their trust. However, the seizure in the credit markets is far more a crisis of confidence than it is a shortage of capital. In such a time, investors must separate individual businesses from a flawed system of finance. The system serves the businesses, not *vice versa*.

The unfolding crisis reminds us of Warren Buffett's discussion of how his eventual successor should think about risk. Quoting from his Berkshire Hathaway 2006 Letter to Shareholders:

> *Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks* <u>*including those never before encountered*</u>*. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions.*

As usual, Buffett saw around the corner, and his foresight has positioned him to be the lender of last resort to some of the country's leading companies.

Our Approach

As you know, we are long-term investors and strive to invest in good businesses with good management that will compound capital over time. We screen an investment candidate for the economic earnings power of the enterprise and the skill and motivations of management. We then relate these factors to the price asked for the business and compare that to the return available from other investments and the rate of inflation. Great businesses run by great managers are difficult to find at an attractive price, and when we do find one, we buy meaningful amounts and tend to add to positions during down markets, so long as the fundamental investment thesis remains intact.

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In general, the businesses in our portfolio generate substantial economic earnings, have decent balance sheets and are managed by people who know how to allocate capital for the benefit of the shareholders in any economic environment. In the current environment, balance sheet strength is paramount, and well capitalized businesses with good cash flow characteristics will successfully manage through the down cycle and emerge stronger once the storm passes.

Opportunity in Prior Bear Markets

The average life of an Avenir investment is more than four years, which is an eternity on Wall Street. This lengthy holding period means our investments eventually are exposed to a number of external shocks, few of which can be anticipated. Several businesses we own have been through <u>all</u> the following events since first acquired: two wars in Iraq, a wave of savings and loan failures, the Russian debt crisis and near simultaneous failure of Long Term Capital Management, 9-11 and the recession that followed, the implosion of the dot-coms, and the Enron and WorldCom frauds and bankruptcies. Avenir made its best purchases during these periods of stress. Examples include our first purchase of one of our core holdings in 1991 when its Kuwait operations were shut down by the first Iraq conflict, effectively halting sales in its Mideast, African and Asian operations. Blind selling of energy and telecom stocks during 2002 permitted us to acquire additional shares of terrific businesses at valuations that come along once in a generation. This basic approach has served us well over our existence and illustrates a fundamental principle: value always wins in the long run.

Year-to-date, the great majority of our portfolio companies are performing operationally to the level of our expectations or above. Several are not, however, and we have made some mistakes along the way. But on a net basis, the managers of our portfolio businesses are delivering the goods for you.

Opportunity in the Current Bear Market

Bear markets often present the best opportunities. Last week, we met with the Chairman, President, and CEO of one of Avenir's largest investments by market value. The business owns and operates wireless communications towers and is in the center of our sweet spot. Its easily understood business model is marked by huge margins, low ongoing capital requirements, a deep and wide competitive moat, and a management team intently focused on per share value. One of the company's best attributes is the years of visibility in its contracted base of revenues. Cell phone carriers typically execute long-term leases for space on the company's towers on which to hang their antennas, meaning much of its future revenue base is known. This practice permits reliable projection of revenues and free cash flows for years to come. In fact, its contracted revenue base is more than *five times* its current annual revenue. Very few, if any, businesses, possess this predictability. Our major underlying assumption is that cell phone usage will continue to increase, a very reasonable and low-risk proposition. Despite the company's metronomic, bond-like cash flows, its share price recently moved down around 25% in a single day and remains depressed. This simply makes no sense. Its cash flows have not changed and therefore, its value has not changed. The company does not require access to the capital markets and is soundly financed. Its free cash flows conservatively support a much higher stock price in a few years' time.

Tower companies are largely immune to the current conflagration, and so are other major elements of the portfolios, such as our investment in the independent power sector. Indeed, an understanding of how an independent power producer rewards investors requires no heroic or complex assumptions. We are investing on the basis that consumption of electricity in energy-short parts of the world will continue to rise over the long-term. Unlike many of its peers, our investment operates on a contract generation model, which results in long-term, predictable, growing cash flows with very limited commodity risk. Yet, as commodity prices have declined over the past several months, the company's stock price has moved lock-step with its commodity oriented peers, declining this year despite its defensive nature and prolific and rising cash generation. The business is intrinsically worth more today than a year ago, was a bargain then, and is twice the bargain today. We note that recently insiders, including its CEO and President, have acquired a significant amount of stock in the open market. There is no more bullish sign. In a market where cash is king, those closest to this business are swapping cash for stock.

We are investors in companies, not in economies. That said, a functioning, if not healthy economy is a prerequisite for successful long-term investment. The major imbalances in real estate and mortgage markets have become like a forest fire that generates its own winds, advancing by tossing embers ahead of itself. Until the mortgage crisis is resolved to some degree, our businesses most closely linked to the health of the consumer or the economy in general will be under pressure. However, their share prices already largely reflect this likelihood and make them candidates for purchase, not sale. The critical judgment at this juncture relates to their balance sheet strength, especially the ability to meet debt service requirements. As we learned in the credit crisis of 2002, well capitalized businesses with good cash flow characteristics will successfully manage through the down cycle and emerge stronger relative to their competition.

We view equity capital as permanent capital and as such, always think about your portfolios in terms of five or ten years or longer and encourage you to do the same. Over that time frame, traditional banking is likely to be one of the growth areas in the economy. The so-called 'shadow banking system' – a term referring to the hedge funds, investment banks, and mortgage brokers who have spent 20 years taking market share from regulated banks by providing banking services on an unregulated basis – has crumbled. It is a sea change shifting momentum to the strongest banks. Deposits are flowing to these banks where they support sensible lending practices. We believe a bank that is healthy today should be worth multiples of its current price in five years, as it will attract an increased deposit base that will turn into well-underwritten, highly profitable loans. You should expect the well capitalized banks to remain among the most profitable financial entities in the US for years to come.

The magnitude and scope of the crisis understandably gives rise to comparisons with the 1930's and the Great Depression. We won't be surprised by a severe recession, but unlike the pernicious monetary contraction that took place in the 1930's, federal policy today takes the opposite approach. The Treasury and Federal Reserve have made it clear that they will provide the footings for recovery by supplying whatever liquidity is required to float the financial system. It is likely we will eventually pay a price in terms of higher inflation, but it is the right tradeoff today. We point out that for more than seven decades, wagering against the US economy has been a losing bet, and we suspect that this time is no different. Ownership of business interests remains the soundest method of accumulating private wealth.

Closing

We note that periods of doom and gloom are usually the best time to invest. The late Sir John Templeton's dictum to "buy straw hats in winter" is no less true today than it was in the 1930's when he was getting his start. Warren Buffett phrases it this way: "Be greedy when others are fearful..." and repeatedly cautions investors to expect a holding to decline by 50% at some point during the investing cycle. We have never seen more investment fear in our lives. This is not to say that the crisis will end soon, or end without more major dislocations. We do know that the brokenness of the financial system is a worldwide phenomenon, and that the broad acknowledgement of its sins and flaws in the U.S. is only a first step toward healing. But the size and underlying strength of the U.S. economy along with the sense of urgency and determination of its leaders strongly suggest that ours will stabilize first. Money goes where it is well-treated, and there remains no more hospitable place on earth for investment dollars. Since the stock market peers into the future, it is likely to begin its recovery before the economy does. Thus, we have confidence that the investments we make during this wrenching period will reward us for many years to come. There may be more pain to come, but when the rewards come, they will come quickly.

Economic phenomena such as today's credit crunch are transient in nature while the principles of wealth creation are permanent and unchanging. A financial system weakened by lax lending standards does <u>not</u> necessarily translate into weak businesses or a permanent reduction in business values. Great businesses run by great managers coupled with strong capital structures remain the best path for capital preservation, inflation protection, and wealth-creation. We believe you own pieces of a number of such businesses and our confidence in them is high. Our personal fortunes are staked to the accuracy of this statement.

We thank you for your steadfastness in the face of recent events. We know how unsettling, even stunning they are, for we own precisely the same businesses and share your investment outcome. We cannot predict the depth of the crisis or the timing of its end but are confident that our system of finance will emerge stronger and cleansed of the toxins that are bringing it to its knees. In the meantime, our businesses as a whole are positioned to survive and compound value over the years to come at rates we believe you will find attractive. We urge you to contact us with any thoughts or comments.

Respectfully,

Charles G. Mackall, Jr. Peter C. Keefe James H. Rooney