

# AVENIR CORPORATION

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## INVESTMENT MANAGERS

September 2009

Two years have passed since the residential real estate bubble burst, causing a series of credit market seizures that tumbled the world economy into its most violent and destructive downturn since the Great Depression. At various times between the bankruptcy of Lehman Brothers in September, 2008 and the bottoming of the capital markets in March, 2009, our systems for banking and credit verged on collapse. At the moment of greatest intensity in March, fear of systemic failure sent yields on U.S. Treasury Bills *below zero* as panicked investors stampeded into this safest of havens, the only time this has happened since the Great Depression. About the same time, the series of massive financial backstops and guarantees implemented by the Federal Reserve and U.S. Treasury quietly began to take hold, a trickle of credit began to flow, and the crisis began to ebb. Recent economic signals suggest that the economy is indeed stabilizing, and credit markets are beginning to function more normally, albeit with continued nursing from the federal government. In response, investors betting on recovery have sent the S&P 500 up more than 50% from its March low.

As you know, what we experienced was not a cyclical recession or ordinary bear market, but the sudden unwinding of a decade of debt-related excesses. Some of them were visible, such as the subprime mortgage buildup, and some were unseen, such as insurance giant AIG's \$100 billion-plus exposure to the credit default swap market, a potential liability that somehow never made it onto the insurer's books. The causes and ongoing cures of the financial crisis have left lasting marks on our economy and financial markets, and as we emerge from the immediacy of the most acute stage of the crisis, it is important that we assess these fundamental shifts and ask what they mean for Avenir investors. In responding to the 'where to from here?' question, Berkshire Hathaway Chairman Warren E. Buffett notes that unpredictable side effects are certain to stem from the unprecedented doses of monetary medicine that have been required to save the financial system and avert a deflationary spiral. These effects, he says, are "invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself." Specifically, Buffett is concerned about the long-term impact of the "whatever it takes" increase in the money supply and federal deficits that were necessary to head off financial meltdown. Such consequences may include higher inflation, higher interest rates, and a weakened dollar versus foreign currencies, and have already resulted in larger deficits and greater federal debt. We take these threats seriously and are concerned that they may imperil the tentative recovery that seems underway.

### **The Current Environment**

The current environment contains many economic headwinds. Foremost is the expansion of government borrowing. The federal deficit as a percentage of Gross Domestic Product will rise to 11.2% this year, twice the previous record excluding World War II. Our federal indebtedness will rise by more than \$1.6 trillion this year to a total exceeding \$11 trillion, or more than

\$30,000 for every person living in the United States, and this figure does not include the present value of future liabilities for healthcare and retirement entitlements, which means that the real debt level is considerably higher (note that accounting rules do not permit public companies to ignore this cost). Moreover, on August 25th, the White House issued a projection that over the next decade, the deficit will grow an additional \$9 trillion, all of which will need to be financed or printed. For comparison, federal revenues are less than \$2.5 trillion annually. From a cash flow perspective, it is not a pretty picture. Ironically, our federal financial statement looks as bad as some of the companies we have rescued, but unlike those companies, our government has the power to print money.

Increase the supply of anything and its value is reduced. In the present case, the dramatic increase in money created to shore up our financial system may have undesired inflationary effects by reducing the dollar's purchasing power. In compensation, foreign entities which finance our budget deficits by lending money to our government may demand higher interest rates, further pressuring our federal deficit and pushing interest rates higher across the board.

For many years we have imported more than we have exported. The net difference equals our trade deficit, or the amount of U.S. financial assets we permanently shift overseas largely in return for impermanent goods like autos, televisions and, especially, oil. Last year, this deficit totaled nearly \$700 billion. While a decline in the value of the dollar will theoretically help mitigate a portion of the trade deficit, it will likely also fuel inflation as imports become more expensive. Moreover, because oil is traded in dollars worldwide, a weakening of our currency will result in higher oil prices for U.S. consumers relative to other nations, further fueling domestic inflation. The trade imbalance with respect to oil is a particular concern. We can add nothing to what has been said and written about oil and its importance to our economy and national security, but no thoughtful investment approach fails to take another oil shock into serious consideration.

In addition to monetary concerns, we envision an extended period of lackluster economic growth, which combined with high unemployment and excess capacity, will mitigate some price pressures until the recovery firmly takes hold. Consumers account for approximately 70% of economic activity, meaning most economic growth is a function of increased consumer spending. Chastened by the economic crisis, consumers today are paying down debt and saving more while spending less. A rising savings rate is good for the household balance sheet but bad news for the retailer. And such a shift could be lasting, as it was following the Great Depression. Consumers burned by the easy credit policies of the past decade are unlikely to soon forget the painful experiences of the past two years and can be expected to exercise more spending discipline. Businesses are similarly likely to be more restrained in their capital spending programs, which can be positive for investors as those capital programs that do get funded are likely to have higher returns. In addition, one counter balancing effect is that fierce competition to pry open the purse of a warier consumer may help keep a lid on inflation while squeezing corporate profits. It's hard to raise prices when nobody is buying.

While the financial crisis caught fire in the residential mortgage market, it may burn out with commercial real estate. There are two big risks present in commercial real estate that are recognized but have yet to play out. First, lenders are experiencing defaults at an accelerating rate due to the weak economy, compounded by the generally poor underwriting standards that prevailed in recent years. Secondly, the ability to refinance the hundreds of billions of dollars

worth of commercial mortgages that mature in the next three to five years, many of which were originated at the peak of the bubble during 2005-2007, is virtually non-existent. Given the declines in commercial real estate values, estimated by some to be as great as 50% in some cases, even high quality borrowers with performing properties may not be able to refinance the full amount owed due to lower values and tighter underwriting standards. Additionally, over the past decade many commercial real estate loans were packaged into commercial mortgage backed securities (CMBS) and sold off in pieces to investors. These securities have a structural flaw in that they never contemplated the refinancing problems described above and lack a mechanism for dealing with them on any scale, unlike banks that have workout departments established specifically for that purpose. This has been visibly demonstrated through the bankruptcy of General Growth Properties, the largest real estate failure in U.S. history.

### **Investing in the Current Environment**

Before we discuss how our choice of investments reflects this new environment, it makes sense to briefly restate our core investment principles. Avenir Corporation seeks to invest in outstanding business franchises characterized by a durable competitive advantage, run by talented, honest, shareholder-oriented managers. Further, we seek understandable businesses that do not require significant ongoing capital reinvestment, permitting its managers flexibility in allocating the substantial amounts of free cash flow such businesses tend to generate. These free cash flows tend to be persistent, measurable and predictable. As we have discussed in the past, we utilize the intrinsic value standard in valuing businesses, capitalizing expected free cash flows over a long period of time, and discounting them back to present value. Most important, we seek to buy the securities of these businesses at a discount to our appraisal; in other words, we seek to buy dollar bills with fifty cent pieces and embrace a 'go-anywhere' approach within the confines of our margin of safety discipline. In short, we look at equities as bonds with irregular coupons. While our investments are concentrated in companies domiciled in the United States, we will invest anywhere around the globe and are not restricted by capitalization. Moreover, many of our U.S. based holdings generate more than half of their revenue overseas.

Our approach assumes that no one can consistently predict the direction of interest rates, inflation or the markets in general. As previously noted, however, we think common sense favors an inflationary bias in our investing for the foreseeable future. Periods of inflation tend to favor businesses with pricing power and hard assets. The best investments are those that do not require that we make any inflation assumptions, and over time, our finest investments have been those that have demonstrated the ability to plow ahead even in the face of general economic hardship. In 2008, two of our largest investments did exactly that. Both of these companies grew their businesses per our expectations despite the financial crackup. Each was worth intrinsically more at the end of 2008 than they were a year before. Each continues to perform well in absolute terms and is correspondingly worth more today than they were at the end of 2008. To differing degrees, each has the ability to raise prices and generates significant revenues in foreign currencies, providing some measure of inflation and currency protection.

Given our comments on consumer spending, you may find it surprising that some of our businesses are directly linked to the health of the consumer. Bear in mind that while the consumer is stressed and spending less, consumers still account for two-thirds of a \$15 trillion economy, and \$10 trillion is still a lot of volume. Examples include an automotive retailer and an outdoor advertiser, both of which have been hit harder in the past year than they have in decades.

Even so, we remain investors in these businesses because each company possesses a unique and enormously valuable business franchise that even in periods of economic weakness generates decent returns on invested capital which will expand to superb levels once modest growth resumes, which it eventually will. Our automotive investment has developed a unique manner of retailing used cars and maintains a dominant position in the wholesale used auto market. In addition, its nationwide assemblage of specialized real estate required to operate its business creates a nearly insurmountable barrier to entry. Similarly, billboards are attractive because they possess a pair of durable advantages no other traditional media format has – unavoidability and scarcity value. The fragmentation of media over the past decade means you can avoid most advertising messages by changing the radio dial, listening to an iPod or commercial-free satellite radio station, or recording a favorite television program and fast-forwarding past the commercials. Consumers are increasingly elusive prey for advertisers, increasing the appeal of billboards as their audience of auto travelers is literally stuck behind the wheel. Meanwhile, the difficulty in obtaining the permits necessary to build new billboards constrains supply and highlights the value of existing locations. Outdoor advertising is essentially unchanged in 100 years, so we note with irony that Google, the symbol of advertising in the digital age, has rolled out a billboard campaign promoting its ‘Apps at Work’ initiative, which targets Microsoft’s Office product. In summary, we own these two businesses because their franchises provide a high-margin claim on basic consumer needs that will persist long into the future.

At this point in the cycle, the franchise characteristics of a business are more discernable than ever, and the businesses we own, typically prosaic in their natures, are essential to either consumers or the industries they serve. They have been carefully chosen based on Avenir’s investment criteria and we are comfortable owning and buying them at today’s prices.

Earlier this year, frozen credit markets provided us with a handful of superb opportunities in high yield fixed income and income producing equities. We deployed a meaningful amount of capital in the bonds and preferred stocks of issuers whose common stock we own and know well. We have also been quite active in a handful of pipeline companies which are structured as master limited partnerships. Often, our purchases were made at distressed prices which provided cash yields in the teens and higher.

Markets often get it wrong, dramatically over - or undershooting fair value. The recent 50% rise in major indices should not be mistaken for evidence that economic growth is returning. More likely, prices at the March lows represented extreme undervaluation stemming from the intense fear of economic failure that gripped investors. Remember that at the time, GE could not refinance its maturing debt without governmental assistance. A company that cannot pay its debt falls into the hand of its creditors and existing owners get wiped out. If GE is worthless, who is not? Such fears were not entirely baseless but governmental intervention has taken the ‘Armageddon trade’ off the table, so some significant value restoration is appropriate.

In summary, we have a constructive view of the investing climate but remain cautious, as evidenced by the elevated cash levels we carry in portfolios. We do not confuse the recent rally for an ‘all clear’ signal and have outlined the issues that cause us significant concern. Nonetheless, we are highly optimistic over the long term for a variety of reasons. First, stock prices are absolutely low in many cases. The major indices are selling for less than they were ten years ago and a third less than their record highs. The bargain bin has been somewhat emptied by

the big runup but prices for many securities we favor still imply good returns. Second, the economy is never static because businesses and consumers are never static. Virtually every business that has survived the financial emergency has emerged leaner, more focused on expenses, and is competing fiercely for scarcer customer dollars. Businesses will adapt and shift. Pools of capital will be formed to take advantage of distressed businesses and industries. Innovation will continue and the economy will recover and grow. Third, foreign economies, particularly those in emerging markets like China, still have a thirst for our products and technologies. Remember that the United States accounts for a quarter of world economic activity. We remain the world's economic powerhouse (but we ought not take that for granted). Lastly, betting against the United States has always been a loser. Our culture of freedom and entrepreneurship makes this the destination of choice for immigrants around the world. Our economy and financial system may need an overhaul, but this remains the land of opportunity.

Avenir's style of investing in a handful of carefully chosen and well-understood compounding machines is an advantage in the environment we envision. Even in a no growth scenario, companies that generate substantial free cash flows and are run by managers skilled in capital allocation will be able to compound per share value over time. Our businesses are far better than average, and if we buy them at the right prices, we should generate far better than average returns.

We are grateful for the privilege of managing your assets and appreciate the graciousness you have displayed over the past two years. The turmoil of 2008 and early 2009 was a trying period for all investors, ourselves included, and we are applying the lessons learned to build better portfolios. It is worth mentioning, as we have in the past, that we own exactly the same securities you own. Our fortunes are yours. Thank you again.

Respectfully,

Charles G. Mackall, Jr.

Peter C. Keefe

James H. Rooney

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