



The Quality Alternative

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The Big Reset

Global equity market participants have managed to exhale since early March, as the abyss many justifiably feared now appears remote: the depth of economic and financial market despair is likely behind us. Nonetheless, the reasons symptomatic of the 2008/early 2009 near meltdown have not vanished, and reminders of that fragile interval will be apparent over the course of the next several quarters if not years. The Big Reset is upon us, the manifestation of which has been captured by pronounced declines in most major asset classes from prior cycle highs, and substantially pared expectations for global economic growth. Unprecedented actions have been instituted by central bankers to arrest the decline in economic aggregates, and many of these efforts involve a high degree of cross-border synchronization – a tacit acknowledgment that we're all in this together.

The Obama Administration has put forth a number of bold measures, and the United States Treasury together with the Federal Reserve mobilized to aggressively implement policy directives. In effect, the appetite for leverage between the private and public sectors is in a rather abrupt upside down phase: after years of heightened debt accumulation collateralized by unsustainably inflated asset values – predominantly, though not exclusively, residential fixed investment – consumers are by necessity and fear determined to replenish depleted savings in the process of restoring the household balance sheet.

The unintended consequences associated with the transfer of massive leverage to the public sector have yet to be clearly understood, much less defined. Left unchecked, the sequential and eventual conclusion would seem to suggest meaningfully higher inflation – typically true when the U.S. Treasury financial printing presses are working overtime. We expect policy makers to gradually pull in the reins to avert a late 1970s inflationary relapse; when implemented, parallel fiscal and monetary tools will temper economic growth below GDP equilibrium (3-3.5%) over the near/intermediate term.

We believe HS Management Partners' manner of investing has the potential to excel in such a climate.

Our Philosophy

The blueprint for conditions both economic and financial in the next several years will be contoured by the severe dislocations of the past 18 months. We believe our singular product focus - and the discipline we employ to maintain perspective when all is swirling about us - is a notable advantage in such times: call us realistic optimists. Realistic in that a bet against the end of civilization – as some postulated just a few short months ago – has never been a smart wager. Optimistic enough to appreciate that the “back to basics”

philosophy will significantly redirect the real/financial world order, that the road ahead is apt to be long while difficult to scale, and that those who understand and embrace such change will, with prudence and patience, enjoy ultimate reward.

HS Management Partners' approach is unwavering, our conviction high, and our resolve to manage client assets to the best of our ability never greater. We are intrigued by the many attractive equities in the marketplace, opportunities that engage our balanced approach to identify beautiful business models at compelling valuations in an effort to attach client portfolios to an earnings and cash flow stream that grows consistently over the long term. Our portfolio holdings share commonalities: superior managements, fortress balance sheets/demonstrated free cash flow, highly recurring (and customer diverse) revenue streams, and meaningful - albeit attainable - growth prospects. In many respects, we contemplate what we choose to own based on an understanding of and appreciation for the underlying business. That is, we think as owners of an enterprise first before qualifying its attractiveness as a security: evaluating equities to be included in a concentrated portfolio through that lens removes much of the fog that otherwise clouds prudent investment judgment.

Our quest for beautiful business models attracts us to certain sectors while dissuading us from considering others. Consequently, our portfolio design is not intended to mimic an index or to seek broad sector representation; rather, the design of our portfolio – as an outgrowth of our repeatable and collaborative process – leads us to favor best in class businesses within and among specific industries.

Everything Old Is New Again: Cash (Flow) Is King; Quality Growth Wears the Crown

Within the context of these thematic considerations, our portfolio is defined by a non-negotiable “fundamentals first” philosophy of arriving at the appropriate balance between risk and reward in a concentrated portfolio. We have long prized balance sheet transparency and the ability of our portfolio companies to generate meaningful free cash flow; we believe these attributes are likely to be more richly appreciated by investors, a condition that could produce improved valuation/capitalization rates to accompany what we expect to be a comparatively resilient cash flow profile in the near term, and a growing store of value over time. Considering that our portfolio trades at a weighted average multiple approaching 15x estimated forward 12-month earnings (as of the end of May), a valuation towards the lower end of the historic range, we believe the prospect for positive multiple revaluation is quite possible from here.

Equity market participants are painfully aware that the affinity for highly leveraged business models (and the second derivative, high returns on comparatively low invested capital balances) was ultimately misplaced. The relevance of financials – the poster child of leverage – is illustrative. Nearly 20 years ago, in 1990, financials represented 7.5% of the S&P 500 market capitalization; by year end 2006, financials occupied 22.3% of S&P 500 capitalization, a position that has since wilted to 13.5%. It seems reasonable to anticipate that the swoon in financials will not soon be erased from the collective consciousness, a lesson that will be replaced by an emphasis on balance sheet integrity and cash flow self sufficiency.

Invariably, secularly attractive businesses with appropriately derived models produce significant sums of free cash flow even after substantial core reinvestment, yielding balance sheet strength, financial flexibility and an ability to reward shareholders through multiple means – strategic acquisitions, dividend increases, and share repurchases. Independent of the resiliency/convenience of the product offering (Wal-Mart, McDonald's), the relevancy of the service (Google, Scripps Networks) and/or the valuation opportunities afforded by market distress (Time Warner, Abbott Labs), consistent and abundant excess cash generation is a shared hallmark among these otherwise disparate businesses. On average, the free cash flow yield of the equities populating client portfolios' equals 6.1%, highly attractive from a historical perspective.

We anticipate free cash flow will be deployed judiciously to conclude strategic M&A with diminished competition from the sphere of private equity (a victor of the leveraged era), offering the specter of more attractive acquisition prices than were practical for much of the past decade. Lower acquisition multiples translate to higher returns on invested capital, a key component to enriched valuation.

Our penchant for attaching client portfolios to an increasing earnings/cash flow stream at reasonable valuations is buttressed by a 2.2% weighted average dividend yield – more than 2x the paltry 92 basis points commanded by two year Treasuries. In a climate where dividend reductions have become more customary, 12 of the 16 names we currently hold that pay a dividend have raised payments in the preceding twelve months. That 75% success rate contrasts favorably with the declining number of dividend paying companies comprising the S&P 500 (362 currently, down from 390 at 12/31/07), and the incidence of dramatic reductions now taking hold. For example, in 2008, 62 companies reduced dividends by a total of \$40.6 billion – a record annual amount. Thus far in 2009, 63 companies have reduced dividends by \$46.3 billion – eclipsing the previous annual high in less than 5 months.

As shareowners, we prefer excess flow be deployed in a balanced manner, with growth initiatives (organic expansion/M&A) and a rising dividend stream complemented by share repurchases when such applications can be executed opportunistically and offer attractive returns on capital employed. With meaningful authorizations in place among the majority of our portfolio companies, we anticipate repurchases will be concluded judiciously given the opportunity presented by market forces, the recent rally notwithstanding.

Real cash flow does have its advantages.

This Time Is No Different

Amidst unparalleled economic and financial turmoil, we would submit that this time is no different: more extreme? yes; different? no. Economic and financial market dislocations have existed since the creation of economies and financial markets, and the crisis is often calmed by a return to fundamental, bedrock investment principles.

We believe the structural damage imposed on Wall Street (and Main Street, courtesy of Wall Street) has altered temperaments in a serious and potentially lasting way, and that highly leveraged, illiquid, and mysterious investment instruments offering the prospect of non-correlated, absolute returns will yield to the timeless virtues symbolized by well capitalized, highly liquid, and easily comprehensible vehicles: quality growth equities represent the quality alternative.

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