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Bottom-Up Approach to Finding Undervalued Names

BEN CLAREMON & EUGENE ROBIN, COVE STREET CAPITAL, LLC

BEN CLAREMON joined Cove Street Capital, LLC, in July 2011 as a Research Analyst after graduating with an MBA from the UCLA Anderson School of Management. Previously, he worked as an Equity Analyst on the long and the short side for hedge funds, Blue Ram Capital and Right Wall Capital in New York, and interned at West Coast Asset Management in Santa Barbara, Calif. His background includes a B.S. in economics from The University of Pennsylvania's Wharton School, followed by four years with a family commercial real estate finance and management business. Mr. Claremon is also the proprietor of the value investing blog, "The Inoculated Investor."

EUGENE ROBIN, CFA, joined Cove Street Capital in July 2011 as a Research Analyst from Proton Capital, a family office, where he developed investment ideas in public and private markets. He was also responsible for vetting and monitoring investments in the alternative asset space. Mr. Robin holds an MBA from the UCLA Anderson School of Management, a computer science degree from UC San Diego and received his CFA charter in 2011. He previously worked at ViaSat Inc. as a Software Engineer.

SECTOR — GENERAL INVESTING

(ADK504) TWST: Please give me a little bit of a background on Cove Street Capital. How long has it been around and how big is it?

Mr. Claremon: We launched July 1, 2011. Our Founder is Jeffrey Bronchick who was the Chief Investment Officer at a much larger firm called Reed, Conner & Birdwell Investment Management. He started there and in the late 1980s, and he moved up the chain to own almost 30% of the firm and be the Chief Investment Officer. It had an interesting management structure, where it was mostly owned by Jeff, an older partner and City National Bank. That complicated management structure was figured out by a sale. So RCB was sold. Jeff basically negotiated to take assets and some people with him, and that is where Cove Street started.

Eugene and I met Jeff in the middle of this process and he brought us on board on day one. The firm is owned by Jeff and his partner at RCB, Daniele Beasley. So Jeff has been in the business 28 years, and Daniele has been in operations, compliance and management for over 20 years.

We focus on institutional clients. We are about 75% institutional, 25% high net worth. We have three strategies. Small Cap Value, All Cap, which is a best of strategy, and then Strategic Value, which is an absolute-return, balanced strategy. We run separately managed accounts and subadvise two mutual funds — the Cove Street Capital Small Cap Value Fund and the Litman Gregory Masters Smaller Opportunity.

We are bottom-up research gurus. There is no macro. It's all bottom up, all trying to figure out where value is. We do a lot of searching through filings. We do modeling. We talk to industry people. It's all really just trying to find the best combination of business, value and people.

We have a more concentrated portfolio than you will see other people have. We concentrate on our best ideas. We try to distinguish ourselves by the depth of research. I think that our core competencies are the depth of our research and our contrarian nature. In this market, the contrarian position is often that you have a longer-term outlook and that is what we do. We try to find things that are undervalued, that may not have an immediate catalyst, but that we are willing to wait for. We believe the market, especially in these times, is not really willing to wait and that is often the opportunity.

TWST: Please tell us about the firm's investment process.

Mr. Robin: Besides the core competency of in-depth research, I think what separates us is also the fact that we have a very repeatable process that we go through. The first thing that we do within that process is generate ideas. Generating ideas happens often through mechanical means, which includes screening through tools, like Capital IQ, where we look for cheap companies that come up on cash flow or free cash flow yield screens or enterprise value to EBITDA screens or share repurchase screens — things like that. They come in automatically every Friday, and we basically have a really quick review on Mondays, where we sit down and go over what we saw and whether or not there is something interesting that we found. That's one way we try to generate our ideas.

Another way is basically through contacts. Jeff has been in this business for a long time and he has dozens, probably hundreds, of contacts across the investment management industry, as well as in the segments and sectors that we look at, at large. So he'll get ideas from a pretty diverse set of people.

Generally, ideas come in very randomly and in bunches. Additionally, sometimes the two of us will organically develop ideas. We might not have as much experience as Jeff, but we also have networks, and they sometimes provide interesting things to look at. Not to mention the fact that during conversations with management, we often get introduced to channel partners or even competitors that might offer an interesting value proposition.

When it comes to screening, besides Capital IQ, we have other things that we use, like the Economic Margin measure that's been defined by a company called AFGView. We screen through segments, or sectors, and divide the companies by this measure in a graphical format so it's easy to see what's trading cheaply. That's another thing that we like to look at.

The next step after we generate an idea is to do a data download into our internal spreadsheet, which probably incorporates 70% of the data we need to understand the fundamental history of the business, the current valuation and the management's track record. This is a really quick way to dig into a company and to see whether it's even worthwhile to perform further research. It helps us to understand whether this is a typical cyclical company, call it a "Ben Graham" company, that we are looking at or is this more of a "Warren Buffett" company, where there is consistency and an identifiable moat that creates a compounding machine. It helps us understand the company and to figure out what questions we should be asking.

In addition to a data download, we also obviously read the 10-Ks, look at the last few Qs, read transcripts, and get a better idea or understanding of what the company is all about. That transitions into the third step or what we call the team tackle and deep dive. We divide into two long analysts and one short, so that we approach the work with a balanced view. The real work consists of everything that I just talked about in terms of public filings, reading over transcripts, listening to analyst day calls, talking to management.

And we definitely do talk to management. We might not believe them all the time, but we definitely talk to them to get a sense of their game plan. We also look at their competitors, customers and suppliers, and try to assemble a somewhat organic, Porter's Five Forces-like view of the business. We have several models that autopopulate from Capital IQ, and with that, we get numbers working and get a better understanding of what the company has done and what it might look like going forward.

On top of the typical DCF analysis, we will also try to triangulate the value by bringing in things, like multiples analysis, and we have a tool that helps sift through the fluctuations, historical fluctuations, specifically for cyclical companies, where their multiples move around a lot. The tool basically cuts off one standard deviation around the general population mean, and helps you to get a relatively good, normalized multiple for a cyclical business. Usually, cyclical companies will look really cheap at the one extreme and look very expensive at the other. So we are trying to get a normal value that we can use to get an estimate of a baseline value.

That sort of analysis we perform on other noncyclical companies as well, in order to triangulate a value and not to rely exclusively on DCFs because, as we all know, those can be very sensitive to assumptions that change your entire value.

We look at private market values as well. What would a strategic buyer pay for this business? It's better to have several different ways to look at valuation than just to rely on a single one. Another one that we like to look at is the sum-of-the-parts approach, specifically for businesses that have several segments that you can break out and find public companies that are comparable.

After the deep dive, we aggregate all these data points in our own format and we put them into a central summary spreadsheet we call a decision process. It's basically every single nuance or detail that we can think of about a company. So an analyst fills out every single piece of information within the spreadsheet, and when we go to present it at our investment meeting, we sit down and actually look at each spreadsheet and all the details contained therein. It helps us track our thinking about an idea or a current position and also keeps you honest. Sometimes an analyst presents a company, and then, five months later, when something doesn't work, they can always say, "Well, I didn't say that." Well, in this case, we definitely keep track of what you did say and what you didn't say. It helps us flush out mistakes because you learn by making mistakes, and it helps you track your own thought process and to see whether or not certain

Highlights

Ben Claremon and Eugene Robin of Cove Street Capital describe the firm's investment approach and process, which is based on in-depth research and contrarian thinking. They discuss how the firm searches for undervalued names and companies that are considered out of favor, such as opportunities in financials. The pair also offer some of their favorite names in holdings. Companies include: White Mountains Insurance Group, Ltd. (WTM); Approach Resources (AREX); Central Garden & Pet Co. (CENT) and The Scotts Miracle-Gro Company (SMG).

things that happened to the individual equity were foreseen by us, or at least, whether or not we thought about it. We do that in an attempt to try and not make the same mistake twice. No one's perfect but the key to long-term performance is to learn from those mistakes.

Mr. Claremon: "In the process of finding things that are undervalued, we will look for things that are out of favor. So let me put this way. We don't really look at industry sectors, concentrations and correlations. What we are looking at, in general, is for undervalued securities."

Jeff likes to call this spreadsheet the "every mistake I ever made in my life" spreadsheet, and that's basically what it is. For us, it's great because it helps establish a reference point for each individual company that we look at as it evolves over time. You can use the shared knowledge that you gain from past experience to guide your analysis of the next company. Like I said, you learn from the past and you apply it to the future.

I think what is really interesting is that all three of us are in the same room, and we debate the equity, with one analyst as the short guy. We arrange the discussion so there are two analysts, one lead and one supporting, and then, there is one short analyst on each company that gets to team tackle and deep dive with a short bent. The short analyst is basically trying to poke holes in everything that the long analyst is saying, and this is a really interesting idea that we came up with because it helps us to think outside the box. Long-biased managers tend to get locked in to the bullishness that is embedded in being long only. What we have tried to accomplish here is to create a situation where we're forced to defend the thesis against the short's attacks. Just to keep anyone from being pigeonholed, we constantly rotate who the short is. It's a good way for us to get a good discussion going and to find things that we haven't thought about. If you are the lead analyst, it's really useful, in general, and a ton of fun.

Finally, within the process, the very last stage is portfolio consideration. At the end of the team tackle and deep dive, everyone gets to submit an opinion. So Ben and I will say, "OK, well, we should buy this at price 'X,' and that's our opinion." Jeff makes the final decision, but all of our opinions are put into the central spreadsheet, and it helps Jeff track his own thinking, as well our thinking, over the course of a stock's lifetime within the portfolio. Jeff has to make the decision whether or not this is a full position, which is roughly 5% at cost of the portfolio or half position, which is 2.5%. A 2.5% position is something that might be a great idea, but probably not to the degree that a 5% position will be in terms of the risk/reward profile.

In general, we don't do any fancy correlations or things of that nature in terms of portfolio construction because, in the end, it really comes down to picking your best ideas and sticking with them. We make sure we're not using the buckshot approach to portfolio construction of having 60, 70, 80 different positions, but instead concentrate on 25 to 30 that we know really, really well and that we have conviction on.

TWST: Looking at the small-cap value fund, as of March 31, 2012, financial services was Cove Street Capital's largest sector holding. Does the firm look at sectors, or does it simply happen that it has a lot of companies in that sector in the portfolio?

Mr. Claremon: In the process of finding things that are undervalued, we will look for things that are out of favor. So let me put this way. We don't really look at industry sectors, concentrations and correlations. What we are looking at, in general, is for undervalued securities. That's going to lead you to places where other people are not — things that are hated, things that are unwanted.

If you think about the last three, four years, I think that one area that has been hated the most is financials. And so it shouldn't surprise you that we are very selectively looking for an opportunity in the financials. We are certainly uncomfortable with certain companies, and then there are just certain other ones that we can get a little more comfortable with.

The quick answer is that we are looking for stocks that are cheap and not in a specific sector. We would be cautious not have 50% weighting or 25% weighting in a single sector, but sectors aren't really our main consideration. It shouldn't surprise you that we are going toward things that are generally disliked.

Mr. Robin: Jeff puts it really well when he calls it value clustering. A lot of times, things are thrown out together. For example, right now, the market hates natural gas. Every single company that is a natural gas producer is lumped into the short or sell natural gas trade. You throw the baby out with the bath water, and a lot of times people overlook great companies just because that particular segment is hated.

1-Year Daily Chart of White Mountains Insurance Group, Ltd.

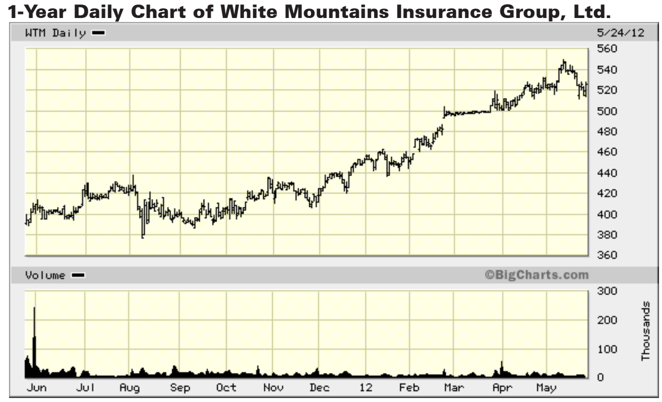

Chart provided by www.BigCharts.com

It may look like we are concentrating on a specific sector, but in reality, it's just because we found three or four really great ideas that are really, really cheap, and the reason why they just happen to be in the same sector is because, currently, that sector is hated and the value comes up from there.

TWST: One of Cove Street's top holdings as of March 31, 2012, was a company called White Mountains. What does

that company do? And what is it that made it a good holding for the firm?

Mr. Claremon: White Mountains (WTM) is an insurance company, and it has been one of our favorite positions. We're all generalists, all three of the analysts, but there is a lead analyst on each company. We have drifted toward areas of interest. Eugene covers energy, defense and tech, based on his background in the satellite industry. I am covering anything having to do with consumers, media, anything in the housing food chain and the banks. Jeff drifts toward health care, non-bank financials, which includes insurance companies, and industrials. Jeff is the lead analyst on **White Mountains**.

Mr. Robin: "For me, I stumbled into energy and became intrigued by the different parts of the energy complex, which have very different value drivers. And for me, my favorite name is a company called Approach Resources."

It is a "Buffett Stock" insurance company. It is a very expensive stock — which often keeps people out — not as to the valuation, but in terms of the dollar amount. When you see a stock with a price in the hundreds, often people get nervous about it. The insurance play — especially in the property and casualty space — is that eventually you're going to a harder market, and these things are going to trade at their book value or premium to book value.

We really like the management team at **White Mountains**. They are incredibly liquid after the sale of their **Esurance** at a terrific multiple, and we're willing to sit here and wait for a better insurance cycle and for them to put the money to work. Given the state of the world today, there should be a lot of opportunity. In the meantime, they have repurchased almost 20% of their shares in the last two shares at a discount to book value, which boosts the intrinsic value of the remaining shares. Jeff is very comfortable with insurance, and this is one of his favorite names.

TWST: Would each of you give me one of your favorite names?

Mr. Robin: For me, I stumbled into energy and became intrigued by the different parts of the energy complex, which have very different value drivers. And for me, my favorite name is a company called **Approach Resources** (AREX). It's a small-cap E&P company that operates in West Texas, in the part of Texas called the Permian Basin. This is probably the hottest play in all of the U.S. When they started originally, they were kind of marginalized because people thought it was so far away — the Southern Permian — and no one really gave them a shot. People thought they were a typical gas producer, so they drilled very profitable gas wells that weren't that exciting, and people passed them over.

But in the process of doing gas drilling, they kept drilling through different zones of shale rock, and back in mid-2000s, horizontal drilling, or fracking, as they call it now, didn't exist in the same sense that it does now. The technology wasn't there to extract that shale. But luckily for **Approach**, the horizontal revolution became available to them roughly in 2007 and 2008, when everyone started to figure out ways to get oil and gas out of shale rock.

What **Approach** had done by that time was drill roughly 600 wells through multiple pay zones. That helped them acquire land at an average of about $300 an acre, which, just to give you a relative data point, right now, roughly within a mile to 10 miles of their acreage, depending upon where you are, leases from The University of Texas have gone from $4,500 to $7,000 an acre. So it's a pretty good investment when you can buy at a price of $300 an acre, and now people around you are buying the same land for 10 to 20 times what you paid.

Approach, right now, is in the process of drilling out their horizontal wells in the northwestern part of their acreage. They started off very slowly, which is why the stock languished for the early part of 2010, and again, in the middle of 2011, as people were doubtful of management's ability to execute on the plan that they put forth. After the first four horizontal wells came in subpar, they made some tweaks and continuously tried to improve their drilling methods. Now, they have basically beat every single type curve that people have put out for the Wolfcamp play with each of their newer wells.

So **Approach**'s well results have more than surpassed everyone's expectations, and thanks to the fact that they're coming in predominantly oily, the company has been put on the map as a real operator. The stock took a great run and has fallen back as of late because the energy complex sold off recently. But, in general, at an $80 oil assumption with $3 gas, you're still looking at something that's easily worth more than where it's trading at. You could even get higher valuations if you assume higher oil prices because the wells that they're drilling now are roughly 80% oil. So it's not a gas company anymore. It's really transitioning into a oil play.

1-Year Daily Chart of Approach Resources

Chart provided by www.BigCharts.com

I try to temper my enthusiasm. Sometimes, I think analysts get ahead of themselves, and they try to assume $95 oil, $100 oil growing out at the strip price, and that's really not how I like to approach oil and gas names. I can't tell you what the oil price is going to be seven years from now, but I can tell you that if you assume a standard, or base level, of oil price that is reasonable and below current market prices, and the company's wells pencil out at that assumption on an NPV or IRR basis, it's probably going to be a good investment in the long run. And in general, I believe **Approach** is that investment for me.

Mr. Claremon: I'm going to talk about another company, **Central Garden & Pet** (CENT). It is a supplier of, not surprisingly, gardening and pet goods. In the gardening segment, they're probably the second-tier player next to **Scotts** (SMG). **Scotts** is the 800-pound gorilla in this industry. **Central Garden** is a secondary player with brands, such as Pennington. But they have everything from weedkillers to things for, like fertilizers for the lawn, and that kind of stuff, and then, in the pet segment, they're one of the dominant players. Any time you go to the grocery store and you see a bunch of little pet trinkets next to the checkout lane, often those are **Central Garden & Pet** products.

The issue with this company is that it has been traditionally run by the Chairman and the Founder, a guy by the name of Bill Brown, and it was essentially a rollup. He rolled up a bunch of little companies, and they were really never put together. You just had a mismatch of companies that were never actually integrated in a way that you could generate some synergies from them. Chairman Brown is still around but he's no longer in charge day to day.

They've brought in a new CEO, Gus Halas, who has come in and has said that he's going to make this a real functioning company. They are going to go down from an unbelievable 25 ERP systems to two. They're going to try to cut SKUs by 30% to 35%. He thinks he can take out anywhere between $30 million and $60 million of inventory each year. He thinks he can probably save $30 million a year on the gross margin line, and then, a little bit on the SG&A line. So this is a new management team.

We like the secular story behind people owning pets and gardening more, and we also like the idea that there is a guy who is going to come in and upgrade the operations to be even more of a world-class company. He has a background of doing just that. He has been able to turn around energy firm called T3, parachute in and change the operations, and then, parachute out. The stock is around $9, and his options are struck at $12.50 to $15.00. That gives you a sense that he thinks this is a great opportunity. Operating margins now are in the 6% to 8% range. He thinks he can get it to 10%, and if things are really kicking, he thinks he can get to 15%.

We went up and met with him, and his description of the lack of management and the low hanging fruit available to him was pretty impressive. We're careful not to fall in love with the new manager story, but the stock is priced so that we don't need perfection. We need directional improvement and we will have a solid winner with little risk from here. So if you look at the stock, right now, it doesn't look that cheap on trailing basis, but if you got to 10% operating margins in the next few years, it's easy to get $13 to $15 price. And you might even get a $20 price if the new CEO really executes.

We would like names, like this, where there is either a new management team in at a company that has been undermanaged, and especially, in a situation where there doesn't seem to be a whole lot of downside. Your upside in this case is from $9 to $15. We're willing to wait for it, and I think **Central Garden** represents what we look for pretty well.

TWST: Cove Street Capital has about 9% cash. What determines how much the firm keeps in cash versus stocks?

Mr. Claremon: The amount of cash is a residual. It is a residual of the number of ideas that we have. We don't sit there and say, "We think that Europe is blowing up and we're going to hold 'X'% cash." It's only about the number of ideas we have. I mean, we're in some amazing business where we don't have to swing. Everyday, ideas come across our desk, and we have the opportunity to choose to not to swing at them. We can continue to watch them. We can continue to do more work on them. Just because you sell something, it doesn't mean that there is another great idea waiting right behind it the same day. So the amount of cash we have is simply a residual based on the number of good ideas we have.

We're not going to put mediocre ideas into the portfolio. This is especially true because of our concentration. The cash will vary. When markets started to tank in September, October last year, we were very inclined to lean into that and buy things, especially things that we owned that got cheaper and things that had been on our radars that had gotten cheaper. So there is always a backlog of companies. We do a lot of work on them, and even if we pass initially, we've done a lot of work on them and we have price targets in mind. We like to have the flexibility of having some cash. The amount of cash we hold depends on where we are in the cycle and how many great ideas we see.

TWST: Thank you. (LMR)

BEN CLAREMON
Research Analyst
EUGENE ROBIN
Research Analyst
Cove Street Capital, LLC
2321 Rosecrans Ave.
Suite 3275
El Segundo, CA 90245
(424) 221-5897
(424) 221-5888 — FAX
www.covestreetcapital.com
e-mail: questions@covestreetcapital.com