COVE STREET CAPITAL

Occupy Yahoo

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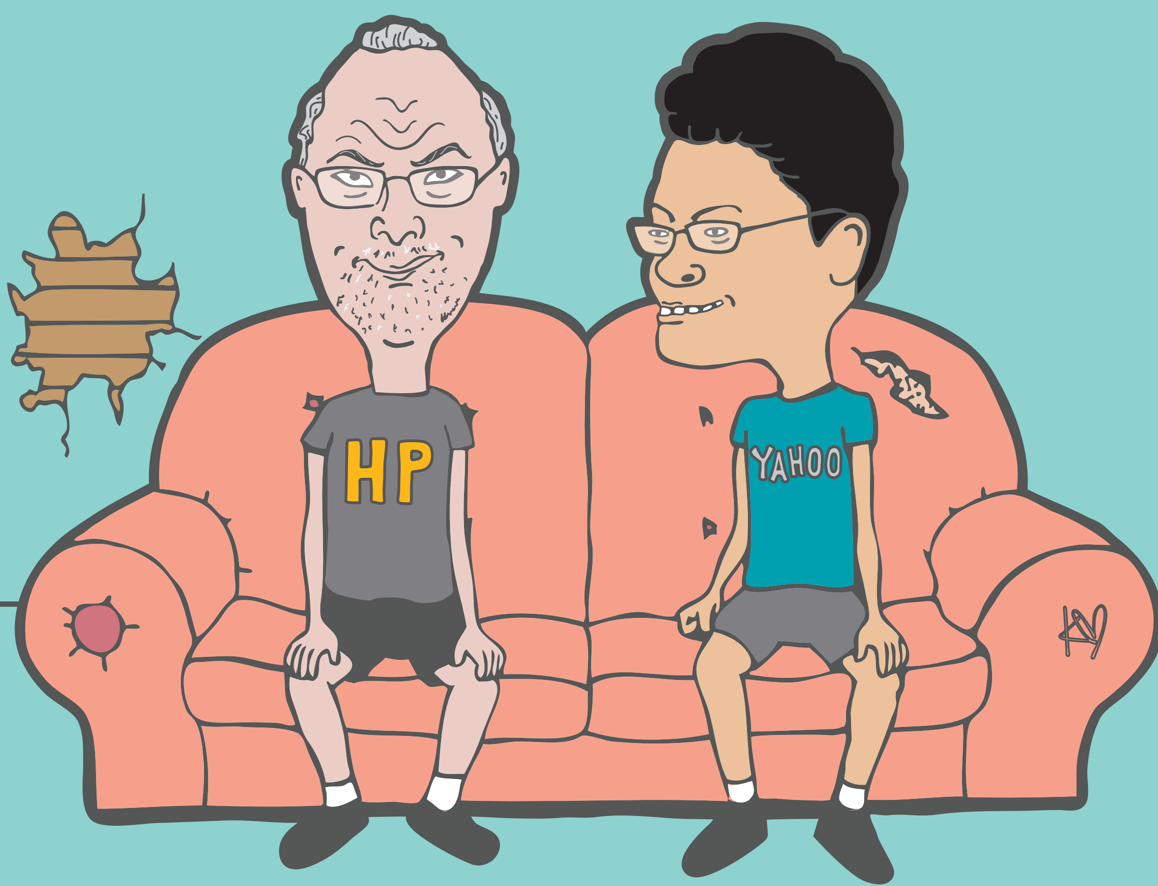

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NOVEMBER 2011 — This is the first part of a non-vampire trilogy, which will explore some of our inner thinking on the juxtaposition of "business vs. value vs. people" in the investment decision making process—a process that has led us to recent investments in Yahoo, Hewlett-Packard and News Corp in our non-small cap strategies. While we have plenty of examples that are applicable in small cap, let's face it—these three are juicy targets that have engendered enough press to ensure the reader will raise some level of visceral disgust and thus serve to make our point. In this first installment, we will focus on Yahoo for no other reason than to honor the company's place within the pantheon of failed corporate governance.

In a perfect world, an investor would wake up every morning with a portfolio of terrific businesses selling at outstandingly cheap valuations and live a life of contented luxury as a dedicated and shareholder-oriented management team and Board of Directors dutifully represented his interests. The "dream" can be had from time to time if one is patient and has the discipline to wait for the opportunities that seem to develop every 72 hours in today's world. But often investors grapple with a Rolling Stone-esque challenge—we cannot always get what we want. Specifically, the three most common types of situations we encounter are as follows: 1. A great business selling at a high valuation (not for us); 2. A mediocre business selling at an absurdly low valuation (perennial temptation); and 3. A perfectly good business selling at a low valuation because it is being run (or is perceived to be run) by the corporate equivalent of Beavis and Butthead.

The latter is our topic for the day and let's start with Yahoo, a position that has clearly not helped us break the bank. The stock purchase was made in early 2009 at $12 per share, based on some fairly classic value parameters. At the time, when we backed out a reasonable estimate of the after-tax value of the company's Asian assets, there was a negative value implied for the core Yahoo business. One can argue over nearly anything in the investment world, but being paid to accept a business that is essentially debt-free and generates $600mm of free cashflow per year presented a compelling risk-reward tradeoff and led to a price objective of $20 within three years.

The difficult competitive position of Yahoo versus Google and Facebook for advertising and search revenue was a clearly identified risk and remains a considerable challenge, but the roughly $600mm a year still manages to emerge from the tech equivalent of my father's Oldsmobile. This brings up an interesting and annoying issue we face when we invest in anything related to technology and media. It seems the advent of unbridled social media and free internet access has enabled ANYONE to say nearly ANYTHING on ANY subject on a completely unedited, 24/7 basis. Nowhere is this more prevalent than in the media and technology industries, many of whose inhabitants appear to have little else to do but blog about each player's actual or rumored activities. All of this chatter enables us to second guess any investing decision in real-time, which is why it is so crucial to blend in a few hard facts—such as getting $600mm a year in free cashflow for free.

What was also identified as a challenge when shares of Yahoo were purchased, and remains a challenge to this day, is determining whether or not the management team and the Board are friends or foes of the common shareholder. What we do know is that they turned down a $31 per share buyout offer from Microsoft for reasons that suggest an agenda that does not put the shareholder first. What that agenda was at the time remains unclear to any and all rational beings. Our opinion when we bought the stock was that having made one bonehead strategic move, it would seem unlikely that a shareholder would endure a repeat performance. But according to recent press reports, rational creatures remain underrepresented on the Yahoo Board.

Just prior to our purchase, the fourth version of the "new CEO story" had begun and that was clearly a mixed bag. We confess to sometimes being a sucker for the cheap stock with a new management story. In theory, we are buying small pieces of real businesses run by real people and often a change in management is the missing link that leads a company to be successful and the stock purchase an investment success. "People" are a qualitative factor that cannot be modeled by a 28-year-old with a spreadsheet and thus organizational change is often underappreciated and undervalued. Oddly, while predicting short-term earnings and stock movements has been statistically proven to be a mugs game for decades, it nonetheless continues to occupy an unhealthy amount of the time of investors—professional and otherwise. Meanwhile, long-term track records of success are seemingly ignored for large swathes of time as stock prices languish. While John Malone's Liberty units are presently a great example, Berkshire Hathaway remains the classic case study as Buffett put up a stupendous public track record and was mostly ignored for decades by "Wall Street" because Berkshire could not be "modeled" and was not courting investment bankers and analyst coverage. We own a variety of "un-model-able" entities where there is definitive current value, but the upside clearly stems from the optionality for compounding represented by a historical track record of success and, as such, Wall Street Wallflowers remain an area of further interest.

Back to Yahoo. While Carol Bartz did bring some sense of adult management and financial discipline to an organization that clearly lacked it, she did not possess the recipe for the "secret sauce" that would enable Yahoo to monetize its enormous web presence and traffic generating ability. A convoluted deal with Microsoft on Search remains what is possibly a classic tech oxymoron—a convoluted deal with Microsoft.

Which leaves us with the conundrum of today: we have a "value" that is further defined than it was two years ago given recent live transactions associated with Yahoo's passive Chinese assets. But we remain at the mercy of a Board that essentially is made up of the same group of perennial optimists who rejected the Microsoft bid. We are witnessing a variety of confusing and semi-public Boardroom leaks that fall under the heading of "Strategic Review," but what we are not seeing is a process that is suggestive of serious internal discussions of the major themes highlighted in the following paragraph, excerpted from our recent letter to the Yahoo Board:

> "I don't think I have to recount the historical follies that the Board must wake up and face every morning, ranging from the parade of CEO's and shifting business plans to the rejection of the Microsoft purchase offer. I want to focus on the following message: The Board of Yahoo has lost any right to manage or decide the fate of the company owned by Yahoo's shareholders. Its only proper and fiduciary responsibility is to specify publicly that the company is for sale, annunciate a clearly defined sale process with appropriate investment banking firms and conclude this process in a timely fashion that results in the sale of the company to the highest bidder before any further value degradation occurs. Additionally, if ANY member of the Board or current management is deemed to be the "winner" in this auction, a fully disclosed list of alternative offers should be published. Recent published suggestions indicating the possibility of a leveraged recapitalization that leaves the company in the hands of the current Board is unacceptable and fails to meet the baseline of good corporate governance."

Our present strategy is to allow this process to play out. Our downside remains further boredom and frustration rather than material capital loss, and we have had worse experiences. The hallowed "catalyst" is in place and there seems to be a likelihood of resolution within a reasonable timeframe. We offer a shout-out and thank you to a Mr. Daniel Loeb and his firm Third Point Capital for undertaking the present yeoman's effort of spending time and money to publicly harass Yahoo's Board and taking actual steps to obtain Board representation. It is a simple truth that when dealing with corporate governance and larger companies, the population of those with large enough pools of capital to aggressively take on multinational firms is quite narrow.

But in late Pacific Time afternoons, we ask ourselves: is Yahoo worth it? Can't we find value stocks that do not have management/Board obstacles? The simple answer is yes—who wouldn't opt for headache-free success? But as we noted in the beginning, life is not always perfect, complete clarity is not always available from the get-go and we always have the optionality as public shareholders to cut and run if we perceive better alternatives; we are not buying into a private company with no out. In this particular instance—and we always emphasize the crucial distinction between "this instance" and the overt generalizations of buying an entire class of stocks—we think there is a reasonable probability attached to an imminent deal and thus a 20% to 30% return in the short-run to close this chapter and create a perfectly acceptable three year return.

The Hewlett-Packard situation, on the other hand, has resolved itself with nothing more complicated than a management change. New CEO Meg Whitman simply has to be a patient adult and the stock will be $50 in 2 years. What was arguably the worst board in corporate America has turned over and subsequently handed the mantle over to Yahoo. Meg does not have to be the next Steve Jobs. That is the beauty of running a quality multinational company selling at 6x cash earnings—which are expected to grow this year and next. Assuming no growth ever again, at the current price the stock offers a potential 20% cash on cash return. The company has an excellent balance sheet in addition to the fact that the businesses produce double digit operating margins and generate $9 billion in annual free cashflow. What Meg has to do is follow a fiendishly simple formula: buy back 4% of the stock annually, raise the dividend consistently and spend the left over $2 billion each year to supplement the R&D pipeline. Then hopefully, like the Kardashians, the last few years of cloak and dagger Boardroom antics, alleged sex scandals and truly awful capital allocation will melt away in the eyes of investors. With any luck, we will then be blessed with a stock trading at a whopping 10x cash earnings multiple that is in line with the rest of the technology sector.

As a closing thought, we think it is important to understand the practical limits of any "we only invest this way" statement. We strongly prefer to invest alongside people whose incentives are properly aligned with our position—which is generally that of a common shareholder—and who have a demonstrated track record of acting rationally on our behalf. But there are times when the degree of valuation discount—which may stem from investor disgust with present management—is so great that the risk of the possibility of another inane corporate venture or further mediocrity is deemed to be acceptable. And as a number of CEO's have found recently, running a public company does not provide the job security of the Supreme Court.

FINAL NOTE—As an FYI, we are putting out monthly to quarterly Strategy Pieces that will only be delivered by email. From time to time, which is a neat way of avoiding odious deadlines, we are putting out very specific pieces and random comments on a wide swathe of topics and stocks, which can be found on our website CoveStreetCapital.com—under 'Thoughts.' You must sign up on the website for that "privilege" and we promise not to abuse it.

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