Value Investor INSIGHT

The Leading Authority on Value Investing

March 23, 2005

Big Misunderstandings

Value investors generally seek cheap stocks and then try to understand why. David Einhorn asks why stocks might be mispriced, and then asks if they're cheap.

Raising money was a bit tough for David Einhorn when he started Greenlight Capital in 1996, before hedge funds were all the rage. "The industry was not what it is today," he says. "Let's just say people were not in big rushes to work with 27-year-old guys with no track record."

Starting small, Einhorn and his partner set up shop with a couple of computers in 125 square feet of office space in New York City. Before long, Greenlight's track record started to speak for itself. Today, after years of stellar returns, Einhorn is one of the hedge fund industry's best-known and most successful investors. His company, from an initial asset base of less than $1 million, now has some $3 billion in assets under management.

Success has not diminished Einhorn's passion for finding mispriced securities and, as this issue's interview makes clear, holding management accountable to shareholders' interests. *See page 2*

David Einhorn
Greenlight Capital

Investment Focus: Seeks special situations that might lead to general investor misunderstanding – and mispricing – of a company's true value. Goes long or short based on the magnitude of difference between his estimate of value and the market's.

Adopting Market Orphans

Some 5,000 companies have market values less than $250 million, and many are ignored by the investment community. That's music to John Lewis's ears.

John Lewis
Osmium Partners, LLC

Investment Focus: With the eye of a strategic corporate buyer, looks for companies ignored or shunned by the market but with a sound core strategy and defensible niche. Many portfolio companies are eventually bought out.

John Lewis's timing couldn't have been better for starting a value-oriented small-cap hedge fund. He opened Osmium Partners in November 2002, just weeks after the beginning of the current bull market, which has been led by small-caps. "Everyone thought we were in the middle of a multi-year low and nothing was ever going to come back," he says. "Value was everywhere."

Osmium's returns have far exceeded even the rising small-cap tide, as Lewis applies his "think like an owner" investing discipline across an eclectic array of businesses, from investor education, to teddy bears, to online diet programs. He leaves to others pursuit of the big-name glamour companies. "We focus on what we like to call two-stop-plane-ride companies." he says. *See page 10*

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Investor Insight: David Einhorn

Greenlight Capital's David Einhorn explains how to look for market mispricings, what situations drive Greenlight to activism, and what he thinks the market is missing in Freescale Semiconductor, M.D.C. Holdings, Allied Capital, France's Renault and Germany's Lanxess.

You've said your investing style differs somewhat from that of traditional value investors. How so?

David Einhorn: We take the traditional value investor's process and just flip it around a little bit. The traditional value investor asks "Is this cheap?" and then "Why is it cheap?" We start by identifying a reason something might be mispriced, and then if we find a reason why something is likely mispriced, then we make a determination whether it's cheap.

Explain the distinction.

DE: If you're looking for something that's cheap, you'll probably do a variety of screens – on price-to-sales, price-to-earnings, price-to-book, whatever – to identify stocks that appear to be inexpensive. Once you have that list, then you start to research if there are good reasons the stocks deserve to be cheap, or if maybe there's an investment opportunity because they're cheap without a good reason. We think that's the way most value investors approach it.

We never do screens like that. We start by identifying situations in which there is a reason why something might be misunderstood or mispriced, why it's likely investors will not have correctly figured out what's going on. Then we do the more traditional work to confirm whether, in fact, there's an attractive investment to make.

So you're often looking for special situations – a spin-off, or a post-bankruptcy, say, where mispricings can be common?

DE: Basically, yes. It happens routinely [in such situations] that the historical performance of a company doesn't give a particularly good view of what the prospective performance of the business is likely to be. It may be due to how the performance had been reported when a now-independent business was part of a larger company. It may be that strategies or capabilities have changed in ways that aren't immediately apparent.

We also find opportunities when there is a large upheaval or rejection of a particular company – or sometimes an entire industry – for reasons that are obviously just plain old cyclical or otherwise based on what the investment fashion of the moment is.

An example: Investors in retail companies are very focused on monthly comparable-store sales, particularly during the holiday season. It seems like at least every other year, particularly in January, we're able to find a retailer that we really like that had negative comparable-store sales during Christmas and the stock trades down to seven or eight times earnings. The company has a clean balance sheet and it's a nice ongoing franchise. We have no idea how the next Christmas will go, but if it goes okay, the earnings will be higher and we will then get a much better multiple on those earnings. We've been through that before with Circuit City and Foot Locker.

You tend to make a few very big investment bets, why?

DE: We believe in constructing the portfolio so that we put our biggest amount of money in our highest-conviction idea, and then we view the other ideas relative to that. We find things that we think are exceptional only occasionally. So if we find something that is really set up, where we think it's mispriced, where we have a good understanding of why it's mispriced, where we think the mispricing is very large and the overall risk is very small, we take an outsized position to make sure we give ourselves the chance to be well compensated for getting it right.

You've also developed a reputation as somewhat of an activist investor. Is that part of your strategy?

DE: Activism for us is Plan B. In cases where we've been activists, we've generally been passive investors for a good period of time first. But while it isn't our goal, when something goes seriously awry, we won't hesitate to try to effect change when we feel it better protects the interest of the partnership than exiting.

Look at a few of the situations for which we're most known for being active: Mercer International we held for five or six years before we had our proxy fight. MI Developments we held for more than a year before we felt they went off course and we had to start trying to

David Einhorn

Accidental Investor

Growing up in Milwaukee and going to college at Cornell University, David Einhorn never expected to become a professional investor. "I studied government at Cornell, and expected to get a PhD and teach," he says. But graduate programs in his field of choice, economics, had few, if any, places for those without extensive undergraduate economics training, so Einhorn joined DLJ as an investment banker. Not liking it much after two years, he interviewed in 1993 for a hedge-fund analyst position and the rest is history. "I worked for some very smart people, who actually took the time to help and train me," he says. "I was very, very fortunate to find that situation."

protect value there. In all these cases, the day we bought the shares we had no plan to be anything other than passive, happy investors.

Are there sectors or businesses you tend to avoid?

DE: Some areas lend themselves better to our types of analysis than others. It's very hard for us to figure out what brands are worth, for example. It's also hard for us to figure out what future scientific developments are worth. We tend to stay away from those kinds of things. But at the right price, we'll consider anything.

Many value investors avoid financial stocks, fearful that they're more subject to being black boxes? Does that concern you?

DE: We generally like financials, which lend themselves very well to our kinds of analysis on both the long and short sides. We don't think they're so "black-boxy." We've done well over the years in property/casualty insurance companies, for example. It's a lot of work, but you can get the statutory filings, and you can look at the claims experience, and you can look at the loss reserves and how they have been developing over time. Maybe a lot of investors don't take the time to do this or don't know exactly what they're looking for, but we're pretty comfortable estimating how the reserves should look. Sometimes we can find something that is unusually conservatively reserved, or aggressively reserved, and we can make an investment accordingly.

It's similar with companies that do a lot of securitizations. We can get the securitization data, and see the prepayments and loss experience on a pool-by-pool or securitization-by-securitization basis. We can see how companies are actually doing versus their assumptions or versus what the market thinks, and sometimes we can find a real disconnect. If we do, there's often a real opportunity to make a good investment, either long or short.

Can you give an example?

DE: New Century Financial was a good example of this for us on the long side. Back in late 2002 there was a lot of concern about exposure they retained from residuals they had on their balance sheet. When we plugged through the math we concluded that there was not significant risk to the residual values and the market was not giving them credit for their origination platform. As a result, people just had their analysis wrong, which made for a very good investment opportunity.

ON CONTROLLING EMOTION:

When management makes us angry, we put the file in a drawer for a while and just don't do anything. We try not to sell just because we're angry.

Does instinct play much of a role in your decision-making process?

DE: Sometimes. As our positions have gotten larger, we often find ourselves in situations where we can't trade out of positions quickly. There have been cases where we own, say, one million shares and we think we want to sell, but we can only sell 25,000 shares right away. You could say "why bother, it's only 25,000 shares." But our feeling is that's silly – it might only help solve 2.5% of the problem, but the problem is now 2.5% smaller than it was. We also find that as you begin to exit a position, sometimes the stomach tells us whether we want to keep going, accelerate, or whether it isn't really necessary.

Another thing we do is when management really makes us angry, we put the file in a drawer for a while and just don't do anything. We try not to sell just because we're angry. We have a large position in a company we've had for a long time, and there have been a lot of times when the CEO has said or done things that got under our skin. The natural reaction would be to just sell the stock and move on, but if we had reacted in that emotional way, it would have cost us a lot of money. If you sell when you're angry, you can imagine everybody else who sells that way reaches the point of exasperation at exactly the same time. That's the kind of thing that creates at least a trading bottom. Better to sit on it for some time, and even if you still hate what the company's doing, you're probably going to get a better chance to get out.

Let's talk about your largest position, Freescale Semiconductor (FSL).

DE: Freescale is a classic example of the type of situation that interests us. This is the semiconductor division that came out of Motorola last year, and if you look at the historical performance over time before the spin-off, it's truly ugly. In 2003, they lost $300 million in operating income. In 2002, they lost $1.5 billion. In 2001, they lost $1.9 billion. Even at the peak of the bubble, when things were good, they made only $200 million in operating profit.

So if you look at that, and average through a cycle, we can understand why you wouldn't want to own the shares. One Wall Street analyst actually went out of his way to put an underperform on the stock before the IPO even happened. That was actually good news for us, because *The New York Times* picked up on the report and it ran on the front page of the business section the day they were trying to price the deal, which helped lower the price of the IPO.

The catch in all of this is that the business as run under Motorola was very different from the business as it's run independently. With whatever global technology and wireless ambitions Motorola had, they were having Freescale invest in all sorts of capital and R&D projects that probably didn't have positive returns, or if they did, only in the context of the broader Motorola empire.

So what's happening now, as a stand-alone, Freescale isn't going to make those investments at the same level they would have under Motorola. As a result, we're going to have much less depreciation going forward, causing the margins to go up. Not a lot has to go right for the profits to grow at a very rapid clip for the next couple of years, just because of a change in the business model.

When companies get spun out you also often see overhead come down as fat gets cut by managers with more of a stake in the bottom line.

DE: We have SG&A coming down a modest amount in our model and they've announced some headcount reductions. But we don't think that's a very big part of the story.

What is another big part of the story is the possibility they could actually win new customers that didn't want to buy from them as a part of Motorola, but who would be happy to buy from them as an independent company. If you're a big cellular phone company, you now have a new supplier option that you didn't consider before. As it happens, Freescale's wireless technology is quite competitive, and it looks like they'll be able to gain quite a bit of market share over the next couple of years.

Have there been any big new wireless wins yet?

DE: They have not really diversified the revenues in that segment outside of holdover Motorola business. But we're actually more confident that they're going to gain extra market share in wireless than we were the day of the IPO. There are a lot of signs that Freescale's technology is really quite competitive and competitors like STMicro have had a lot of bad news in their own wireless technology portfolios. But it does take a while to win new designs and then have it actually show up as revenues and profits.

A lot of value investors would look at Freescale and say this is a fast-moving technology business, where it's difficult to predict cash flows three years from now, let alone further out. How have you gotten comfortable with that?

DE: A few ways. As I mentioned, we're comfortable in understanding the financial dynamics of the company, that they're likely to have prospective results that are much better than historical results. We also understand why people might look at this company and not be attracted to it, which at the IPO led to a valuation very different from any other semiconductor company out there. At the IPO price ($13) we paid less than one times revenue, on an enterprise value basis, for this company. That was a 50% discount to STMicro or Texas Instruments. So you really had to view this as the worst company around in order to feel there was a lot of risk in the shares.

The future leverage is in wireless, where the technology does move fast, but they also have a lot of business besides wireless. The biggest portion of revenues comes from the auto business,

INVESTMENT SNAPHOT

Freescale Semiconductor
(NYSE: FSL)

Business: Spun-off from Motorola in July, 2004, designs and manufactures embedded semiconductors for use primarily in the automotive, wireless, consumer and networking markets.

Share Information
(@3/22/05):

Price	**17.05**
52-Week Range	12.06 – 19.67
Dividend Yield	0.0%
Market Cap	$6.84 billion

Short Interest:
(@3/8/05)

Shares Short/Float	1.4%

Financials (TTM):

Revenue	$5.72 billion
Operating Profit Margin	4.6%
Net Profit Margin	3.7%

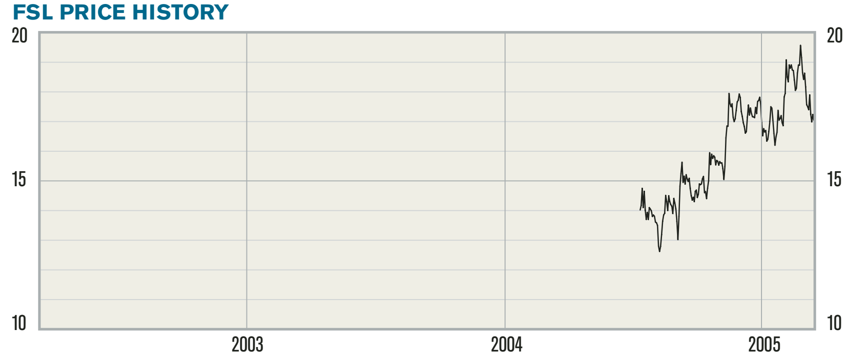
Valuation Metrics:
(Current Price vs. TTM)

	FSL	S&P 500
P/E	16.1	20.4
P/CF	7.2	12.8

Largest Institutional Owners:
(@ 12/31/04)

Company	% Owned
Greenlight Capital	15.9%
Fidelity Mgmt & Research	14.9%
Wellington Mgmt	9.1%
Dodge & Cox	8.1%
Capital Research and Mgmt.	5.0%

FSL PRICE HISTORY



THE BOTTOM LINE

An independent Freescale will operate much differently than it did under Motorola – in capital spending, in R&D spending, and in its ability to win business from Motorola competitors in the booming wireless industry. Given his expectation that margins will increase dramatically, David Einhorn believes the shares are "very inexpensive" at an enterprise value (market cap less net cash) of 110% of sales.

Sources: Company reports, other publicly available information

where they have leading market share and continue to announce positive design wins. That's a relatively stable business, with model production runs that last for years. We also see in the auto business that there is a nice secular trend of more electronic components in cars. So even though there may not be a lot of unit growth in cars on a global basis, every year there are more electronics, from satellite radios to power windows to steering to brakes and these guys are selling some pretty basic microcontrollers into that demand.

At a recent $17 a share, how do you think about Freescale's valuation today?

DE: Because we're looking for margins to improve dramatically over the coming years as this plays out, we're inclined to look at the relevant valuation on a price-to-sales basis. They have over $2 per share in net cash, so that's an enterprise value of about $6 billion, which is only 110% of sales. For a business of this sort, we believe this is very inexpensive.

Do you have a target price?

DE: No. That's another general rule we have here. We hate to make any investment decisions that we don't have to make today, because we'll have more information later. A lot of people will ask "If you buy a stock at $10, do you have a price at which you'll sell it?" And the answer is really no. All we have to know today is do we want to buy or own it at $10, because that's the price that's available in the market today. By the time it gets to $20, there will be lots of new information and we can assess what we want to do at $20 when it gets there. We try not to clutter our heads with things that aren't available for us to evaluate today. We just believe today that it's worth well more than $10.

So with Freescale a target price is just not something we have to figure out right now, and I'm not just saying that to be cute. We really don't know. We think that the shares are worth a lot more than $17, without much risk, and that's really all we have to figure out today.

You're a long-time holder of M.D.C. Holdings (MDC). Few sectors elicit as much controversy in the value community as homebuilders do today. Some are comfortable with the industry dynamics and have made a fortune in the past few years. Others are convinced this is a bubble. What's your view as it relates to MDC, currently trading around $72?

DE: The way we approach it, there is plenty of history that shows that through the cycle this business is still going to have a premium return on equity. It doesn't have to be in the high 30s that they're getting now, but on an average basis – even if you assume some rough years coming – it's going to earn a very acceptable return on equity, and, in MDC's case, with relatively low financial leverage.

Then look at what average earnings can be expected to be through the cycle. If one wanted to take a very pessimistic view, assume that earnings

INVESTMENT SNAPHOT

M.D.C. Holdings
(NYSE: MDC)

Business: Builder of mostly mid-priced homes in major U.S. markets, including Arizona, California, Florida, Nevada and Texas. Subsidiaries also provide home mortgage lending and title agency services.

Share Information
(@3/22/05):

Price	**71.75**
52-Week Range	43.13 – 81.11
Dividend Yield	0.8%
Market Cap	$3.11 billion

Short Interest:
(@3/8/05)

Shares Short/Float	6.6%

Financials (TTM):

Revenue	$4.01 billion
Operating Profit Margin	15.9%
Net Profit Margin	9.8%

Valuation Metrics:
(Current Price vs. TTM)

	MDC	S&P 500
P/E	8.2	20.4
P/CF	7.2	12.8

Largest Institutional Owners:
(@ 12/31/04)

Company	% Owned
Greenlight Capital	9.7%
Barclays Bank Plc	6.1%
Aronson + Partners	5.1%
Wasatch Advisors	4.4%
Axa	3.5%

MDC PRICE HISTORY

THE BOTTOM LINE

Even with an inevitable cooling of the housing market, David Einhorn expects this excellent operator to generate strong earnings and return on equity deserving of a market multiple. If that happens, even at 2/3 current per share net earnings, he estimates MDC would be worth signficantly more than the current $72 per share.

Sources: Company reports, other publicly available information

through the cycle from here might average 2/3 the present level. This is a cyclical growth company with very good returns on equity. We don't see why it shouldn't be worth at least a market multiple on the mid-cycle earnings. So MDC today earns around $9 per share. 2/3 of that is $6. At a market multiple the shares would be much higher. We think that if there is a cyclical earnings decline, the multiple will expand and the shares will continue to do very well instead of shrinking.

That's been our analysis the last several years, and the funny thing has been that instead of shrinking, each year the earnings have continued to grow. The average cycle earnings keep proving to be higher than we would have thought a few years ago, and the value of company keeps growing.

Isn't the key question here not just average cycle earnings, but trough earnings? Go back to the last housing downturn, and MDC actually lost money for four consecutive years, from 1988 to 1991. Could things go back to being as bad as they were?

DE: I wasn't suggesting $6 was the trough earnings, but the mid-cycle earnings. Clearly you could come to a trough number that is considerably less, though we would expect MDC to remain solidly profitable at the trough. But the homebuilding industry is a very different industry now than it was 10 or 15 years ago. The fundamental difference: Back then if you wanted somebody to buy a house you had to build it first so they could look at it and decide if they wanted to buy it. Companies have gotten much better in their risk management today. They build a model house, and then have some good computer programs to show the customer how they can customize it, and visualize how the house will actually look before it is constructed. So the customer is comfortable committing before construction.

So you'd argue that things really are different this time?

DE: The industry has gone from "build it and then find a buyer" to "find a buyer and then build it." That has changed the risk profile dramatically. In the old days, if you built the house first and couldn't find a buyer, you had to cut the price until someone would take it off your hands. So in a cyclical trough, you wound up losing money. I think the industry has changed to the point that the next trough will be higher than the last one 14 or 15 years ago. The market is not giving it credit for a change in its business model, hence the stock is mispriced.

Independent of one's general view, what's special about MDC?

DE: We believe they are simply better operators. They are very disciplined in their land selection, very effective in their construction, and very good at pricing their product. They have the highest operating margins and the lowest financial leverage. The CEO owns an enormous amount of stock, so they've taken the risk of capital very seriously. This company went just about to the verge of collapse at the bottom of the last down cycle, so they've seen what can happen if they don't do a good job. We think they learned from that.

The risk of course is if there is massive collapse in housing. We just don't think it's going to happen, certainly not on a national basis. There's not a lot of history of national deflation in housing. And you don't need ongoing price increases for MDC to make great returns.

Another controversial holding of yours is Allied Capital (ALD), on which you've been negative for nearly three years. The stock has hardly budged. Has your investment thesis changed over time?

DE: Our original claim, which we still believe, is that the company has inflated its balance sheet by mis-marking various portfolio holdings, and inflated its income statement by taking in a bunch of income from what amounts to related parties. They're an investment company, so they don't consolidate investments they control, and can treat from an accounting perspective non-arm's-length agreements as if they're arm's length. That has a positive impact on their reported results. We also thought the company had come through the recession with a portfolio of risky mezzanine loans to middle-market companies and had recognized almost no losses during that period. Our thinking has been that this will eventually adjust itself, and the shares would go down.

We're three years later and we're not in a substantially different place. The company has been extremely effective at what I would call fooling some of the people all of the time. Instead of addressing at face value the things we have criticized them for, they have made a series of false and misleading statements that distract investors from their ongoing, serious problems. They have figured out they have a core constituency of shareholders that are perfectly happy to hear them on their terms and focus on their quarterly distributions.

The company has changed some of its accounting, and has begun to recognize some of the portfolio losses. Over the last three years, Allied has earned hundreds of millions less than analysts initially estimated.

Describe some of the regulatory issues involving Allied.

DE: Last year, it came out that in 2000 Allied had shifted problem loans off its own balance sheet to its largest investment, Business Loan Express, and in 2003 had taken back the same loans, which had by then defaulted, at full value. There was no disclosure about the 2000 transfer and minimal and misleading disclosure about the 2003 transaction. Allied justified the secret deals by saying that there had been an oral agreement between the two companies. From our perspective, the only reason companies have "oral agreements" is because they don't want someone to find out what they are up to. It seems to us the acknowledgement of an "oral agreement" is tantamount to an admission of fraud. Now there is some pretty significant regulatory review as to what Allied and Business Loan Express have been doing. We are

INVESTMENT SNAPHOT

Allied Capital
(NYSE: ALD)

Business: Provides debt and equity investment capital to small and mid-market companies. Also invests in high-yield commercial mortgage-backed securities and collateralized debt obligations.

Share Information
(@3/22/05):

Price	**25.54**
52-Week Range	21.60 – 30.72
Dividend Yield	8.8%
Market Cap	$3.41 billion

Short Interest:
(@3/8/05)

Shares Short/Float	11.4%

Financials (TTM):

Revenue	$367.1 million
Operating Profit Margin	55.0%
Net Profit Margin	68.0%

Valuation Metrics:
(Current Price vs. TTM)

	ALD	S&P 500
P/E	13.6	20.4
P/CF	13.7	12.8

Largest Institutional Owners:
(@ 12/31/04)

Company	% Owned
Capital Research and Mgmt	5.7%
Goldman Sachs	2.8%
Robert E. Torray & Co	2.2%
Torray Corp.	1.9%
Kayne Anderson Rudnick	1.5%

ALD PRICE HISTORY

THE BOTTOM LINE

As a business development company making loans and other investments in private companies, Allied has discretion in valuing its investment portfolio and income from related companies. David Einhorn believes reported company results have misstated the health and viability of ALD's investment companies. Should ongoing regulatory inquiries validate his thesis, he believes the shares will fall sharply.

Sources: Company reports, other publicly available information

optimistic that the government will get to the bottom of what's transpired here and that eventually things should be satisfactorily resolved for us.

Are you still uncovering new information to support your view on Allied?

DE: We don't have anything that isn't available to the general public. A lot of their portfolio companies are private, so there's no financial information one way or the other. But we keep close track of the news on the companies in their portfolio. A number have gone bankrupt, so we've been able to review the bankruptcy filings and compare the histories of these companies with how Allied has historically reported on them. We've learned a lot about the general accounting practices there, and it seems to us there are some very significant issues. We have found companies that went bankrupt where it's clear they've been in deterioration for four or five years, and then shortly before the bankruptcy Allied belatedly takes the first impairment.

The company has done a good job from a PR perspective of making the debate about what they're doing a personal one, about how they are this nice company that through good people and hard work supports the individual investor and pays healthy dividends.

You know, it's not actually a dividend Allied pays. A dividend in a company is profit earned that isn't required for the ongoing growth of the business and can be distributed to shareholders. Allied is quite different. It is a type of investment company called a business development company. It is governed by the same tax regime as mutual funds, which means they don't pay tax at the fund level, but they distribute the taxable income to their investors. Mutual funds understand that investors don't want taxable distributions, so each year they sell their losers to get their tax losses and let their winners ride, which is the efficient thing to do from a tax perspective.

Allied takes that taxable distribution, breaks it into four equal parts and calls it a "dividend." Instead of minimizing it, they aim to maximize it. So their investment policy, essentially, is to sell their winners to maximize their distributions, and let their losers carry on into the portfolio into future years. They have "educated" their investors that for Allied such taxes, I mean "distributions," are a good thing. Allied's investors have bought it.

Then they say, "Look, we have all these realized gains that prove what good investors we are."

What's the catalyst for you here? The federal investigations?

DE: That seems to be the most likely outcome. Either the government in its investigations will come to agree with our perspective, or it won't.

Based on what you said earlier, we're guessing you won't say what you think Allied is worth.

DE: Let's just say sufficiently enough less than the current price to make this all worthwhile. The last three years haven't really been fun and games here.

Some European investments have recently caught your eye. Tell us first about Renault?

DE: Renault is free. Absolutely free. How can you be against that?

INVESTMENT SNAPHOT

Renault SA
(PARIS: RNO)

Business: Global car and truck manufacturer based in France, operating primarily under the Renault brand. Also owns large consumer/commercial finance operation.

Share Information
(@3/22/05, Exchange Rate: $1 = .7570 euro):

Price	**€68.05 ($89.89)**
52-Week Range	€53.20 – €70.40
Dividend Yield	2.1%
Market Cap	€19.4 billion ($25.6 billion)

Financials (Full-year 2004):

Revenue	€40.7 billion ($53.8 billion)
Operating Profit Margin	5.3%
Net Profit Margin	8.7%

Valuation Metrics:
(Current Price vs. TTM)

	RNO	CAC
P/E	5.1	14.5

RNO PRICE HISTORY

THE BOTTOM LINE

At today's prices, Renault owns minority equity interests worth around €16 billion in Nissan and €3 billion in Volvo. The value of the profitable auto finance business is roughly equal to total debt. The result, says David Einhorn: "The car and truck business, which made about €2 billion last year, is free."

Sources: Company reports, other publicly available information

Define free.

DE: Renault has a market value of €19 billion today. But they own about €16 billion worth of Nissan, and they own €3 billion of Volvo. They still have €2.5 billion of debt, which is covered by the value of the finance subsidiary that generates €290 in after-tax income and has a €1.7 billion book value.

So you're left with the Renault car and truck business, which generated EBIT in 2004 of €2 billion, for free.

What's the catch?

DE: The catch is there are no natural owners for this. If you're a growth investor, you're not going to be interested in Renault. A plain vanilla value investor won't be comfortable because of the valuation of Nissan. But, if you do what we do, which is hedge out the Nissan and Volvo stakes, you get the Renault business at a price we like to pay. One day the discrepancy should resolve itself.

Your final stock, Lanxess, is a recent German spinoff of Bayer AG. What's the thesis here?

DE: Lanxess is a hodgepodge of businesses in chemicals and plastics and rubbers. As in most spinoffs, there are a few absolute dogs in their portfolio, a lot of mediocre businesses and a couple that are actually good.

The thesis is that at a time when the stocks of U.S. basic materials and chemicals companies are trading at high multiples on next year's profits that assume lots of price increases, this is a company trading at a low multiple of this year's profits that don't assume a lot of price increases. Lanxess is trading at only around 5x EBITDA on 2005 estimates.

Everyone hates this company because it's a bunch of businesses Bayer didn't want and has low margins. So it trades at a lower-than-average multiple on the lower-than-average margin. But we think there's a real opportunity here for management to reengineer the portfolio – close businesses that are a drag, maybe reallocate capital among businesses. It's very much like Freescale in that you could wind up with a much better multiple on much higher profits. If that were to come to pass we'll have a very good investment result.

Looking at the available financial and strategic information on Lanxess, which isn't very enlightening, how do you analyze the individual businesses?

DE: This is too opaque to have a strong view about the individual businesses. You have to bet on whether you think the people they put in charge are capable of reconfiguring the portfolio in a way likely to create value for shareholders. They brought in a CFO who had a similar successful experience at Aventis. Our subjective judgment from hearing management present and speaking to them on the telephone tells us it's a worthwhile bet.

Any parting advice or thoughts?

DE: Maybe one thing I didn't mention earlier. We try not to have many investing "rules," but there is one that has served us well: If we decide we were wrong about something, in terms of why we did it, we exit, period. We never invent new reasons to continue with a position when the original reasons are no longer available. VII

INVESTMENT SNAPHOT

Lanxess AG
(Frankfurt: LXS)

Business: Recent spin-off from Germany's Bayer AG, portfolio of businesses focused primarily on global manufacture of chemicals, synthetics and plastics.

Share Information
(@3/22/05, Exchange Rate: $1 = .7570 euro):

Price	**€16.11 ($21.28)**
52-Week Range	€13.63 – €17.95
Dividend Yield	n/a
Market Cap	€1.2 billion ($1.6 billion)

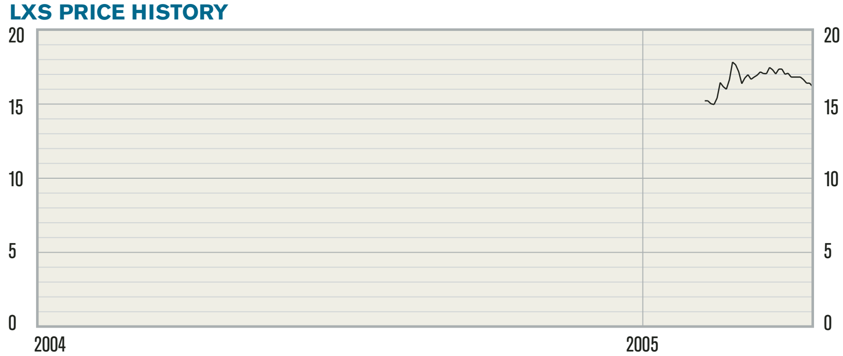
Financials (Est. full-year 2004, prior to spin-off):

Revenue	€6.7 billion ($8.8 billion)
Operating Profit Margin	1.5%
Net Profit Margin	(0.2%)

Valuation Metrics:
(Current Price vs. TTM)

	LXS	DAX
P/E	n/a	16.1

LXS PRICE HISTORY



THE BOTTOM LINE

While U.S. chemicals stocks have "high multiples and assume strong industry price increases," says David Einhorn, LXS trades at only 5x estimated 2005 EBITDA, assuming little or no price increases. As the portfolio of businesses is reengineered in coming years, he sees significant upside from higher profits earning a much better multiple.

Sources: Company reports, other publicly available information