Yacktman Capital Group

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Client Letter - June 30, 2009

Equity markets brought welcomed relief as they continued the early March rally with the S&P 500 up nearly 16% over the second quarter. From the March 6th intraday low, including dividends, this represents a return of over 38%. While this type of market advance is extremely rare, it is not uncommon when coming off such a precipitous decline. Market prices continue to rebound on the notion that the economy is deteriorating at a slower pace than expected, but nonetheless, still worsening. In the ambitious hunt for “green shoots,” we believe it would be a mistake to conclude all is well from only a small number of positive economic indicators. Besides, what if these “green shoots” turn out to be weeds? Prices can march forward only so long before an actual *sustained* economic recovery becomes necessary for further advancement. Amongst all this positive news, the facts on the other side of the coin are appearing to be somewhat overlooked: continued deleveraging pressure, decreased spending among consumers who represent two-thirds of the economy as the savings rate increases and unemployment rises, excess supply of homes and more mortgage resets and losses to come, reduced credit and investment, long-term inflationary pressure, and long term effects from government actions seeking to ease immediate pain. It seems there is far more to be concerned about than what is being conveyed by the media.

Health Care

Given our defensive stance, we thought we would take a moment to briefly discuss our outlook on the health care sector and then touch on a few individual health care companies. Should the economy continue to struggle, this resilient sector should continue to grow at a healthy clip. During tough times, due to the essential nature of health care, expenditures remain relatively unscathed. Additionally, most purchases in this sector are done through a third party – insurance – and so consumers do not alter purchasing patterns because they do not directly feel the impact to their pocket book. Finally, the baby boomer generation wave is just reaching retirement age. Conversely, the fear of nationalized health care and the risk of strong government pricing power have led to much uncertainty about operating margins and future cash flows. But we feel the underlying fundamentals and valuations are compelling enough to offset any unfavorable impact that will stem from government action.

As you may know, we maintain a blog on our website at www.yacktmancapitalgroup.com/thoughts. We have decided to share a few excerpts from these informal blogs regarding some of our holdings.

Medtronic: Times are tough – can’t afford that stent (May 19, 2009)

Yeah, right! Yes, you can. I don’t know anybody in a life or death matter who would say, “Doc, I’m strapped for cash, can’t afford that stent.” The numbers Medtronic reported today support that. In an economy needing a defibrillator, last year Medtronic seemed immune to the downturn. Revenues were very robust, up 8% despite a strong dollar (more than 1/3 of their revenues are overseas in 120+ countries). In fact, all of their 7 businesses grew year over year, with five of them growing in double-digit territory.

What's been holding their stock down? First, health care reform could affect future revenue as their products are subject to Medicare reimbursement rates. Also, as with many other health care companies, there is always the patent expiration issue and the legal issue. Over the last few years, Medtronic has made a number of voluntary recalls which can also hurt confidence in their products (Although, fatalities have been few and some suits brought against them were recently dismissed in a court victory in February). There has also been rumor that their sales reps have engaged in inappropriate marketing methods. Finally, their forecast for the upcoming years was less upbeat than what analysts had hoped for.

However, we feel the market has overreacted, for there is much to cheer about. Medtronic is the world's largest manufacturer of implantable devices and famed for inventing the pacemaker fifty-two years ago. As we already stated, they continue to grow and have a very diverse revenue stream stemming from 7 different business segments. They have dominating market share in defibrillators, spinal products, and insulin pumps. As we expected (see our 1/28 blog), Medtronic is expanding their empire during tough times by agreeing to purchase companies such as CoreValve (for $700MM) and Ventor Technologies (for $325MM). These two acquisitions in particular will provide entry into the transcatheter valve industry (a less invasive procedure for valve replacement). Additionally, they continue to cut costs and have committed to return 40% of their cash flow to shareholders via dividends and stock repurchases. Not only are they buying back stock for shareholders, but management has been purchasing stock themselves in the open market. In a bleeding economy and a retiring baby boomer generation, we're glad to own Medtronic at the cheapest P/E we've seen on this stock in over a decade.

Unitedhealth Group: Unitedhealth Posts Solid Results (April 24, 2009)

UnitedHealth provides health insurance to more than 70 million individuals. Last Tuesday, as we expected, they posted strong results. One source of concern has been that with unemployment rising, membership from business health insurance plans will shrink. While there has been a reduction here, revenues from Medicare have more than offset this decline by continuing to grow at a healthy pace.

At $23/share, we believe UnitedHealth is significantly undervalued. Thus, we were excited to see they repurchased $700 million of their own stock over the past quarter. We estimate free cash flow per share to be in the $3-3.50 range. With 1.2 billion shares outstanding, at this pace, the company is returning 2/3 to 3/4 of free-cash flow to shareholders in the form of share repurchase.

The main reason for the favorable valuation resides in the political uncertainty surrounding the company. However, no matter what reforms are made in the Obama administration, health insurance is an essential service and somebody has to administer it. In fact, UnitedHealth is currently the largest administrator of Medicare plans, making up 25% of their revenue. We feel the cheap price will provide a satisfactory return, regardless of any changes coming.

Pfizer: Viva Pfizer! (June 12, 2009)

Although a manufacturer of consumer products, hospital products, and animal health products, Pfizer is known for being the largest producer of pharmaceuticals in the world boasting annual sales of over $46 billion, 58% of which comes from overseas. Some of their well-known patented blockbuster drugs include: *Lipitor*, *Viagra*, *Zoloft*, *Celebrex*, *Zyrtec*, *Zithromax*, and *Diflucan*. Before the end of the year, pending shareholder approval, Pfizer has agreed to purchase rival Wyeth for $68 billion. Wyeth is also a leading manufacturer of prescription drugs (such as *Effexor*), over-the-counter drugs (such as *Advil*, *Dimetapp*, *Centrum*, *Robitussin*), and consumer products (such as *ChapStick* and infant formula) with $22 billion of annual sales (53% overseas). The combined entity will have a very diversified product base – 17 lines that have annual sales in excess of $1 billion.

The patent on Pfizer's biggest drug, cholesterol-lowering Lipitor, is set to expire in 2011. No question generic competition will erode profits, but we believe the long-term growth prospects are under appreciated. Their R&D pipeline for new drugs is currently the largest ever and there is plenty of room for international growth. Additionally, with their strong financial position and distribution network, they are a fantastic fit for small companies who need financing to develop new drug ideas and get them through the FDA approval process. The other main concern is the political uncertainty over pending healthcare reform. While strict drug pricing controls would hamper margins, increased drug volume sales from universal coverage and lower prices might alleviate some of the pain.

We estimate free cash flow to be around $2.25/share. Should these aforementioned fears materialize more than we expect, at $15/share, this represents a 15% free cash yield, a substantial margin of safety. In fact, if you analyze cash flows for each drug individually, at this price it's as if you get the current pipeline as free icing on the cake. We're happy to collect a hefty dividend while we patiently wait for price and value to converge.

Concluding Remarks

If investors mistake weeds for "green shoots" and extrapolate this supposed positive news, with such high levels of cash in money market funds, we cannot discount the possibility of investors becoming less risk adverse. We would then see the market continue to advance in the short run despite long term headwinds. Thus, we continue to believe that the market will widely fluctuate in the ensuing years, however, in the end not make much progress. On the other hand, there will be some companies that will continue to grow, and we believe many are found in the health and consumer staple sectors. This is why we will continue to diligently focus on *investing* in companies on a *case by case basis* rather than make decisions based upon *speculating* market directions.

Sincerely,

Brian A. Yacktman — William D. Kruger

Manager — Manager