WILLIS INVESTMENT COUNSEL
Principled Investing

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THE IMPORTANCE OF PRUDENT CAPITAL ALLOCATION AND ALIGNED INTERESTS

In recent quarterly correspondence to clients, we focused on the significant financial strength of corporate America. By "financial strength," we mean low debt, tons of cash, and solid profitability. A story in the April 9 issue of the *Wall Street Journal* summed it up this way: 'Big U.S. companies have emerged from the deepest recession since World War II more productive, more profitable, flush with cash, and less burdened by debt'. The bottom line is that for the majority of corporate America, balance sheets are rock solid, with companies holding more cash than ever relative to their assets.

In our view, this is largely due to the enormous amounts of free cash flow that companies have been producing over the years. In fact, the ratio of free cash flow to stock market value continues to hover near all-time highs (excluding financial services). *Free cash flow* is the residual cash available to shareholders after all operating expenses and capital expenditures have been covered.

For over 33 years, Willis Investment Counsel has closely followed free cash flow generation. We consider free cash flow a far more reliable indicator of the progress of the companies in which we are invested, and ultimately of the portfolio, than stock prices. Such robust cash generation usually pushes stock prices and portfolio performance upward over time. While risk management is multi-faceted, one of the unique risks that robust free cash flow and burgeoning cash balances presents is ***capital misallocation risk***, which is the risk that corporate management teams will allocate capital poorly or recklessly.

Because many of our portfolio holdings are highly cash generative, judgments about management's capital allocation skills are important to us. If we expect to own a cash flow generative company for several years, management is likely to make hundreds of capital spending decisions, the aggregate of which may meaningfully impact how sustainable returns on equity ultimately prove to be.

Ideally, we aim to invest alongside capable management teams that have demonstrated solid track records of integrity and prudent capital allocation. This does not mean we need to physically meet with the management team of a prospective holding. In fact, unlike many investment management firms, we rarely meet or talk with the management teams of the companies in which we are invested. We can adequately judge the record of management simply by evaluating the returns generated by historical capital allocation. Said more simply, we care a lot more about what management is doing, which is well documented in the numbers, than what they are saying. We can see how conservative or aggressive they are. In addition to the numbers, we can review historical shareholder letters to determine if management is discussing problems openly and addressing them to determine if disclosure is complete and easy to understand. We look for "straight talk."

Another way we guard against capital misallocation risk is by paying significant attention to insider ownership and compensation structures to ensure managements' incentives are aligned with ours. Ideally, we want to see material ownership positions or ownership positions via stock options where the option strike prices are significantly above where the stock is trading.

The table below contains companies we own that have particularly high cash balances relative to their respective market capitalizations. In the far right column, we note either the insider ownership or the recent insider activity surrounding that particular position. Remember, the main risk we are trying to guard against is capital misallocation. Fundamentally, we believe that human beings ultimately act in accordance with their best interest; therefore, the insiders running the companies below would seem to be highly motivated to employ excess cash in a productive fashion. Significant insider ownership or recent insider buying does not remove capital misallocation risk; however, we firmly believe that it can meaningfully dampen this risk.

TABLE: REPRESENTATIVE HOLDINGS FROM WIC'S GREEN STREET FUND[1]

Company	Net Cash per share	Cash as % of Total Value	Insider Activity
Convergys	$6.50	45%	CEO receives 70% of base salary in form of stock
Interdigital	$16.14	56%	Jan/12: Chairman bought 10,000 shares Jan/12: CEO bought 6,828 shares
McDermott	$3.42	33%	May/12: CEO bought 102,368 shares May/12: Director bought 150,000 shares
IDT Corp	$7.36	76%	CEO owns 24%; Other directors own 2%
Shaw Group	$18.23	69%	CEO owns 3.5%; Other directors own 1.6%
Genie Energy	$4.49	58%	CEO owns 18%; Other directors own 11%
Howard Hughes Corp	$9.65	16%	CEO owns 1%; Other directors own 15%

Convergys Corporation (NYSE: CVG)

Convergys Corporation is a good example of what we are looking for when we own companies with significant cash balances. Convergys is the second largest operator of global call centers and billing services. If you are an AT&T, Comcast, or DirectTV customer, you rely on Convergys to record your data and voice usage, manage your bill, and provide customer support. The business is very steady and highly free cash generative -- as the mobile and cable providers are reluctant to replace an incumbent call center partner for fear of disruption.

Convergys was spun out of Cincinnati Bell in 1999, and through much of the past decade, was managed with an inefficient "Bell-like" mentality. We originally purchased Convergys in early 2011 after noting that an activist investor helped bring about management change, replacing the long-time CEO with board member, Jeff Fox. The new CEO inherited three stable but disparate business units, with the core call center and billing business responsible for over 85 percent of annual revenue. In simple terms, with the right incentives and strategic moves, we believed that Convergys could simplify itself into a more focused and profitable company while unlocking significant shareholder value.

Mr. Fox was the first outsider to run Convergys and brought with him an impressive operating track record of running businesses. Perhaps equally important was that this new CEO elected to receive no base salary and instead receive over 70 percent of his annual compensation in the form of restricted stock.

We believed that each of the three businesses valued independently would yield much greater value than the current market capitalization. After reviewing Mr. Fox's compensation and ownership structure, we saw Convergys as a sum-of-the-parts investment with new, highly aligned management and an activist holder with board representation poised to unlock value.

So what has happened since? In the past 15 months, the company has announced the sale of both of the smaller business units, with proceeds either approximating or exceeding our prior estimates. The company's current market capitalization is approximately $1.5 billion. By the end of the second quarter of 2012 (and net of taxes), the company will have around $750 million in cash and no debt. This leaves the core business selling for $750 million despite at least three to four transactions being done within the industry at double Convergy's current valuation multiples. Looking forward, we expect one or more of the following to occur, any of which should result in a meaningfully higher stock price: 1) a special dividend; 2) sale of core business to a private equity firm or strategic investor; 3) a significantly accretive acquisition of related businesses. In our view, the significant insider ownership of stock by the company's CEO dampens the odds that the company could allocate this growing cash hoard inappropriately.

Interdigital Corporation (NASDAQ: IDCC)

Interdigital is another relevant example. Founded in 1972, Interdigital has emerged as one of the leading patent holders in the wireless industry with a portfolio of approximately 18,500 assigned or pending patents. The company's deep pool of licensees (roughly 80 percent of 2G and 50 percent of 3G technology) includes key members of the wireless community: Apple, HTC, LG, RIM and Samsung, among others.

We uncovered Interdigital in September 2010 after researching its larger peer Qualcomm. At the time, Interdigital had approximately $13 per share, or roughly 50% of its then market capitalization, in the form of cash. Patent licensing is a litigious business, but management had cited the need to only maintain about $100 million to $200 million ($2 to $4 per share) in cash for patent protection purposes, leaving ample excess capital at management's discretion.

At the time, we noted reasonable insider ownership, but we also noted an evolving and improving ownership mentality taking shape at the company. In the past two years, Interdigital has instituted a meaningful quarterly dividend, eliminated its staggered board provisions, conducted two separate $100 million share repurchases, and both the CEO and Chairman have purchased reasonable amounts of stock in the open market.

So what has happened since? Several weeks ago, Interdigital announced the sale of approximately 8% of its patent portfolio to Intel Corporation for $250 million net of taxes, representing 44% of its then market capitalization net of cash. Concurrent with this announcement, the company doubled the size of its current share repurchase authorization, essentially signaling to existing investors that it would be returning the excess capital to shareholders.

While Convergys and Interdigital are just two examples, we apply the same framework towards each and every company we evaluate for client portfolios. By paying attention to insider ownership, management incentives, and recent insider activity, we believe we can further reduce the risk of capital misallocation as a result of many of our holdings having significant cash balances.

We take comfort in the financial strength and cash flow generation of the companies in which we invest. However, investing is a dynamic process; therefore, we will continue to apply a mosaic approach that pays close attention to the operational performance of the companies in which we invest - especially their free cash flow from operations, while also focusing on issues such as Europe, other geo-political situations, macro risks, and the political winds in and out of Washington.

James J. Kilroy

[1] These stocks provide examples of our methodology. You may request a list of all stocks bought and sold by WIC during the last twelve months. Our clients' portfolio rate of return, and fees, are detailed in their quarterly report. Past returns should never be used as an indication of future returns. A description of our firm, our SEC disclosures and fees can be found at www.wicinvest.com.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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