The Commonsense

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Buybacks and Splits

Last month we declared our distaste for stock splits. This month we will cheer on some of the companies that are making buybacks. In this article we will refer to our holding OMI, which is a great example of a company that has been judiciously buying back shares and creating shareholder value. When a company buys its own shares and retires them so they no longer can be re-issued, often this creates shareholder value.

Buyback can increase shareholder value when done right.

In the case of OMI management has stated that they are buying back shares because they believe that the company's shares are under valued. We whole heartedly agree. When this situation is true, a company can generate much higher returns for shareholders by buying their own shares. Most of the shares OMI has bought back over the past two years have been in the $17 to $19 range. The shares are now trading at more than $22. OMI is generating cash from operations so fast they are having a hard time deploying it productively. When a company's shares are trading at a discount to their true worth, buying back share creates value for shareholders in two ways. The result is seen in higher share prices.

The primary way buybacks help increase share price is by increasing earnings. For arguments sake lets assume a company has 100 shares of stock and the company earns $10. Each share has $.10 of the earnings linked to it. If the company bought back 50 shares, each of the 50 shares left now has $.20 linked to it. Or as it is more commonly stated, the company has earnings per share of $.20. When earnings go up and the prospects of future earning look higher, share prices often adjust higher. Simply stated, higher earnings can support a higher share price.

Buying shares back when a company's shares are trading at less than market value is an excellent way a company can utilize cash they generate. It magnifies the earnings increase that can be generated from buying in shares. A company has to answer the question; what is the use of cash that will generate the highest return for shareholders. When shares are selling for $.75 on the dollar or even less, buying back shares creates more than a dollar of value for the remaining shareholders. With that said, nobody is standing with a sign announcing shares are trading for less than market value. We go through various contortions to uncover companies that are.

Plenty of companies are also guilty of buying back shares when their share price is obviously overvalued. In this case the money would be much better returned to shareholders in the form of a dividend or used to pay down debt or some other, better, alternative use. Often when excessive amounts of stock options are granted to management, a company tries to prevent diluting the owners interest by buying back shares. We know of examples where companies buy back hundreds of millions of dollars worth of shares to cancel out the effect of option grants. This generates no value for shareholders other than avoiding watching their ownership interest shrink.

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Several companies have been extremely successful at buying in shares to increase shareholder value. Altria is a great example. The company formerly known as Philip Morris has had stagnant revenues for quite a few years. Over the past five years, revenue has grown from $89b to $97b, a 9% rise over the four years. At the same time, earnings per share have grown from $3.88 to $5.10 or a 31% increase. Earnings measured on a net basis have moved from $8.6b to $10.7b which represents a more modest 24% increase. How can earnings per share increase faster than net earnings (income)? When the share count declines, earnings per share increase. This is exactly what Altria has caused to occur with their buyback. The company also happens to pay a 4% dividend. All of the cash they generate from operations is not used to buy shares. They split it between buybacks and dividend payments. The end result is that the company's share price has risen from around $40 to $80 over the time period we are considering. It is obvious that the buybacks have helped create value for shareholders. With shares now at $83, it is questionable as to how much benefit shareholders will receive in the future from current buybacks. Spending $100mm on a buyback will buy many less shares at $80 than at $40. The boost to earnings in the future will be inhibited by the higher current share price.

We previously stated that OMI has a very successful buyback program. In 2004, the company generated $565mm in revenue versus $652 in 2005, for an increase of 15.4%. Net income rose from $246mm to $275mm for an 11.8% increase. When we look at earnings per share, we see that they have grown from $2.86 to $3.39 or a 18.5% increase. The large buyback initiated in 2004 has already helped drive earnings per share up faster than revenue and net earnings.

It also helps to look at this from a dollars spent standpoint. In 2004 the company bought back 7.89mm shares for $141.4mm, or $17.92 per share. In 2005 the company bought back 15.035mm shares at an aggregate price of $269.9mm. This works out to $17.95 per share. In 2004 the company had 93.6mm shares outstanding. By the end of 2005 the company had 73.5mm shares outstanding. Currently the company has 66.8mm shares outstanding after buying back 5.16mm shares this year for $96.5mm, at an average price of $18.71. The chart below summarizes the changes that have taken place over the past two years. (The buyback began the last half of 2004 and continues currently.)

Year	Shares Outstanding in mm's	Shares Repurchased in mm's	Value of Shares Repurchased in mm's	Avg. Price Paid	Share Price	Market Value in bil's
2004	93.6	7.89	$141.4	$17.92	$12.00	$1.12
2005	73.5	15.04	$269.9	$17.95	$18.15	$1.33
2006	66.8	5.16	$96.5	$18.71	$22.52	$1.50
total		28.09	$507.8	$18.08		

note: For 2004 we used the shares outstanding after the issuance of 12mm shares during the summer of 2004.
2006 numbers are of the end of August

The change in market value over the past two years has been an increase of $380mm. The company has spent over $500mm. To this point the buyback looks like it has been beneficial for shareholders. In this case we feel the company is still undervalued. Buybacks often take more than two years to have an effect on share prices. The shipping industry has also been soft over the past few years. If the $507mm used to purchase shares had been paid out to shareholders, each shareholder would have received $5.45 per share. The share price since 7/31/2004 has climbed from $12 to over $22 or a more than $10 jump. Would it have move up this much without the buyback? Definitely not. It may have moved up some, but not nearly the amount that it has in the past two years. Buybacks do not happen in isolation so it is tough to analyze them. Overall we are satisfied with OMI's action. We also expect the buyback to continue to be beneficial in future years due to the permanently reduced share count. This will continually boost the earnings per share numbers reported in future periods leading hopefully to even higher share prices.

Watch List

This month we have two new additions along with one deletion on the list of stocks that we have an interest in. Gone is XTO who's usefulness was limited since we made our investment in Chesapeake. In its place we added two small companies we have an interest in. Alliant Techsystems (ticker symbol ATK) is a manufacturer of ammunition, rocket motors, other weapons systems and space systems. Servotronics (ticker symbol SVT) is an extremely small company that operates two divisions. Their Advanced Technology Group produces products that include servocontrol valves, torque motors, actuators, check valves, pressure regulators, metallic seals and many other products which are in a wide range of applications. These applications range from outer space, military, and commercial aircraft, helicopters, ground vehicles, test equipment, and precision controls of all types. They also have a Consumer Products Group that produces knives for both military and commercial applications.

Both companies are virtual unknowns. ATK is small with a market cap of $2.6b. SVT is as small as a publicly traded company gets, with a market cap of a mere $16mm. ATK is benefiting from the war in Iraq and their high tech weapon system developments including work on the missile defense system and high tech efforts related to the space program. Servotronics is set to benefit from the next generation military plane the joint strike fighter (that our holding Astronics also has content on) and also on many commercial planes. The company also has their products used on missiles.

We like ATK because they have been successful in landing a steady stream of new contracts. SVT has several strong points. They have a nice hoard of cash along with a strong balance sheet and have been benefiting from the upturn in the commercial aviation market. With sales of $23mm, SVT is a fairly low risk investment considering the low $16mm market cap. The company has more than 40 years operating history. The only year the company was cash flow negative in the past six years was in 2002 which was at the bottom of the commercial aircraft capital expenditure cycle brought on by the aftermath of the 9/11 tragedy. With the commercial airlines finally increasing much delayed capital expenditures this bodes well for SVT. We are just beginning our analysis of ATK. We like that fact that they do not get much attention and that they are very aggressive developing new products.

As we progress with our research on these companies we will update you on our progress. Another drop in share prices on several of the companies in the list below would go a long way towards increasing our chances of investing in them. Here's to hoping we get our wish.

Company	July price	June price	Change from June	P/E	52 Week High	52 Week Low	Estimated '06 EPS	Dividend Yield
Alliant Techsystems Inc./ATK	$80.14	$76.35	4.96%	18.8	$84.90	$67.20	$4.21	n/a
Altria Group, Inc./MO	$79.97	$73.43	8.91%	15.0	$84.48	$68.36	$5.32	3.80%
Bioanalytical Systems, Inc./BASI	$6.29	$7.31	-13.95%	n/a	$7.80	$4.75	n/a	n/a
Canadian Natural Res./CNQ	$53.24	$55.38	-3.86%	14.0	$64.38	$36.64	$3.05	0.50%
CSP Inc./CSPI	$7.08	$7.07	0.14%	n/a	$8.38	$5.59	n/a	n/a
Kensey Nash/KNSY	$28.26	$29.50	-4.20%	75.6	$33.33	$19.32	$0.67	n/a
Landauer, Inc./LDR	$46.77	$47.90	-2.36%	24.9	$53.95	$43.11	$2.20	3.80%
Markel	$340.65	$347.00	-1.83%	19.0	$371.00	$307.41	$26.24	
ModPac/MPAC	$9.57	$9.95	-3.82%	n/a	$13.99	$8.00	n/a	n/a
QLT Inc./QLTI	$7.07	$7.08	-0.14%	n/a	$9.00	$5.93	$0.37	n/a
Rayonier/RYN	$39.81	$37.91	5.01%	22.8	$47.50	$34.00	$1.76	4.70%
Servotronics Inc./SVT	$7.11	$6.35	11.97%	9.6	$10.30	$3.85	n/a	n/a
Tejon Ranch Co./TRC	$40.81	$41.16	-0.85%	n/a	$52.94	$37.55	n/a	n/a

The Investletter Portfolio

The chart below shows our investments and the proportion of our portfolio they represent. As you can see, we are heavily weighted towards three stocks. This is considered extremely risky by the popular investment community. We feel perfectly comfortable with it. To achieve the same returns we will receive, you can buy all of the stocks we own in roughly the same proportion. After some time considering how best to invest in the Investletter Portfolio, we have decided that it is best to just invest in all of the stocks we recommend immediately without picking and choosing. The buy price can serve as a target to guide you as to how we feel the shares are currently priced. This can be compared to what the company is currently selling for and be used in making short term purchasing decisions.

This past month was marked by all kinds of crazy events. Astronics shares dropped below $12 for part of a day late in the month. Culp shares reached $6.75 for a short time in early July. OMI reported absolutely huge earnings of $1.92 per share for the second quarter. Much of it was the result of one time ship sales but the resulting cash flow was astounding. The company had over $400mm in cash move through their accounts in the past couple of months.

Several of our smaller positions continue to flounder. Headwaters has to this point come up empty in their quest for agreeable tax legislation. Fortunately, this malaise has not spread to Gencor which also is a large benefactor of the section 29 tax credits. Cell Genesys announced more delays in getting their clinical trials fully enrolled and PDL Biopharma announced disappointing trial results for one of their drug candidates. Terra Systems price fell for no reason whatsoever which is just what we expect to see with a company of their size. Hopefully this month it will move back up for the same reason.

With all of this hubbub we feel we are well positioned for the second half of the year. The companies we have most confidence in are the ones that make up our largest holding. Which is just the way we intend it. Astronics finally got the news they were looking for with the Eclipse very light jet getting its provisional certification. This means that production for the Eclipse will begin to ramp up and Astronics will get a nice revenue boost in the second half.

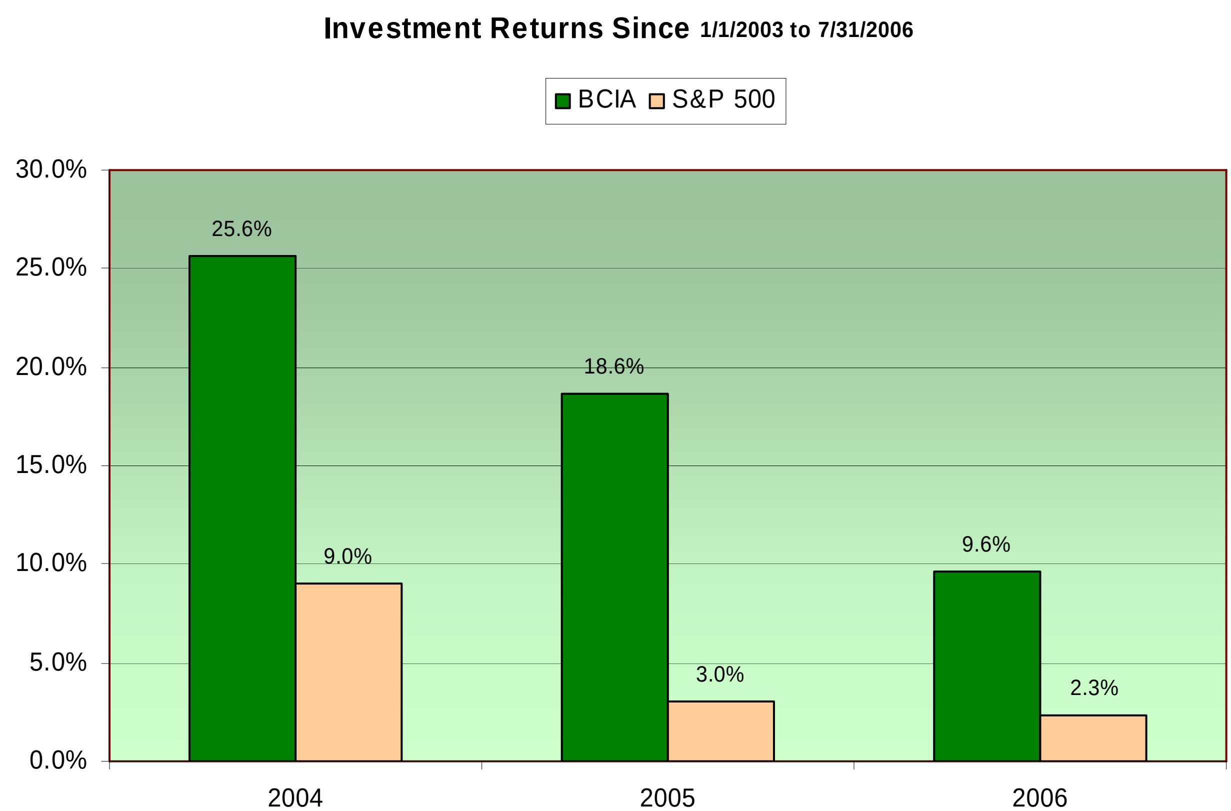
OMI's management has taken care of the owner by paying down $130mm in long term debt the first half of the year and retiring nearly 4mm more shares in the second quarter alone. The company also locked in more time charters and has their operating expenses covered through year end 2008. Guaranteed profitability over the next two plus years has a nice ring to it.

Company	Porfolio Percentage	July price	June Price	Percentage Change	Buy Price (less than)	P/E	Dividend Yield
Alico/ALCO	13.90%	$54.50	$55.11	-1.11%	$50.00	45.3	2.00%
Astronics Corporation/ATRO	13.40%	$13.16	$13.38	-1.64%	$13.00	22.8	n/a
Berkshire Hathaway B/BRK.B	8.70%	$3,047.00	$3,043.00	0.13%	$2,900.00	13.8	n/a
Cash	16.70%	$1.00	$1.00	n/a	n/a	n/a	n/a
Cell Genesys, Inc./CEGE	2.90%	$4.91	$5.02	-2.19%	$5.00	n/a	n/a
Chesapeake/CHK	4.70%	$32.95	$30.25	8.93%	$30.00	8.0	0.80%
Culp/CFI	2.90%	$5.19	$4.89	6.13%	$4.40	n/a	n/a
Gencor/GNCI	7.50%	$9.20	$9.40	-2.13%	$8.50	3.6	n/a
Headwaters/HW	2.60%	$23.14	$25.56	-9.47%	$25.00	8.6	n/a
K-Tron International/KTII	4.40%	$51.00	$51.00	0.00%	$42.00	16.4	n/a
OMI Corporation/OMM	19.90%	$22.00	$21.65	1.62%	$18.00	8.49	1.70%
PDL Biopharma/PDLI	1.00%	$18.01	$18.41	-2.17%	$24.00	n/a	n/a
Specialized Health Products/SHPI	0.80%	$0.40	$0.39	2.56%	$0.40	n/a	n/a
Terra Systems/TSYI	0.60%	$0.65	$0.65	0.00%	$0.60	n/a	n/a

Performance

Last month the stock market was virtually unchanged from the previous month. Fortunately, our portfolio bucked the trend. We again widened our lead over the S&P 500 market average. With our solid July performance we now have a 7.3% percentage point lead year to date. Since the beginning of 2004 when we began publishing the newsletter we are up more than 62%. With five months left we still have a ways to go to match last years strong returns.

Our four largest holdings (ALCO, ATRO, BRK-B and OMM) have generated year to date returns of 22.9%, 19.6%, 4.5%, and 25.7%, respectively. Without holding dogs like HW, CEGE and AMGN our performance would be even better. ATRO and OMM both reported very strong earnings this quarter. They both should be solid performers the rest of the year. When our large holding do well, our portfolio tends to do well. Some of the smaller positions we have can barely make a dent in the performance numbers of the portfolio.



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