Survivor: the Corporate Edition

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Our position in brief
The current recession, financial crisis, and bear market have sorely tested the survival skills of corporations worldwide. We think the companies that should most effectively survive this exceptional test tend to exhibit these traits: they use hard times to bolster their competitive advantages, they have strong balance sheets and substantial backlogs of orders, and they continue to take risks and innovate.

Highlighted are 22 companies that we think should be among the hardiest survivors: Best Buy, Google, Kohl’s, Target, and Nintendo in the consumer sectors; Aqua America, BHP Billiton, Monsanto, and Southwestern Energy in the cyclical sectors; BlackRock, T. Rowe Price Group, Industrial and Commercial Bank of China, MasterCard, Visa, and Northern Trust in the financial-services sector; Abbott Laboratories, Gilead Sciences, and Teva Pharmaceutical Industries in the health-care sector; and Apple, IBM, Qualcomm, and Taiwan Semiconductor Manufacturing in the technology sector.

Surviving a triple test
The triple whammy of the recession, the financial crisis, and the bear market has tested the mettle of companies everywhere. In some cases, it has made the strong stronger and the weak weaker. And it has presented opportunities in industries for the challengers to gain on the leaders. In any case, how effectively companies respond to the recession, the financial crisis, and the bear market should largely determine whether they survive or not (and if they do survive, how competitive they will be going forward).

To us, the strongest survivors tend to share a number of distinguishing traits -- traits that enable them to get through hard times relatively unscathed or emerge even better off than before. As we see it, these four traits are particularly significant:

1. Survivors tend to use hard times to concentrate on and bolster their competitive advantages. McKinsey & Company likens competitive advantage to “two branches, both growing from the same root:” the ability to take business away from another company at a profit and the ability to drive the costs of doing business low enough to ensure survival in hard times.

Survivors’ profits endure
The soundest survivors generally have an above-average degree of pricing power and
profitability, due either to their leadership position or the uniqueness of their products or services. As a result, when product prices decline during a down cycle, for example, the survivors’ revenues may suffer, but their profitability usually remains above the cost of capital. Their less-sound rivals, on the other hand, are likely to have their profits morph into losses and may be compelled to cut costs severely, often to the ultimate detriment of their competitiveness and market share.

Also, survivors are more likely to take advantage of hard times to pare costs even in their most profitable businesses. In our judgment, survivors like retailers Kohl’s and Target tend to be acutely conscious that profitable businesses, in common with bad businesses, are prone to acquiring overhead, clutter, and inefficiency, which they purge in hard times. Such a consciousness helps explain why they are low-cost operators in many instances.

2. Survivors tend to maintain strong balance sheets in good times that give them a margin of safety to survive the inevitable downturns. As BusinessWeek characterized it, “Cash is the new black” at companies today, with the bigger the pile of cash, the better. The extreme tightening of credit during the financial crisis has made a sound balance sheet and prudent cash-flow management fashionable -- and critical to corporate survival recently.

Play offense or defense
In essence, we think cash has given companies the means to play offense or defense. In this recession some companies are playing defense and adding to their cash hoards to give themselves some breathing room. Others, such as Google, IBM, and Qualcomm, are going on offense, using their cash to pursue opportunities such as acquisitions and capital investments intended to increase their market shares. Google, for instance, is opportunistically snapping up good engineers, as companies slash engineering jobs.

3. Survivors tend to have substantial backlogs of orders -- an indication that they have the good fortune to be in a favorable competitive position or in a business with favorable economics or both. For example, IBM’s backlog totals $114 billion, a sum greater than the gross domestic product of the Dominican Republic, Guatemala, and Costa Rica combined.

4. Survivors tend to keep taking risks and innovating. In any industry, but especially in highly competitive, fast-changing industries such as semiconductors and biotechnology, it can be perilous to reduce investments in innovation. By innovation, we don’t mean just research and development. Innovation can encompass something as bold as launching a new business when the competition is reeling from a recession or something as prosaic as redesigning the box of a laundry detergent to rekindle consumer interest in a brand.

To walk the tightrope
A number of studies have shown that companies that continue spending on acquisitions, advertising, and R&D during recessions fare much better than those that cut back. McKinsey & Company found that companies that remained market leaders or gained market share during the 1990-1991 recession had increased their acquisition, R&D, and ad budgets, while companies at the bottom of the pile had reduced them. This is one of the trickiest aspects of corporate survival. Business is nothing if not an exquisite balancing act, and the soundest corporate survivors tend to be those who are nimble enough tightrope walkers to both spend on innovation and keep costs under control.

So, which companies exhibit those four traits and seem likely survivors of the current recession, the financial crisis, and the bear market? As we see it, the following 22 U.S.- and overseas-based companies have all the earmarks of sound survivors. If the 22 were a mythical TV show, they might be *Survivor: the Corporate Edition*; they have endured the extraordinary series of sledgehammer blows from the economy, the
financial crisis, and the stock market and remained standing tall.

Our list is by no means comprehensive; there were hundreds of survivors to choose from. The 22 survivors cited meet two criteria: 1) they are as representative a cross section as we could gather within the practical limitations of space for this paper and 2) they are on especially solid footing in relation to their peers, in our judgment. We think that, with the possible exception of bankruptcy lawyers, they are taking the greatest advantage of all the short-term economic and financial difficulties. But unlike bankruptcy lawyers, their efforts are likely to have happier consequences: higher profits and higher market shares when business conditions improve. We have categorized our choices of survivors by stock-market sector and alphabetically (as opposed to any subjective descending order of merit).

Survivors in the consumer sectors:
Best Buy, Google, Kohl’s and Target, and Nintendo

With failed competitors Circuit City Stores and Tweeter out of the picture, we think Best Buy is in a front-and-center position to seize market share in consumer-electronics retailing. Best Buy’s current market share is about 21% in the U.S. Bradbury H. Anderson, the company’s chief executive officer, maintains that a prime reason why Best Buy has gained market share since 2004 is that the company thinks of itself as a friend who can help consumers gain digital connectivity at home and elsewhere. That friendly help is rendered through services like the Geek Squad, which maintains hardware, and Magnolia Home Theater, which offers counsel on components for home-entertainment centers. We think that kind of technical assistance is a key differentiator for Best Buy; it allows consumers to feel more secure about making a big-ticket electronics purchase from Best Buy than they would from competitors like Wal-Mart Stores or Amazon.com.

The success of Google as a “new-media” company in this decade is at the expense mainly of newspapers. Google is winning over the newspapers’ readers and advertisers, and we anticipate that trend is likely to continue. Since 1993 the Internet has grown by a factor of about 10,000, as has Google’s search index, providing a medium for cost-effective, measurable advertising related to the search information displayed on its pages. Also, the company has high hopes for new services such as Google Book Search, which offers the full text of nearly 10 million books. Google anticipates that those services will be part of an Internet environment in the next decade that will be 100 times faster and attract at least 1 billion more users than in 2000.

Hard times in retailing has put up for grabs $27.4 billion of sales from stores that are either closing or struggling, according to Deutsche Bank. We think Kohl’s and Target should gain a disproportionate amount of those sales and be primed for when the economy recovers. Kohl’s and Target are discount stores that have succeeded by maintaining a low-cost structure: uniform store formats, lean staffing levels, sophisticated management-information systems, and savvy buying, advertising, and distribution. Sensing opportunity, Kohl’s and Target are capitalizing on the recession to open more stores. In many cases, they have their pick of sites, as scores of good retail locations nationwide once occupied by bankrupt chains such as Mervyns are now vacant -- and cheap.

You might be tempted to say “What global recession?” after seeing Nintendo’s recent sales and profits. The Japanese video-game company’s sales in 2008 were $16.7 billion, an increase of 73% from the previous year, and net income was $2.6 billion, up 48%. Nintendo has flourished by serving what hard-core video gamers call “noobs,” consumers who are playing video games for the first time. Noobs have gravitated to “casual video games,” which are easier and thus more fun to play. The casual game is largely Nintendo’s invention, due to
innovations such as its Wii (pronounced Wee) console. Nintendo has sold about 50 million Wii consoles since their introduction in November 2006. For Nintendo, we foresee continued opportunities for growth, much of it in Asia, Europe, and Latin America, that could extend well into the next decade.

**Survivors in the cyclical sectors:**
**Aqua America, BHP Billiton, Monsanto, and Southwestern Energy**

Aqua America, the largest private U.S. water company, isn’t glamorous like Google or Apple; it operates in a heavily regulated, regional industry, in which the regulators allow a monopoly, then set the monopolist’s profit margins at typically modest amounts above costs. However, we think Aqua America should be a good financial performer, generating long-term growth in earnings per share of at least 7% annually. The company stands to benefit from the $650 billion in water and wastewater infrastructure projects that we expect to be carried out over the next decade. And it deals in water, a resource called “blue gold” because of its increasing preciousness. The company has been an active acquirer of other water companies, in an industry that’s highly fragmented (there are more than 55,000 separate water systems in the U.S.).

To us, BHP Billiton is the materials/processing sector’s equivalent of Procter & Gamble: the Australian mining company is the biggest and most broadly diversified in its industry, with businesses that include alumina, coal, copper, uranium, manganese, iron ore, nickel, silver, titanium, oil, gas, and diamonds. That diversification has helped BHP Billiton to generally produce a smoother stream of earnings and more stable cash flows than many of its competitors have, especially in down cycles. Its revenues are increasingly coming from the emerging economies in nearby Asia as well as in South America, Africa, and Russia. The company operates in 25 countries and is making $24.8 billion in capital investments to expand its presence in them.

**Survivors in the financial-services sector:**
**BlackRock and T. Rowe Price Group, Industrial and Commercial Bank of China, MasterCard and Visa, and Northern Trust**

The fundamentals of investment-management firms like BlackRock and T. Rowe Price Group tend to reflect the fortunes of the capital markets to some degree. Their fees -- their source of revenue -- are derived from their asset levels. So as their assets appreciate in rising capital markets, so do their fees. Even though the rewards from the capital markets haven’t been highly generous lately, to say the least,
BlackRock and T. Rowe Price have held their own. In 2008 BlackRock’s and T. Rowe Price’s net inflows of new investment remained positive. Both companies have little or no debt and substantial cash reserves. As we see it, when the next bull market in stocks rages definitively, both firms should collect even more assets and shine.

In a sense, Northern Trust is a throwback to the classic white-shoe banks in the Gilded Age of financier J. Pierpont Morgan. Northern Trust’s stately image is burnished by a well-heeled clientele of individuals and families, whose net worth typically surpasses $75 million, and elite corporate customers. As one of our contacts observed, “In many respects Northern Trust is what most banks would like to be.” Northern Trust has proven adept at generating recurring sources of fee-based income and is one of a select group of banks that generates more revenue from fees than net interest income. The company has a conservative balance sheet (a ratio of tangible common equity to assets of 5%, compared with 2-3% for troubled major banks) and is well diversified globally, both of which have been instrumental in helping it ride out the recession.

Survivors in the health-care sector: Abbott Laboratories, Gilead Sciences, and Teva Pharmaceutical Industries

The fundamentals of Abbott Laboratories, with franchises in drugs, medical devices, and health-care products, have remained good over the past two years, and we expect little change in that trend. The company has a number of potentially promising drugs in early development in fields such as neuroscience, oncology, immunology, and infectious diseases. Two of Abbott’s biggest revenue drivers are Humira, the principal treatment for rheumatoid arthritis and psoriasis, and Xience stents, the leading stent in the U.S. and Europe for patients with coronary disease. To compete more effectively in the growing vision-care market, Abbott this year acquired Advanced Medical Optics, a maker of cataract surgical devices, Lasik surgical devices, and eye-care products.

Gilead Sciences has suffered no slowdown in demand for its leading drugs, such as Atripla, the first once-daily tablet for treating HIV infection. Nor is that demand likely to slow in the near
future, since more than 56,000 people nationwide contract HIV each year. As such, the company is one of the rare biotechnology firms that expects to record double-digit increases in sales in 2009. *Fortune* magazine calls Gilead’s HIV drugs a “premier portfolio” of treatments in “a booming antiviral business that brought in 88% of Gilead’s $5.3 billion in revenue last year.” The company also markets products that deal with liver, cardiovascular, and respiratory disease, and that product lineup may broaden in the future, as a result of an R&D pipeline that Chairman John C. Martin characterizes as the most promising in the company’s 21-year history.

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Teva Pharmaceutical Industries is a leading, low-cost generic-drug manufacturer, with more than 320 products sold in more than 1,000 dosage strengths and packaging sizes. Based in Israel, the company introduced 289 generic drugs in the U.S. last year. Its new and existing drugs account for about 19% of total U.S. generic prescriptions. As of early 2009, the company had 201 abbreviated new drug applications (ANDAs) awaiting approval by the Food and Drug Administration, the most for the company in any 12-month period. With those 201 generic equivalents, Teva is seeking to supplant branded drugs that produced U.S. sales of $110 billion in 2008. In our estimation, the company is benefiting from the stabilization of prices for generic drugs. We foresee the company’s growth continuing to be fueled by the substitution of generics as cost-saving alternatives to brand-name drugs.

**Survivors in the technology sector:**

**Apple, IBM, Qualcomm, and Taiwan Semiconductor Manufacturing.**

In the first quarter Apple defied the recession (and analysts who fretted that the company would fall apart while Chief Executive Officer Steve Jobs was on medical leave) by producing a 15% increase in profit versus a year earlier. The company’s gross profit margin rose to 36.4% from 32.9%. We think that margin may diminish slightly in the near term (the second and third quarters have historically been the weakest for tech companies) but could still hover around 30%. In the quarter, Apple sold 3.8 million iPhones, more than double the sales of a year earlier. The iPhone is now Apple’s largest revenue and profit generator (and largely accounts for Apple’s nearly $5 billion in deferred revenue, which we roughly equate with a backlog of orders). We expect Apple to continue to introduce simple, elegantly designed, and differentiated products.

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Suddenly IBM, your grandfather’s technology company, is spry again. The company has revitalized itself in recent years, applying computing power, analytical tools, and consulting services to help assess and solve some of the world’s thorniest problems, such as improving the efficiency -- or as IBM prefers to call it, the “smartness” -- of utility grids, traffic, and financial systems, among other things. IBM has tripled its earnings per share since 2002. To help fuel that growth, IBM has spent $50 billion on acquisitions and R&D, which has yielded more than 4,000 patents annually (70% of which are for software and services).

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Qualcomm is the leading designer of Code Division Multiple Access (CDMA) semiconductors that are technological spine of the cell phone (the world’s most popular device, with more than 1 billion sold annually). Qualcomm has deep pockets and spends heavily on R&D. Qualcomm’s financial strength is such that it recently hiked its quarterly dividend -- “yes, a company boosting its payout while other firms slashed theirs,” *BusinessWeek* noted in a tone of mock surprise tinged with admiration. For our part, we admire the company’s innovative streak, which should help inspire a wider adoption of the next-generation 3G wireless standard. Qualcomm earns a royalty of $4 to $8 for every 3G phone sold, and 3G phones are expected to account for 70% of the world’s cell phones by 2012, versus about 40% today, estimates Hilliard Lyons, an investment firm.

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Taiwan Semiconductor Manufacturing, the world’s largest semiconductor foundry (a specialized plant that makes chips designed by other companies), ranks in the top 10 in semiconductor sales worldwide. The company differs from an Intel in that it doesn’t design or make semiconductors under its own brand name. Its customers, such as Qualcomm, are referred to in the industry idiom as “fab-less” -- they rely on others to make chips on their behalf. The company holds a 47% share of the semiconductor-foundry market, about double the share of its closest competitors. Taiwan Semiconductor makes about 7.5% of all semiconductors, and we think that percentage could rise to 9% over the next three years.

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As of March 31, 2009, Turner held in client accounts 3.2 million shares of Best Buy, 661,769 shares of Google, 3.8 million shares of Kohl’s, 13,270 shares of Nintendo, 1.9 million shares of Aqua America, 1.4 million shares of BHP Billiton, 2.0 million shares of Monsanto, 4.2 million shares of Southwestern Energy, 1.2 million shares of BlackRock, 4.0 million shares of T. Rowe Price Group, 600 shares of MasterCard, 1.5 million shares of Visa, 2.1 million shares of Northern Trust, 3.9 million shares of Abbott Laboratories, 5.5 million shares of Gilead Sciences, 1.2 million shares of Teva Pharmaceutical Industries, 2.2