
FINDLAY PARK PARTNERS LLP

FINDLAY PARK AMERICAN FUND NEWSLETTER 8TH JUNE 2012

Price of Dollar Shares: \$49.71

Price of Sterling Hedge Shares: £27.10

Please note that the Net Asset Value of the Fund may fluctuate and that investors are exposed to foreign exchange risk if they are invested in the Dollar-class of share.

The above prices are based upon a 9.00am valuation on the above date.

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Economy and Stock Market

World growth has been slowing over the last couple of months. Risk aversion has been on the rise and safe haven bond markets and commodities are screaming that something is wrong with the world economy. Europe is politically challenged, China is slowing and the US has had some disappointing data points.

However, some of this is being reflected in the valuation. The US market is selling for approximately 12.5 times this year's earnings and around 11.5 times next year's current estimates. Companies are generating huge free cash flow and US equities ought to be a serious consideration for a wide group of potential investors, with bonds and cash having a negative real yield. In addition the US consumer is very sensitive to the price of oil, particularly as there is very little tax on it in America and the price of gasoline has dropped from around \$4 to nearer \$3.25 a gallon. This will be a big tax cut for consumers as we move into the second half of this year. This is the main good news at the moment but it is happening partially because demand has come down with world growth expectations, but also supply is ramping up with Libya back to 1.4 million barrels from a peak of 1.6 million. The US will produce around 700,000 barrels more by the end of this year, about double the expected Chinese demand growth in 2012. The main focus has been on Europe, where the bond vigilantes have again been pushing up bond yields in the southern periphery countries, to levels that are close to being unsustainable. Mario Draghi, the head of the European Central Bank, has recently hit out at political paralysis and said that the Central Bank could not 'fill the vacuum' left by member states' lack of action. This is a very different statement to when he came into this position in the second half of last year and immediately put in place the LTRO programme which, at least in the short term, dealt with bank liquidity needs. We now have a sovereign and a bank crisis again, and we watch the situation develop with great concern.

Charlie and James went to listen to a prominent expert on China from one of the bigger investment banks a few weeks ago to try and better understand what was happening there. He gave a very formal presentation arguing the case for 9.5% GDP growth in the 2nd half of this year in China. He claimed house prices were not down in aggregate in the top 39 cities. We both came away sceptical of what we had been told, and this indeed is the problem with China. It is very opaque and they have recently said that they will not announce another major stimulus plan to help themselves and the world economy. We recently listened to an interview with Larry Fink, chairman of Blackrock, with our

favourite interviewer, Charlie Rose. When asked about China, he said the biggest problem is that it has been so export-dependent. They have been working on improving domestic demand for the last five years but the savings rate over this time has actually risen from 35% to 45% and this is often overlooked. The one thing Charlie and James came away with from their meeting with the Chinese specialist was that there were a huge number of levers the Chinese government can pull to help improve the economy.

Statistics on the US economy have generally been much less favourable over the last couple of months, highlighted by the last two jobs reports which have been well below expectations. In January and February jobs reports were way above expectations, which created a huge amount of enthusiasm for the US as investors began to feel the US was emerging from a very slow growth period held back by housing and to some extent auto production. There were clear signs earlier in the year that the housing market was beginning to improve, but employment and housing were helped by very good weather earlier in the year. Recent employment numbers have been restated downwards, but there does seem to be the stirrings of a recovery in the housing market, although it is going to take time. The US needs the housing market to come back for unemployment to be significantly lower here, as many of the people employed in construction cannot easily be employed elsewhere. In the interview, Larry Fink, who is very well regarded, believed excess housing inventory would be gone within one year and clearly in some regions of the States things have picked up very nicely.

In America there is always someone trying to buy a distressed asset and as Warren Buffett said in his annual report, anyone not buying a house with a 4% mortgage which can be refinanced if interest rates move down further, but where you can keep a 4% interest rate if rates move higher at any time over the next 30 years, should do so. Houses are available well below replacement cost, particularly as many of the raw materials that go into housing have not come down significantly in value. Many of the current economic problems were caused by excesses in the housing market, and there are many programmes which have been put in place by the administration to help sort out the mess. One is called short sale, where individuals can go to the bank and negotiate with them over selling their house, even though it is under water on the mortgage. By finding a buyer who takes on a new, lower mortgage, the bank takes a write-down much smaller than it would normally do if the house was repossessed and the people, whose mortgage is then cancelled, end up with a much better credit rating than they would do otherwise if they foreclosed. Statistics on housing can be thoroughly confusing but we have enough anecdotal evidence to suggest that we are at the beginning of a long

recovery path. Many housing-related stocks have run way ahead of this recovery and they think many of these stocks could correct further. The feedback we are getting from individual companies is that the US economy continues to grow but rather slowly. Most companies were expecting a pick-up in the second half in China but the managers who have been there the longest are expecting this to be fairly modest. **The good news this year compared to last was that although the world economy was growing faster last year, most emerging market countries were slamming on the breaks, raising interest rates, trying to slow growth down because inflation was getting out of control. With the recent drop in the oil price and food price comparisons getting somewhat easier, these countries are easing which should lead to better growth.** About half the growth in the US economy in the first quarter was driven by auto production, with the Japanese transplants rebounding from the tsunami last year, and also US manufacturers ramping up production. Auto inventories have been building as people deferred purchases with the spike in the oil price earlier this year, and the auto sector could be a drag on the economy for a while.

Jon Tredgett spent a day at the Wells Fargo Investor Day a couple of weeks ago which happened to coincide with the FDIC releasing updated quarterly data for the US banking industry. We thought it would be interesting to highlight to non-US investors how much the US banking system has recovered from the depths of the 2008-09 credit crisis. Regarding credit, non-performing loans (NPLs) at FDIC-insured banks are at the lowest level in 3 years, delinquencies have fallen for 8 consecutive quarters, and net charge-offs (NCOs) are at the lowest in 4 years. As Wells Fargo management pointed out, banks have not written many bad loans in the past 4 years after the industry tightened lending standards. A multi-year period of improving credit performance is likely barring a significant deterioration in economic activity. Regarding capital, the sector's shareholders' equity increased to \$1.5trn and the Tier-1 capital ratio rose to 13.28%, the highest level ever attained. Importantly, the quality of this capital base is much improved from a few years ago (i.e. primarily tangible common equity). The industry generated \$35.3bn in net income in 1Q12 - up +23% YoY and the highest quarterly profit since 2Q07 - and a 1% return on assets (RoA). However, in *per share* terms – our key metric - earnings are well below prior peaks due to the large increase in shares outstanding driven by recapitalisation efforts to address past credit problems. Most banks impaired their future earnings power during the credit crisis, hence the importance of identifying banks that were able to *enhance* their earnings power during the crisis with opportunistic acquisitions (like PNC and Wells Fargo). The “strong get stronger” theme is very visible in this sector: in 1Q12 Wells Fargo originated 33% of all US

residential mortgages and Bank of America originated 6% - a few years ago they had similar market shares. Wells Fargo's CEO John Stumpf indicated that the competitive environment in US banking was the best he had seen in the past 30 years at their investor day and Warren Buffett has pointed out that the US banking system is awash with liquidity. The industry's key challenge today is earnings power which is being suppressed by anaemic loan growth, net interest margin (NIM) compression, and regulatory burdens. To remind investors, we now have just over 3% in US banks after viewing the sector as un-investable for much of the past decade. Our exposure is concentrated in domestic-focused, regional banks while avoiding banks with high exposures to Wall Street-type leverage, derivative and trading practices. We do not ever expect to have a high single-stock or sector exposure to the banking industry but we are alert to these industry dynamics and the latent earnings power that could be unleashed if we were ever to see a sustainable change in loan growth or the yield curve.

One thing that really surprised us recently were some statistics, produced by Jon Tredgett on the average miles per gallon fuel consumption of a car now against 30 years ago. We were shocked to see that it was pretty much the same. Obama introduced legislation over the last 18 months which significantly reduces the amount of fuel cars must use per mile over the next few years. This is very good news and leads into the next discussion which is energy and the US.

Over the last year we have been talking about the amount of new gas being found in the United States in oil shale. Indeed so much has been found that it has caused a crash in the price of gas down to about \$2.5 per MCF which compares to about \$10 in Europe and \$15 in Asia. Many companies have reduced the amount of gas drilling rigs and the rig count for dry gas has fallen by about a third over the last six or nine months. Many of these rigs have been redirected towards drilling for oil, mostly also in shale formations, particularly in the Bakken in North Dakota and the Permian in South Texas. Many of the rigs have also moved from drilling for dry gas to wet gas, which is heavy in liquids which are traded more in line with oil. These rigs drilling for wet gas are also finding plenty of gas and the market may remain over-supplied in the short term. It really depends on how hot it is this summer and the state of the economy. Longer term this is very bullish for the United States and many forward-thinking companies such as Federal Express and some waste disposal companies are ordering trucks which can use natural gas and gasoline stations are installing facilities to fill these trucks up. This all creates jobs and makes America a lot more efficient. Indeed the price of WTI relative to Brent spiked out at one stage to a \$25 discount last year, because there was so much oil being found but the country did not have the infrastructure to cope with the movement of the oil. The US is working hard

to upgrade the infrastructure to move this oil and take advantage of the arbitrage. Again this all creates jobs and is very positive in the long run. America has the ability to be energy self-sufficient within about 10 years according to some reports, and a policy to achieve that should be put in place in our view. Cheap gas not only reduces inflation but also makes many American industries much more competitive than they were in the past from chemicals to refineries, steel, fertilisers etc.

One negative we highlighted in the last newsletter was the fiscal cliff in 2013 if the Bush tax cuts run out, the payroll tax normalises from 2% relief and the automatic deficit cutting kicks in, triggered by the inability of the Simpson-Bowles Bipartisan Commission to reach an agreement. This potentially could have a 3-4% drag on GDP in 2013 and is partially the reason we have been reducing more economically sensitive stocks in the last couple of months. It will be hard for them to outperform towards the end of this year, even if the economy picks up, when the fiscal cliff is overhanging. The good news is there is already a bipartisan commission driven by Simpson and Bowles to try to work out how to manage through this without damaging the economy too much. It does remain a major uncertainty in our view.

Portfolio

Since the last newsletter we have increased our cash position from 8% to 15%. This is partly a result of a takeover (Cooper Industries) but mainly due to the sale of stocks that are a little more economically sensitive and the reduction in some stocks with heavy overseas earnings . The Euro has dropped about 5% since the end of the last quarter and this will be reflected in the earnings translation.

Outside raising the cash position, the structure of the portfolio has not changed significantly and remains very diversified with the biggest position being 1.9% of the Fund and no overly large sector weightings. A record amount of our companies continue to use their free cash flow to buy back stock and we thought it would be a good exercise to put the following table in, showing a company growing at a modest 5% per annum, selling at 12 times free cash flow and using all its free cash flow to buy back stock. It shows that over a 5-year period the buyback, combined with a 5% growth, allow the company to double its free cash flow per share. This is a rather overly simplified version of what a lot of our companies are doing. **We think many have very attractive, rather unique business franchises and if they can use a large part of their free cash flow to shrink their equity in a low-growth**

environment, you can get very meaningful accelerated growth in earnings and free cash flow per share over time, without a very exciting business model. We think a reasonable portion of the returns in the portfolio over the next few years are likely to come from this.

										<u>5-Year</u>
									<u>5-Year</u>	<u>Cumulative</u>
		<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>		<u>CAGR</u>	<u>Growth</u>
Free cash flow		100	105	110	116	122	128		5.0%	27.6%
Market cap		1,200	1,260	1,323	1,389	1,459	1,532			
Free cash yield		8.33%	8.33%	8.33%	8.33%	8.33%	8.33%			
Share count		100	92	84	77	71	65		(8.3%)	(35.3%)
FCFPS		\$1.00	\$1.15	\$1.31	\$1.50	\$1.72	\$1.97		14.5%	97.2%

Sherwin Williams

Sherwin Williams was first purchased in 2010, as a low risk, attractively valued US housing play, which was pricing in little if any recovery – despite US paint volumes being down 20% from the peak in 2006. During this period the company’s margins and free cash flow remained consistent despite its high fixed cost model, which is a testament to the strength of its business and the calibre of its management team.

Sherwin Williams manufactures and distributes paints and specialty coatings. The majority of its revenues and EBIT (54% and 65.5% respectively) are from its paint stores group, which consists of 3,400 company owned stores. These stores focus primarily on the pro-decorator, where quality, availability of products and service is key. Paint is a cost pass through for most contractors, (i.e. their bill equals labor + materials), and therefore products which save the contractor time are paramount. This positions Sherwin well since its shops are a ‘one stop’ shop, as they stock a huge array of paint and painting related products. In addition to this convenience, Sherwin Williams paint is seen as being the highest quality and it is exclusive to their stores. To reinforce the convenience angle of their stores to the pro-decorator, imagine you are a contractor, you have a job that requires 50 gallons of paint, specialist spray equipment, ladders etc. The job is out of town and has a strict completion deadline. At Sherwin you can order the paint, collect it early (due to their earlier opening hours) and pick up any other items you may need at the same time. In addition Sherwin will also guarantee you the price of the paint and hold the quote for a month (particularly important given the commodity cost inflation seen in late 2010 and 2011), this ensures your quote is accurate. Also due to

the fact Sherwin's paint is high quality, the job may only require 1 coat rather than 2 for the same finish.

Sherwin's US paint store business has faced a number of macro significant headwinds over the past few years, the majority of which directly impacted Sherwin's core business, i.e. housing and commercial construction, this in addition to a general economic downturn, in which people defer home spending or move away from using contractors to more DIY. These external events were also exacerbated by rising commodity costs, most notably titanium dioxide which is 25% of cost of goods sold.

Despite the above economic backdrop the company has executed extremely well during the downturn, as it has grown its store base (in contrast to the majority of its competitors who have closed stores) and they have been working diligently on improving their productivity. Since 2007, the company has reduced their fixed assets by 30%, by closing 14 of their high cost US plants and reallocating capacity to their lower cost plants. Management believes that they won't need to open a new factory in the US in the next 10 years even if volumes return to their previous level. As a result of these actions we believe that once paint volumes return to more normalized levels, the company's incremental margins will be closer to 35-40% vs. 25% historically.

Sherwin's other business segments include its Consumer Group and its Global Finishes Business which are 14.5% and 9% of revenues respectively, both segments have lower margins than its core paint store group, but are well positioned due to the strong presence of its brands such as Minwax (No1 in stains and protective finishes) and Krylon (No1 aerosol paint brand).

The economic outlook for Sherwin Williams is starting to improve after 5 very tough years. The US residential construction market appears to have stabilized and is starting to see some signs of life albeit from a depressed base. Employment has started to improve and we have begun to see a shift back to people using a contractor, as deferred work once again resumes. Raw material inflation has also started to ease. A significant advantage of the paint business, which is often overlooked, is the ability of the manufacturers to raise prices to offset inflationary pressures, albeit it with a 6 month lag, however they usually manage to keep the price increase thereby improving margins as cost inflation subsides.

As we have said in the past, at Findlay Park we try to look for companies that fit into the 'strong get stronger' camp and Sherwin Williams fits firmly into this category due to a combination of pricing, operational excellence, seasoned long term management and strong capital allocation.

Sherwin is like a lot of Findlay Park investments in that they buy back their own shares. Over the past 9 years they have reduced their share count at a 4% CAGR resulting in a third of outstanding shares being retired.

Latin America

Our strategy within the Fund is to have a very solid American portfolio, which we were comfortable with in a variety of economic environments, and have around 10% in Latin America where the growth prospects are rather better and there are more policy options available in a weaker world environment. To remind investors, James and Rupert visited Brazil in November last year when the market was still quite depressed and we added a modest amount to our weighting at that time. This helped our relative performance in the first quarter but has held us back a little recently as the Brazilian real has weakened from around a high of 1.70 to around 2.00 to the dollar, having started the year at 1.86. Our focus has been on domestic companies benefiting from the middle class coming through and with no commodity exposure within this part of the portfolio, the individual stocks have done relatively well this year compared to the Latin indices. As a rough indicator, the Latin American Fund is up 7% in dollars YTD.

Conclusion

The stock market has corrected over the last couple of months as a result of the significant slow-down in world growth and question marks over Europe and China, which are not easily answered. The last two months' employment figures have been rather disappointing, particularly as previous months were revised downwards. The feedback we are getting from our many company visits is that the US economy continues to expand, but at a modest pace and has slowed a bit in the last couple of months after a nice bounce at the beginning of the year, helped by auto production ramping up and the housing market showing some signs of life. Confidence remains very fragile and it remains extremely

difficult to handicap the outlook. There is a fiscal cliff in the United States at the beginning of 2013. Messrs Simpson and Bowles have already put a committee in place to reduce the impact of this fiscal cliff, which no doubt will be diluted down, but it is still a large issue on the horizon, particularly as American politics is so bi-polar at the moment.

The good news is the stock market looks to be on a very reasonable valuation of around 12.5 times this year's and approximately 11.5 times next year's earnings. The companies we invest in are generating enormous amounts of free cash flow as is most of corporate America. Balance sheets are generally in very good shape. We recently saw a chart showing that 60% of the S&P 500's stocks offer a higher yield than treasuries, above the 50% or so at the bottom of the market in 2009, and this is despite only a 30% pay-out ratio. The fall in the oil price is a big boost for the US consumer and indeed the world economy, and is very beneficial to inflation expectations allowing more easing around the world. Also the decline in interest rates over the last couple of months to record lows should accelerate any recovery in the housing market. The US economy tends to respond to the price of oil with about a 6-month time lag.

Many of our stocks had a large move between the lows last year and March this year, and we have taken some profits, mainly in stocks that have moved to optimistic valuations and also where there might be some economic sensitivity.

There is considerable anecdotal evidence that the housing market is beginning to recover, despite mortgage availability still being restrictive. America needs housing to recover to reduce the employment rate significantly from the current rate of 8.2%.

We currently have around 15% cash, up from 8% at the time of the last newsletter. The team have many stocks we are looking to buy either at a specific price even in a very bad environment or which we are happy to add to if some of the macro clouds appear to be lifting. In the current uncertain environment we are focusing on companies that are in control of their own destiny and have been reducing some investments which are more dependent on world growth.

Many of our companies are buying back stock at low valuations with their free cash flow and we show an analysis of the impact of this in the table on page 7. This gives us some comfort in what is still a very uncertain world.

With a higher cash balance and less economically sensitive stocks in the portfolio we will underperform in a risk on environment but view the relatively high cash weighting as a sensible approach given all the macro uncertainty.

Annual Performance	Findlay Park \$ change	Russell 2000 change	S&P 500 change
Inception to Year end 1998	-0.40%	-8.49%	16.81%
1999	49.10%	19.62%	19.53%
2000	1.28%	-4.20%	-10.14%
2001	9.31%	1.03%	-13.04%
2002	-11.25%	-21.58%	-23.37%
2003	39.48%	45.37%	26.38%
2004	24.82%	17.26%	9.14%
2005	15.67%	3.09%	2.86%
2006	24.06%	17.00%	13.62%
2007	16.24%	-2.75%	3.53%
2008	-30.87%	-34.80%	-38.49%
2009	33.25%	25.22%	23.45%
2010	23.93%	26.28%	12.80%
2011	-2.54%	-5.67%	0.41%
YTD	5.45%	2.06%	4.11%
Performance since inception	397.10%	64.89%	24.96%
Compounded Rate of Return from inception to 07 June 2012	11.92%	3.57%	1.58%

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