Stocks 2014

12 STOCKS TO OUTSMART THE MARKET TODAY

The Motley Fool®

To Educate, Amuse & Enrich™

2014 and Beyond

ALEX SCHERER, CFA
TMFENOCHROOT

Market mavens will point to the macro picture to explain the rise of stocks in 2013. They see low interest rates (and a Federal Reserve that seems insistent they'll stay that way), vague inflation fears, and modest but steadily rising GDP growth. That's been a recipe for rising appetites in the stock market; in the span of 12 short months, the S&P 500 rose more than 25%, and momentum darlings such as **Netflix** (Nasdaq: NFLX), **Tesla** (Nasdaq: TSLA), and **Facebook** (Nasdaq: FB) have led that charge with gains well into the triple digits.

If 2013 has taught us any lesson, it's that the old saw of "buy low and sell high" sometimes lags a strategy that Motley Fool co-founder David Gardner has proposed as one of his preferred heuristics: "Buy high and don't sell."

IN WITH A WHIMPER, OUT WITH A TWEET

It wasn't always thus. Last year at this time, we watched Facebook struggle with a "failed" IPO, and you weren't likely to find many investors concerned about being left out of a stock market celebration. That was 2012, though. Momentum has taken charge this year, and Facebook has rebounded not just back to its $38 IPO price but well beyond, more than doubling from November to November.

As I write, that other massive social media platform is making its debut. **Twitter** (NYSE: TWTR) is now open for trading on its IPO day, up 77% from the initial public offer and valued at more than $25 billion. No failed IPO here, Fools; this is a momentum market made for stories like Twitter's.

TRENDS THAT CAN CONTINUE WILL

You won't find a recommendation for Twitter in these pages, but it's not for lack of trying. Not one but two Foolish analysts wanted to include Twitter, weeks before either had even the slightest idea what price Mr. Market would be asking for the shares. If deadlines were later, or the IPO was sooner, maybe you'd have seen that one grace these pages.

A willingness to "buy high and don't sell" has paid off in spades, and not just for a year. We recently celebrated a milestone at Fool HQ, as David Gardner's 1997 recommendation of **Amazon.com** (Nasdaq: AMZN) hit 100-bagger status. That kind of generational momentum goes well beyond shifting market sentiment and is just what many of our analysts seek. You'll find a few examples inside.

TRENDS THAT CAN'T CONTINUE WON'T

But it's not the only way to heaven. In a momentum-frenzied market, it's all the more important to also open your eyes to those other opportunities that hide in plain sight.

We've got them for you here, too. Deep value turnarounds. Founder-led businesses off the momentum radar. Cash flow producers with temptingly low expectations baked into the price. These are all Foolish approaches that can pay off for the patient investor, particularly when market sentiment shifts (as it inevitably does) away from the flavors of the month.

As the results from more than a decade of our annual reports attest, investing the Foolish way can set you on the right path, so long as you stay engaged for the long haul. Celebrate today's successes, but always be on the lookout for tomorrow's opportunities, wherever they may lie. 14

Alex Scherer, CFA, is an associate advisor for *Stock Advisor*.

For disclosure information, see page 44.

CalAmp

Businesses count on CalAmp to connect to the Internet of Everything

DAVID MEIER
TMFHUMBLESERVANT

WHY BUY?

1. CalAmp is enabling the Internet of Everything — a huge trend connecting machines and data.
2. Its technologies add value to the companies behind millions of connected devices.
3. Even after a run-up, the stock remains attractive, and CalAmp has a huge market to grow into.

Today, we take the Internet with us, using our smartphones and tablets to stay connected wherever we are. Tomorrow, almost every device will connect to the Internet, sending data back and forth to optimize all kinds of things.

According to Cisco's research, the Internet of Everything is a huge, emerging trend. And **CalAmp** (Nasdaq: CAMP) sits right in the center of it. The company offers products and services that enable machine-to-machine (M2M) communication and mobile resource management (MRM). Basically, it's turning the Internet of Everything into a reality.

THE COMPANY & SECTOR

CalAmp's business model is very simple. CalAmp sells products that collect data from devices out in the field. The data move from the source to a cloud-based

NASDAQ

TECHNOLOGY

CAPS

$806 m	$30 m	$7 m	$23.35	$28
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *CalAmp*

network over a wireless network. Finally, software applications, either in CalAmp's or the customer's private cloud, use the data as needed.

CalAmp focuses on the energy, government, and transportation markets. Its products collect a wide variety of energy data about the power transmission grid, which power companies use to keep electricity flowing smoothly. CalAmp also helps local governments, big companies like **Caterpillar** (NYSE: CAT), and logistics businesses such as **Fleetmatics** (NYSE: FLTX) manage their fleets of assets. They can transmit location, usage, and even "need" data in real time.

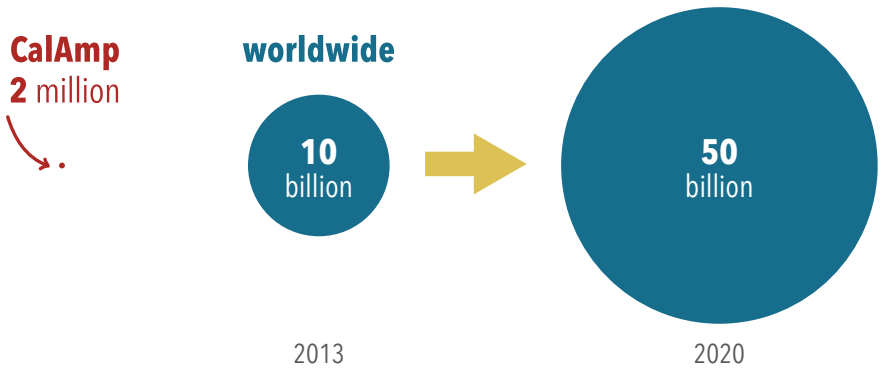
Many people are finding new ways to use M2M technology. Used-car dealers, finance companies, and insurers look to CalAmp for new solutions dealing with automobiles. For example, if a dealer finances a car purchase, it can use M2M technology to disable the car if the owner misses a payment. And insurance companies can monitor vehicle usage tendencies to help price risk, as opposed to simply relying on legacy data.

THESIS & OPPORTUNITY

As I mentioned, CalAmp sits in the center of the huge Internet of Everything trend. **Cisco Systems** (Nasdaq: CSCO) estimates 10 billion devices will connect to the Internet in 2013, many of them PCs, smartphones, and tablets. But over the next seven years, that number should grow to about 50 billion, a fivefold increase. That represents an incredible opportunity for CalAmp when compared with the 2 million connected devices the company had in its portfolio at the end of 2012. ▼

As the Internet grows, connections are becoming more and more valuable. Co-founder Reid Hoffman built **LinkedIn** (Nasdaq: LNKD) on the idea of connecting professionals with employment opportunities and each other. **Facebook** (Nasdaq: FB) and **Twitter** (NYSE: TWTR) are platforms for social connections. Together, these companies are worth almost $150 billion in the stock market. CalAmp wants to harvest the value of device connections by helping companies optimize their assets, increase their productivity, and improve their customers' experiences.

CONNECTED DEVICES



Data from Cisco.

According to the company, its addressable market totals $3.4 billion. Management expects that opportunity to increase to $6 billion in 2015. Most of that will come from its wireless datacom division. Less than 8% will come from its legacy satellite segment, which sells equipment to EchoStar. The satellite segment will continue to shrink as the wireless datacom grows.

CalAmp has the reputation and the know-how to serve its existing and future customers. Its experience brings the customers in the mix. Its customized services, such as selling remote vehicle starting systems to Directed Electronics, keeps customers happy. And the combination of the two will help CalAmp build its portfolio of connected devices — especially if industry projections hold true and the market expands 26% annually over the next seven years.

FINANCIALS & VALUATION

CalAmp has enjoyed considerable success over the past couple of years as it's focused more attention on its M2M and MRM businesses. Sales have averaged just under 26% growth, not including the almost 30% rise over the past 12 months. Its gross margin has been climbing, too, moving from 25.9% in fiscal 2011 to 32.8% over the past 12 months. Rising sales and margins have translated into more and more cash flow, including $23.2 million over the past 12 months on $205.3 million in sales.

Seeing the incredible opportunities ahead, management has increased its investment in research and development from 7.9% to 8.7%. That's exactly what investors want to see from a company that wants to capitalize on a large, growing trend.

Looking ahead, analysts see CalAmp's sales doubling from $180 million in fiscal 2013 to $360 million over the next three years — an average of 26% per year. As profitability and cash flow generation increase, the market should continue to reward shareholders with a higher valuation. Although the market has started to recognize CalAmp's potential, I still think investors can earn 15% annual returns over the long term from a $28 price per share.

One last thing to note: CalAmp does not have a very large group of analysts following its progress. But success has a funny way of drawing a crowd, which could lead to higher sales and earnings estimates.

RISKS & WHEN TO SELL

CalAmp faces two big risks: competition and commoditization. Big market opportunities such as the Internet of Everything attract plenty of competition looking to reap the same rewards. CalAmp will go up against companies such as **Sierra Wireless** (Nasdaq: SWIR), **Novatel Wireless** (Nasdaq: NVTL), and **Digi International** (Nasdaq: DGII) when competing for future deals. Fortunately, the opportunity is large enough that it's unlikely to end in a winner-take-all situation.

Increased competition does increase the likelihood of commoditization. Smart buyers can learn to play suppliers against each other to reduce prices over time. The key to mitigating this risk will be for CalAmp to continue to customize solutions for its users.

Because M2M communications is a new trend with lots of potential, investors shouldn't consider selling simply because the stock price is up. Instead, look to CalAmp's business momentum for the signal to sell. I recommend selling if its momentum starts to wane because the company isn't able to generate new solutions for its markets.

THE FOOLISH BOTTOM LINE

The Internet of Everything will be built on devices and data. CalAmp has the knowledge and expertise to build communications solutions that help customers use data to make their assets more productive. This emerging trend is starting to build momentum, and CalAmp is an attractive opportunity for investors ready to ride the wave. 14

David Meier is an associate advisor for *Million Dollar Portfolio* and an analyst for *Rule Breakers*.

For disclosure information, see page 44.

Capital One Financial

It's not just in your wallet anymore — it's a play on the burgeoning Internet banking market

ANAND CHOKKAVELU, CFA
TMFBOMB

WHY BUY?

1. This entrepreneurial, tech-savvy bank is expanding from credit cards to an Internet opportunity.
2. Its scale and track record of growth in good times and bad bode well.
3. Co-founder, Chairman, and CEO Richard Fairbank is a visionary leader who's been there from the start.

As a consumer, you probably know **Capital One** (NYSE: COF) as the "What's in your wallet?" credit card company. As an investor, though, you should know that Capital One offers so much more.

THE COMPANY & SECTOR

In just 25 years, CapOne has grown into the sixth largest bank in the United States. The five heavyweights ahead of it — **Bank of America** (NYSE: BAC), **Wells Fargo** (NYSE: WFC), **JPMorgan Chase** (NYSE: JPM), **Citigroup** (NYSE: C), and **US Bancorp** (NYSE: USB) — had, on average, a 130-year head start!

When Capital One emerged in 1988, it wasn't called Capital One; it was the credit card division of Signet Bank. It would spin off six years later to become a credit card specialist (a "monoline," in finance parlance).

NYSE

FINANCIAL

CAPS

$40.1 b	N/A	N/A	$69.39	$80
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Capital One Financial*

As anyone who's been saddled with credit card debt knows, collecting the sky-high interest rates and penalties can be quite lucrative for the other side. However, the downside of extending credit card loans is that when the economy sours, customers increasingly stop paying. Getting 20% interest is great in theory, but not when 100% of the loan and interest goes unpaid.

Exacerbating this problem is the issue of funding. Banks have to get the money they lend from somewhere. In a bad economy, credit tends to tighten (in other words, it's harder to get new money as old debt expires). When your customers aren't paying you back at the same time your funding sources are cut off, you can quickly go from bank to bankrupt.

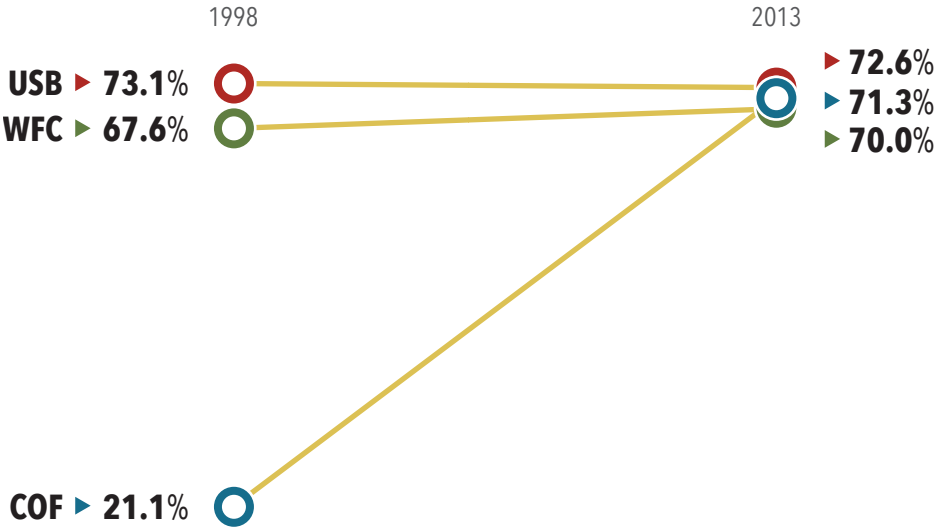
Capital One has helped mitigate both problems by transforming itself from a credit card one-trick pony — albeit a clever one — into the diversified bank it is today. It did this via a slew of acquisitions in the past decade, including regional banks Hibernia, North Fork, and Chevy Chase as well as the American portion of ING Direct.

Now, whether you look at profits or its loan book, CapOne's credit card division only makes up about 40% of its business. Meanwhile, its consumer banking business (home and auto loans) is almost as big, and its commercial banking (business loans and business-oriented real estate loans) makes up the last 20% or so.

In addition, it's funding those loans with an increasing amount of deposits. More deposits means less reliance on the debt that can dry up in bad times. In 1998, CapOne supported about 20% of its assets with deposits and 60% with debt. These days, that funding mix has more than flipped to roughly 70% deposits and 10% debt.

To bring the point home, look at how Capital One's deposit base has grown to mirror those of Wells Fargo and US Bancorp — the prototype flag bearers of big retail banking. ▼

BANK COMPARISON: ASSETS FUNDED BY DEPOSITS



Data from Capital IQ.

THESIS & OPPORTUNITY

Chairman and CEO Richard Fairbank co-founded Capital One in 1988 based on his belief that "the power of information, technology, testing, and great people could be combined to bring highly customized financial products directly to consumers."

There are two things that pique my interest in that statement:

First, if you're a fan of investing in founder-led businesses (I am), Capital One offers us the rare chance to do so in big banking. John Pierpont Morgan has long since passed into legend, but Richard Fairbank continues to disrupt.

Second, those founding principles were manifest in how Capital One innovated in its original business. As *The Washington Post* has explained, CapOne "revolutionized the credit card industry by using complex computer programs to micro-target customer groups and customize rates based on a cardholder's behavior." Today, we see that spirit in Capital One's move into online banking — one of the industry's key disruption spaces.

As in the retail industry, the allure of cutting costs by eliminating bricks and mortar is tempting, but gaining a customer base is easier said than done. So Capital One, already an online banking presence, turbocharged its relevance by buying ING Direct USA — arguably the most successful player in the space. At the time of the 2012 purchase, ING's $83 billion in online deposits made up more than 20% of the entire deposit base of online-only banks. Factoring in its 1,000 or so physical branch locations, its scale, and its very recognizable brand name (ING Direct is now Capital One 360), CapOne may be the most formidable competitor in the burgeoning online banking space.

We're getting the size and balance sheet strength of an old-school bank with the potential of a new-school bank — all run by the guy who built it. Plus, we're getting Capital One's recent focus on cost reduction and its plan to ramp up its total payout ratio (dividends plus share buybacks as a percentage of net income) to more than 50% in 2014.

Altogether, this package is quite compelling if the price is right.

FINANCIALS & VALUATION

On the price side, Capital One is looking like a good value. Its stock price is hovering around book value. Its return on that book value is 10.7%, resulting in a P/E ratio of around 10.

WE'RE GETTING THE SIZE AND BALANCE SHEET STRENGTH OF AN OLD-SCHOOL BANK WITH THE POTENTIAL OF A NEW-SCHOOL BANK — ALL RUN BY THE GUY WHO BUILT IT.

Kicking the tires a bit, we can see pretty solid numbers. CapOne's latest quarterly net interest margin clocks in at a robust 6.9% (versus 3.4% for both Wells Fargo and US Bancorp), but that is juiced by credit card loans whose 3.8% net charge-off rate is especially economy-sensitive. Still, it's provisioning for loan losses in proportion to its charge-off activity. Its asset leverage is conservative at 7 times equity, and its capital position appears to be in good shape ahead of the application of the more stringent Basel III requirements.

Interest makes up 83% of its income. While that obviously means CapOne is sensitive to changes in interest rate spreads, it bodes well if regulations constrain credit card fees.

Its dividend yield is a reasonable 1.7% with the prospect of future increases.

Keeping in mind its solid performance during the trying times of the financial crisis, we're seeing a good price for a good company.

RISKS & WHEN TO SELL

Many of Capital One's risks are endemic to investing in too-big-to-fail U.S. banks and the spaces in which they operate. Regulatory risks include potential pitfalls from the implementation of Basel III standards, Dodd-Frank reform, and the Fed's annual review of capital plans. An example of legal risk was evidenced when Capital One became the Consumer Financial Protection Bureau's first public enforcement case, resulting in a $210 million settlement related to deceptive credit card marketing. A poor economy or unfavorable interest rate environments can hurt all banks, but Capital One may be especially sensitive. And because Capital One doesn't participate as heavily in the derivatives market as many of the other big banks, it doesn't have too much in the way of unobservable Level 3 assets, but there is still complexity there and in items like its variable interest entities.

In addition, Capital One faces risk coming from two of its strengths: Richard Fairbank's leadership and management's successful acquisition strategy. The flipside of relying on a visionary is one day losing him. As for acquisitions, Capital One has a

tremendous track record. It couldn't be where it is today via purely organic growth. That said, as Bank of America so famously showed with Countrywide, no matter how good your prior run, one bad acquisition can cause tremendous harm.

As Capital One goes forward, we want to make sure it's properly balancing risk mitigation efforts with its growth efforts. If not, it's time to sell.

THE FOOLISH BOTTOM LINE

In Capital One, perhaps the greatest banking growth story of the past quarter-century is available at a good price. Its scale, deposit base, and loan diversity offer stability, while its entrepreneurial heritage and culture ensures it will continue to seize the opportunities of the data and Internet age. Consider depositing shares of Capital One in your portfolio today. 14

Anand Chokkavelu, CFA, is the editorial director of Fool.com.

For disclosure information, see page 44.

Colfax

This industrial parts business applies efficiencies to acquisitions, pumping out value for investors

JEREMY MYERS
TMFTANK

WHY BUY?

1. Colfax is the market is leader in multiple industries that benefit from multiple macro trends.
2. It has created a business culture obsessed with lean manufacturing and focused on customers' needs.
3. A recent, transformative acquisition should create significant value for shareholders once it's integrated.

In 1990, a group of MIT researchers published *The Machine That Changed the World*, a book that introduced the Toyota Productions System to the world — and changed the manufacturing industry forever. Since then, many companies have tried to copy Toyota's system of lean manufacturing, but few leadership teams have embraced it as fanatically as brothers Mitchell and Steven Rales, the reclusive billionaire founders of manufacturing conglomerate **Danaher** (NYSE: DHR) and a lesser-known industrial business called **Colfax** (NYSE: CFX). Though Colfax has been overshadowed by the legendary success of its big brother — Danaher has generated an astonishing 21% annualized return since the company adopted lean manufacturing in 1987 — Colfax has recently stepped into the limelight thanks to a transformational acquisition that I believe will create shareholder value for years to come.

COLFAX

NYSE

INDUSTRIAL

CAPS

$5.7 b	$639 m	$1.5 b	$56.19	$57
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

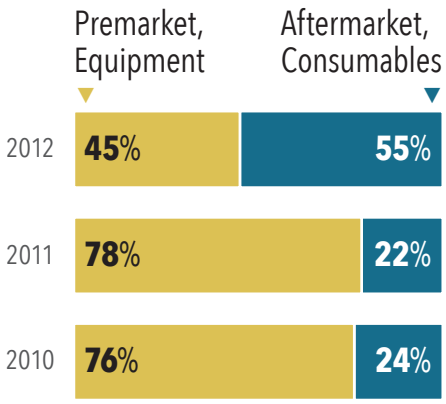
▶ *Colfax*

THE COMPANY & SECTOR

The Rales brothers founded Colfax in 1995 with the intention of building a global, multiplatform industrial enterprise. As they did at Danaher, the Raleses focused on creating a *kaizen* culture of constant improvement, and management has spent the better part of the past two decades perfecting the Colfax Business System, a lean manufacturing philosophy that borrows heavily from the Toyota Production System and the Danaher Business System. Also similarly to Danaher, Colfax has adopted the strategy of acquiring underperforming businesses with strong brands and then unlocking value through the application of the CBS.

For most of the past decade, Colfax focused exclusively on fluid handling applications, becoming the leading brand for high-capacity industrial three-screw pumps. Then, in early 2012, the company completed the massive acquisition of Chartered International, an underperforming U.K.-based industrial business that generated sales 5 times as large as Colfax's. Chartered was the combination of two market-leading brands: the 150-year-old Howden line of high-capacity industrial fans and the 100-year-old ESAB line of welding and metal cutting equipment. The addition of these two profitable brands to the portfolio has the added benefits of diversifying the revenue stream, increasing the ratio of repeat aftermarket sales, and offering greater exposure to fast-growing emerging economies. ▼

REVENUE BREAKDOWN



Data from Capital IQ.

This improved revenue mix should help mute the cyclicality of the legacy fluid-handling business, provide cross-selling opportunities in the related markets, and generate more predictable free cash flow to invest in future acquisitions.

THESIS & OPPORTUNITY

While Colfax management works to improve the operating performance of Howden and ESAB, I expect that the company will continue to add small bolt-on acquisitions and use the CBS to cut costs, reduce working capital requirements, and improve order turnaround times. Though management doesn't expect to make any large acquisitions over the next two years, I expect it to look for another large acquisition to opportunistically add new business lines to the Colfax platform.

I'm confident that Colfax will be able to successfully execute its growth plan because the company is chock-full of managerial talent. CEO Steven Simms is a former Danaher executive, and co-founder Mitchell Rales serves as chairman and owns 11% of the

company. The company has also hired a large number of Danaher managers over the years, yet it makes a point to develop internal talent and hire from within to perpetuate the Colfax culture.

Colfax has an all-star board of directors that includes Tom Gayner, the renowned chief investment officer at **Markel** (NYSE: MKL), and San Orr, the chief operating officer for BDT Capital Partners, a merchant bank famous for helping Warren Buffett structure deals. As a small investor, I always feel better knowing that the board includes a number of savvy capital allocators with big equity investments who can protect shareholder interests. Also, BDT has a large network of private, family-owned businesses that should help keep Colfax's acquisition pipeline full.

FINANCIALS & VALUATION

After the acquisition of Chartered, Colfax carries $881.9 million in net debt, and restructuring charges have muddied its profitability. Management believes that by applying the CBS at Howden and ESAB, it should be able to generate $55 million to $65 million in cost savings in 2013, achieve another $70 million in combined savings over the following two years, and eventually reach an operating margin around 15%. This improved profitability should allow the company to deleverage rapidly and realize management's goal of owning an investment-grade balance sheet within three to four years. Also, improved working capital management from the CBS implementation should continue to generate cash for acquisitions.

At first glance, Colfax's stock looks pricey at 24 times forward earnings estimates. The stock has jumped nearly 40% so far this year, and the market appears to be pricing in a seamless integration of the Howden and ESAB businesses. So far, management has delivered on its promises: The operating margin last quarter was 3.7 percentage points higher than last year, putting cost-cutting efforts slightly ahead of schedule. Though the stock prices in a rosy future, I don't think investors fully appreciate Colfax's potential to repeat this process with multiple future acquisitions. Looking out five years, it's easy to make a case that Colfax's stock could double, generating 15% annual returns for investors.

RISKS & WHEN TO SELL

For this investment to be profitable, management has to keep making savvy acquisitions and then use the CBS playbook to extract value. If management is too aggressive and overpays, then it'll be the other company's shareholders extracting value, not us.

Colfax's heavy exposure to emerging markets means that currency fluctuations are likely to affect earnings. If U.S. interest rates rise, then a stronger dollar will likely drag on future earnings.

Finally, several of Colfax's end markets have struggled. If that persists, it will cramp projected margin increases and could spook investors who are used to management underpromising and overdelivering.

THE FOOLISH BOTTOM LINE

Colfax has created (some say "copied") a corporate culture focused on creating shareholder value. I rarely consider a company's management team to be a sustainable competitive advantage, but in Colfax, we're investing alongside a group of proven winners with a disciplined, battle-tested business strategy. The stock has been on a heck of a run this year, but I think investors would be wise to start a position now and add to it on pullbacks. 14

Jeremy Myers is the senior analyst for *Hidden Gems*.

For disclosure information, see page 44.

Express Scripts

Pharmacy benefits managers sit at the nexus of the health-care market, and Express Scripts is top dog

MICHAEL OLSEN, CFA
TMFAGEWONE

WHY BUY?

1. Express Scripts can capitalize on two problems: health-care cost inflation and an aging population.
2. As the juggernaut of its industry, Express Scripts' scale enables it to earn outsized margins and ROIC.
3. Growth should benefit from increasing generic drug use, mail-order prescriptions, and insurance rolls.

For all its strengths, the United States faces spiraling health-care cost inflation, the world's highest per capita health-care spending and comparatively worse patient outcomes. Opinions on potential solutions aside, we can agree: It's a huge problem.

In a health-care system benighted by conflicting stakeholder interests, **Express Scripts** (Nasdaq: ESRX), the nation's largest pharmacy benefit manager, sits at the intersection of a huge opportunity to improve patient health, reduce systemwide health-care costs, and mint cash for shareholders. The market differs, however, with concerns over its growth prospects, the impact from private and Affordable Care Act–sanctioned insurance exchanges, and longer-term concerns over its competitive position. I believe that diagnosis is short-sighted and as the stock trades at 12 times my estimate of trailing free cash flow, the market has failed to credit the strength of Express Scripts' moat and the durability of its growth prospects.

EXPRESS SCRIPTS®

NASDAQ

HEALTH CARE

CAPS

$50.3 b	$1.3 b	$14.2 b	$62.37	$67
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Express Scripts*

THE COMPANY & SECTOR

Express Scripts is best thought of as the pharmaceutical supply-chain equivalent of **Costco Wholesale** (Nasdaq: COST) or **Amazon.com** (Nasdaq: AMZN). Those two used their retail muscle to build the most powerful competitive advantage, where economies of scale meet a network effect. Because many vendors are eager to tap their captive bases of customers, the companies can use their influence to connect customers with the best prices.

Express Scripts' role in the pharmaceutical supply chain and its competitive advantages bear striking similarities. The product of the 2011 marriage of Medco Health Solutions and its namesake, Express Scripts is the largest PBM in the United States, filling 1.4 billion prescriptions in 2012, one-third of the nationwide total.

Express Scripts sits at the center of a web of health insurers, pharmacies, drug distributors, and drugmakers. PBMs administer prescription drug benefits on behalf of insurers — processing claims, negotiating drug price with pharmaceutical companies and terms of reimbursement and network participation with pharmacies, and in some cases, delivering drugs by mail. For every claim processed, it takes a spread on the drug's cost.

The three largest PBMs — Express Scripts, **CVS Caremark** (NYSE: CVS), and **Catamaran** (Nasdaq: CTRX) — control about 60% of the U.S. market. Their size offers considerable leverage to negotiate lower prescription drug costs on behalf of customers. Drugmakers eager to tap large customer bases typically offer volume discounts. Pharmacies and drug distributors, also keen to get a piece, accept lower reimbursements.

As the industry's goliath, Express Scripts' bargaining power is unsurpassed. Because plan administration is complex and switching PBMs can contribute to customer angst, retention rates are typically quite high, around 95%, and contracts relatively long, around three years.

Over many years, Express Scripts collected data surrounding health-care outcomes and drug interaction, and the most effective, economically viable treatments. It has employed these data stores to expand its product suite from claims processing to mail-order delivery of prescriptions, specialty pharmacy (managing the pharmacy component of complex drugs), and prescribing drug formularies (recommended treatment plans) and recommended copays to insurers. With each incremental offering, its value proposition — and the stickiness of its revenue streams — has increased.

THESIS & OPPORTUNITY

Despite the industry's attractive dynamics and Express Scripts' fortified position, the market hasn't credited its still-robust opportunity. I believe concerns over the ACA, private health-care exchanges, and Express Scripts' growth prospects couldn't be more short-sighted. Express Scripts stands to capitalize from more mail-order prescription fulfillment, incremental penetration of generic offerings, and a rapidly aging population.

THE AFFORDABLE CARE ACT AND PRIVATE EXCHANGES: With state health-care exchanges operational and private exchanges getting traction, investors' attention has pivoted to the prospective impact. Some worry

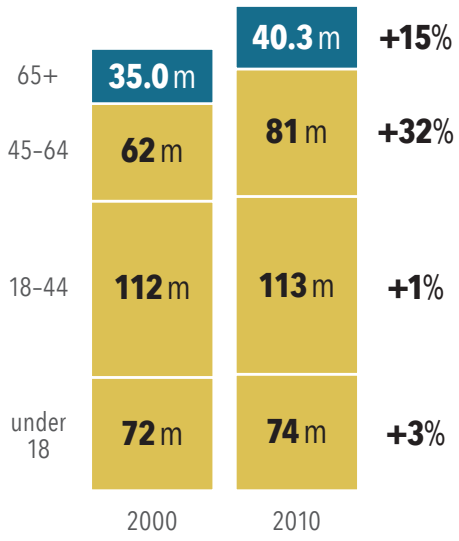
that as employers turn to exchanges — public or private — Express Scripts' clout will erode, and PBMs will be forced to accept lower margins (as PBM contracts move from employers to insurers, which are typically lower margin) or lose business.

There's truth to these concerns, but they fail to acknowledge the bigger picture. This dynamic reinforces Express Scripts' core strengths. Insurers will try to reduce plan costs, and Express Scripts' size and scale position it well. Arguably, its influence — and ability to command pricing — will be reinforced. And if not, then lower per-claim profitability should be offset by fixed-cost leverage from more claims.

THE MARCH OF TIME: Yet another camp worries that as the "generic wave" passes, which has boosted profitability and margins, Express Scripts' growth is history. But there's another wave coming. America is getting old, and quickly.

According to the 2010 U.S. census, the 65 and older population rose 15% between 2000 and 2010. ▼

U.S. POPULATION GROWTH



Data from U.S. Census.

In the next 10 years, that figure will continue its march higher. Among this population, prescription drug use is 5 times higher than for those 25 and under. Likewise, as attention increasingly turns to preventative care, the magnitude of "wasted" health-care spending is increasingly apparent. A 2013 IMS Health study estimated the annual cost of "medicine misuse" at more than $200 billion, against total prescription drug spending in 2013 of just $325 billion, 10% of total U.S. health-care spending. Still other reports from Thomson Reuters and the New England Health Institute estimate avoidable costs at $3.6 trillion and $680 billion.

Effective use of pharmaceuticals might prevent or, at very least, curtail the rate of these occurrences. As regulators and policy wonks focus on cost containment, these factors should prove powerful momentum for prescription totals. And with the ACA's implementation, Express Scripts will get another bump, as the nation's 32 million uninsured receive coverage. Taken together, I expect prescription numbers to jump 50% to 60% over the next 10 years.

A GENERIC OPPORTUNITY: Effectively employed, prescription drug use mitigates health-care cost inflation, by preventing more costly long-term issues. But they've also contributed to the problem. A basket of branded drugs that cost $100 in 2008 would cost $181 today, while over the same period, a basket of generic drugs slipped to $51.50. The solution is obvious: Push patients to generics, as opposed to brand-name drugs. Whereas branded drugs are patent-protected, generics face fierce competition, and capitalism works. Competition pushes prices lower.

For Express Scripts, there's a nice confluence. Profitability on generic prescriptions substantially exceeds branded drugs — sometimes by roughly double or more. Though about 80% of Express Scripts' prescription volumes are generics, a 5 percentage point bump equates to a 10% increase in operating profits. With $40 billion of branded drugs losing patent protection in the next two years, generic prescription share is primed to jump.

IT'S IN THE MAIL: When it comes to generics, mail-order serves two ends — it lowers overall health-care costs and drives higher profits for Express Scripts. By cutting out the pharmacist, Express Scripts saves customers money and pockets some of the difference. And for mail-order, Express Scripts negotiates directly with manufacturers, using its size and scale to negotiate larger discounts. Generic mail-order prescriptions' profitability can be several times that of an ordinary generic prescription.

Despite the prospective benefits, mail-order prescription penetration stands around 10%. Yet again, a small step forward can kickstart profitability. To give a sense of the possibility: Were mail-order penetration to increase from 10% to 15%, operating profits could grow by 50%. As regulators and companies focus on cost containment, that could happen.

FINANCIALS & VALUATION

An asset-light company with relatively low reinvestment needs and the ability to scale fixed costs across a large client base, Express Scripts earns a consistently high return on capital. As prescription totals increase with the population's aging, and as mail-order and generic penetration rates climb as well, its operating margin should

expand. A virtuous cycle follows: Express Scripts can pass additional savings to consumers as its influence with drugmakers increases, all the while increasing profits.

It stands to reason that, as Express Scripts grows ever larger, its ability to expand its cash flow could actually increase. Looking ahead, I expect that Express Scripts will drive additional administrative cost savings from the Medco merger, as the company completes its migration from the two companies' legacy systems to a centralized platform and wrings out redundant administrative costs.

In the next decade, I expect prescription numbers to increase at a 4% to 5% annual clip and for Express Scripts to capture an increasing share of economic profits as its influence grows. On a combination of more claims, growing mail-order and generic penetration, and additional cost savings from the Medco deal, I anticipate the operating margin increasing to 6.2% over 10 years, from 3.9% over past 12 months. On this basis, I estimate the stock to be worth $97.

RISKS & WHEN TO SELL

Operating in the health-care sphere, Express Scripts isn't immune from the regulatory hot potato. If regulators deem the company's share of the savings negotiated from pharmaceutical companies as too large, they may seek to rebalance the distribution from PBMs to consumers. Provided Express Scripts continues to reduce drug costs for consumers, I doubt this will be a problem, but it bears watching.

If the government, as the largest health-care payor, opts to insource the PBM function, it could erode Express Scripts' competitive position. Building the infrastructure and influence would be difficult and unlikely, but it's not inconceivable.

Last, if the large insurers enter the PBM business in an attempt to capture profits and expand their influence within the medical supply chain, Express Scripts may find itself in a nasty dogfight. **UnitedHealth** (NYSE: UNH), the country's largest health insurer, has recently made moves to insource its PBM functions. That could pressure pricing, but given its influence and the scope of its network, competition is unlikely to whittle away its position. I'd contemplate selling for two reasons: management's missteps on capital allocation, or regulatory winds and industry change threatening disruption.

THE FOOLISH BOTTOM LINE

There's no shortage of complexity to the tangled web of our nation's health-care infrastructure. But buying Express Scripts offers straightforward benefits — keeping your portfolio and our fine nation healthy. 14

Michael Olsen, CFA, is a senior analyst for *Special Ops* and *Million Dollar Portfolio*.

For disclosure information, see page 44.

Geospace Technologies

Geospace offers oil companies the best equipment — and investors an opportunity for rich returns

TAYLOR MUCKERMAN
TMFRUNAMUCK

WHY BUY?

1. In offshore oil and natural gas, proven technology wins the day — and Geospace has set itself apart.
2. Relationships are forged over time, and I'm confident in management's reputation within the industry.
3. Geospace has no debt and generates enough cash to fund its growth without requiring leverage.

No matter whom you talk to in the energy industry, offshore oil and natural gas development tops the list of long-term plans and expectations. Conventional sources of these valuable fossil fuels remain on the decline, and onshore shale deposits have shown proclivity for steep decline curves. For these reasons, among others, exploration and production companies of all sizes have lines out in the deep blue seas, waiting for that big kahuna to bite. And much like traditional fishing ventures, a significant portion of success boils down to the bait and tackle at your disposal. Thankfully, **Geospace Technologies** (Nasdaq: GEOS) and its innovative team have been providing these oil anglers with state-of-the-art seismic data acquisition products and technology since 1980.

NASDAQ

ENERGY

CAPS

$1.2 b	$10 m	$0	$95.62	$97
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Geospace Technologies*

THE COMPANY & SECTOR

Captained by Gary D. Owens, a man with 43 years of seismic activity in his live well, the Geospace vessel has become the leader in its industry. As I mentioned, the company was founded in 1980, but until 2012, the company went by the name OYO Geospace Technologies. Geospace has nothing to be ashamed of; the change simply has to do with OYO Corporation USA selling its stake in the company in February 2012. Just prior to the name change, it was named one of Fortune's fastest growing public companies of the year.

This growth has continued unabated, and since its IPO in 1997, retained earnings have increased at 17% a year. It even managed to turn a profit during the tumultuous 2009 that ravaged the majority of the energy industry. With its wireless segment providing much of the growth the past five years, and its niche reservoir products surging lately, Geospace has developed a differentiated portfolio of niche products that has given the company pricing power in the market. The company's deep moat is evidenced by its increasing gross margin and a return on capital that has averaged more than 16% since 2010.

THESIS & OPPORTUNITY

Leaning heavily on a long list of core values, Geospace Technologies strives to provide one of the most reliable and commonly used technologies in the petroleum industry's global quest to find, develop, and efficiently produce hydrocarbon resources. In an industry in which the top 50 spenders put $186 billion at risk last year to explore for and develop oil and gas assets, the words "reliable" and "efficient" resonate quite well with a CEO's managerial geophone.

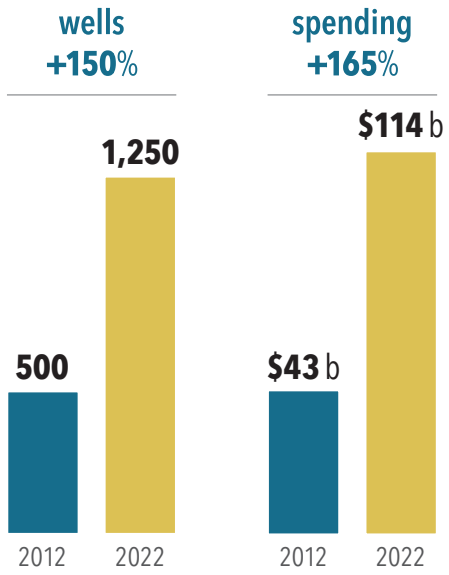
Now, given that this spending was 20% above the 2011 level, a company like Geospace, which provides products integral to the E&P process, should've realistically seen the same boost to its top line. Unfortunately, that wasn't the case. For 2012, Geospace's revenue only rose 10.8%. This has all changed dramatically in 2013, with year-to-date revenue already up 21.4% versus all of 2012.

A large portion of this growth stems from a major contract awarded to Geospace by **Statoil** (NYSE: STO), in which the company will provide 660 kilometers of seabed seismic reservoir monitoring systems for Statoil operations off the coast of Norway. Statoil expects that this initiative could lead to an additional 30 million barrels of oil being recovered. Success here could go a long way toward reaffirming Geospace's importance in the market, given that this is the largest seismic project of its kind.

I expect that contracts such as this will become a regular occurrence, assuming predictions hold true. The well-regarded industry research group Wood Mackenzie, for example, foresees the number of deepwater exploration, appraisal, and development wells to surge 150% higher by 2022, helping drive overall deepwater spending to $114 billion per year by that date. ▶

Boosting expected ultimate recoveries using Geospace's permanent reservoir monitoring technique could go a long way towards validating this level of spending — Statoil is hoping for $3.15 billion of additional oil to be recovered by this project.

DEEPWATER PROJECTIONS



Data from Wood Mackenzie.

FINANCIALS & VALUATION

When it comes to its financials, Geospace has separated itself from the pack. Not many companies can boast annual revenue growth of 20% for the past five years while using minimal debt. Add its cash position together with an unused credit facility, and investors should feel secure with the company's $35 million liquidity position.

From a valuation perspective, I believe Geospace warrants a 15 times EV-to-EBIT multiple, which puts its stock price at a 15% discount to my $104 price target. If Geospace is able to achieve my assumption for long-term growth of 5% and a 19% return on invested capital, this price target is well within reach. For those who might be wondering how those assumptions stack up to current fundamentals, the company has increased its operating profit at 36% for the past five years, and its ROIC last clocked in at 21.8%. Given that a company can't grow at 36% into perpetuity, I think that 5% long-term growth makes sense, taking into account the company's international exposure to industries with above-average growth expectations. Also consider that, if Geospace traded at an EV-to-EBIT multiple closer to its peer average, its stock would be priced closer to $118 right now.

RISKS & WHEN TO SELL

Clearly, Geospace Technologies relies heavily on spending within the upstream oil and gas industry, so investors need to monitor those trends. For the past couple of years, capital expenditures have increased for multiple reasons: The price of oil has remained relatively high, it is more costly to discover and produce oil these days, and global demand continues to grow while existing wells decline. I believe these should be sticking points for the foreseeable future, but if that pace changed, I would take it seriously. Still, Geospace's solid balance sheet and flexible cost structure provide it with a bit of insulation during trying times.

However, should such a downturn occur, inventory levels could become an issue for Geospace Technologies, possibly leading to write-downs. Currently, the company has a considerably higher inventory valuation than it typically carries. Though management is comfortable with this because of the build-out for the Statoil deal, a change in the purchasing and leasing habits of its other key customers could have an impact on inventory valuation.

THE FOOLISH BOTTOM LINE

Advanced technologies to help enhance oil and natural gas production are typically valued at a premium, but Geospace Technologies trades at a discount — even though it provides a superior service — which is why I believe it's such a great investment at the moment. The deal with Statoil will go a long way toward proving the viability of its wireless reservoir-monitoring systems in a harsh environment. Should the deal lead to the 30 million additional barrels of oil recovery that Statoil is expecting, a tidal wave of new orders could ensue. Don't miss out on this big fish. 14

Taylor Muckerman is Fool.com's energy and materials analyst and is an analyst for *Stock Advisor Canada*.

Kohl's

This discount department store may be done growing, but now is the time to harvest its gains

CHARLY TRAVERS
TMFCandyMountain

WHY BUY?

1. Management knows how to allocate capital to help the business and shareholders.
2. Today's discount on the stock is as attractive as Kohl's prices for shoppers.
3. Income-loving Fools should receive steady dividend increases.

In his book *The Outsiders*, William Thorndike details CEOs who delivered tremendous returns for their shareholders. At **Berkshire Hathaway** (NYSE: BRK-B), **General Dynamics** (NYSE: GD), and **Teledyne** (NYSE: TDY), one key trait the CEOs shared was an exceptional talent for allocating capital.

Kohl's (NYSE: KSS) stock has crushed the market since its IPO in 1992, gaining nearly 3,000%, compared with 320% for the S&P 500. For much of that period, Kohl's investors benefited from the company's nationwide expansion, during which the build-out of new stores increased the company's profits and the stock price rose accordingly. Now with 1,158 stores, Kohl's growth is over, and CEO Kevin Mansell has spent much of his five-year tenure deploying profits into store remodeling, share buybacks, and dividends. If Mansell sticks to this playbook, Kohl's shareholders are in for a wonderful ride over the next decade.

KOHL'S

NYSE

SERVICES

CAPS

$12.3 b	$592 m	$2.5 m	$56.85	$60
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Kohl's*

THE COMPANY & SECTOR

Each Kohl's location is a value-oriented department store — a one-stop shop for clothes, appliances, and home goods. The company offers a mix of national name brands such as KitchenAid, Levi's, and Nike alongside its own private brands like Chaps and Sonoma LIFE + Style that offer shoppers the best value in the store. Private and exclusive brands account for more than half of Kohl's sales.

Kohl's is not unique in this regard. Numerous U.S. department store chains, including **Dillard's** (NYSE: DDS), **J.C. Penney** (NYSE: JCP), **Macy's** (NYSE: M), and **Sears** (Nasdaq: SHLD), battle over the same finite pool of consumer dollars spent on back-to-school clothes, wedding registry gifts, and linens. Of course, there is also the unstoppable force of **Amazon.com** (Nasdaq: AMZN), whose e-commerce dominance has forever altered the retailing landscape.

Despite playing in a crowded field, Kohl's is performing admirably. The company's profit margins and returns on capital are remarkably stable for a retailer. Management's use of those profits is what makes investing in Kohl's a good idea today.

THESIS & OPPORTUNITY

Retail is all about getting customers in the door to make a purchase. This requires the right assortment of products at the right price and setting the goods in an attractive shopping environment. Over the past six years, Kohl's went to great lengths to invest in its store base. At a cost of $4.9 billion, Kohl's built 234 new stores and remodeled another 352. This means that half of the company's stores have a fresh look and a shopping layout that optimizes the size and placement of the cosmetics counter, features electronic signs, and moves the customer service center to the front of the store. The end result of a store remodel is an average sales uptick around 1% to 4%.

In 2013, Kohl's is building only 12 new stores and remodeling 30, indicating that its investment binge is over. The company's capital expenditures of $640 million over the past 12 months are the lowest in a decade, which increases the cash available to shareholders.

The way management is allocating that free cash flow — approximately $800 million over the past 12 months — forms the crux of my Kohl's investment thesis. Kohl's is buying back its stock at a torrid pace: From the beginning of its 2010 fiscal year through the midway point of fiscal 2013, Kohl's repurchased $4.9 billion of its stock. Kohl's shares outstanding dropped 29%, from 306 million down to 218 million. This has sent earnings per share soaring, up 32% to $4.17 from fiscal 2010 to fiscal 2012, at a time when net income is flat.

My expectation is that over the next five years, Kohl's could repurchase another 50 million to 75 million shares, sending its EPS close to $6, if not higher. If the P/E ratio holds steady at 12, Kohl's share price should increase commensurate with its EPS growth.

FINANCIALS & VALUATION

Kohl's capital allocation priorities show how shareholder-friendly uses of cash can turn a boring business into a superstar performer for shareholders. Given that Kohl's has saturated its U.S.

growth opportunity with more than 1,100 stores and wisely has no international expansion plans, revenue growth will probably be close to 2% a year, or in line with the overall growth of the economy. ▼

AS THE STORE COUNT SLOWS ...

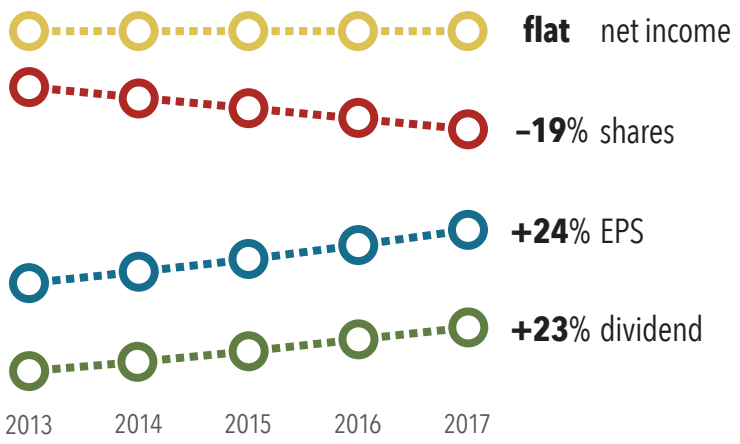
	Stores	Revenue	Net Income	Shares	EPS	Dividend Per Share
FY 2010	1,089	$18.4 b	$1.12 b	306 m	$3.66	0
2011	1,128	$18.8 b	$1.17 b	271 m	$4.30	$1.00
2012	1,146	$19.3 b	$0.99 b	237 m	$4.17	$1.28
TTM	1,158	$19.3 b	$0.97 b	227 m	$4.28	$1.34

TTM through September 2013. Data from Capital IQ.

However, Kohl's aggressive share buybacks could lead to impressive growth in both eps and dividends per share, even with flat profits. Here is one scenario that uses a simplifying assumption that 10 million shares will be repurchased each year, which is considerably lower than the recent pace of buybacks. ▼

... BUYBACKS CAN DRIVE EARNINGS

	Net Income ▼	Shares ▼	EPS ▼	Dividend Per Share ▼
FY 2013	$1.00 b	210 m	$4.76	$1.43
2014	$1.00 b	200 m	$5.00	$1.50
2015	$1.00 b	190 m	$5.26	$1.58
2016	$1.00 b	180 m	$5.56	$1.67
2017	$1.00 b	170 m	$5.88	$1.76



Data from analyst's estimates.

I expect Kohl's stock to fetch at least $70 at some time along this horizon. The upside to that estimate could come from more aggressive buybacks, perhaps with low-cost debt, or an improvement in profitability. Kohl's net margin of 5% over the past 12 months is the company's lowest since 1998. A return to a 6% net margin, which it earned as recently as 2011, would add $0.75 per share to earnings at today's share count.

RISKS & WHEN TO SELL

The Kohl's thesis only holds up if the company's cash flow remains strong. In other words, it can't morph into J.C. Penney or Sears, which have skimped on investing in their stores in a short-sighted attempt to save money. I'm confident that the recent store updates of its stores will keep customer traffic and sales steady. But if Kohl's starts turning in several quarters in a row of negative same-store sales and cash flow erosion, it will be time to get out.

I am recommending Kohl's because of its aggressive share buybacks and dividend increases, both of which I expect to continue. If the company retreats from returning its free cash flow to shareholders and does something like go on a new-store building spree, I'd put Kohl's back on the rack.

Kohl's is an established, cash-cow business unlikely to surprise us with unforeseen growth avenues. If the valuation on the shares starts looking pricey, it is time to sell. This isn't the type of business that can increase its profits enough to support a lofty earnings multiple.

▶ *Kohl's*

THE FOOLISH BOTTOM LINE

Kohl's is harvesting its gains from half a decade of investment in its store base. The company is shrewdly deploying its free cash flow into massive share buybacks and dividends. Over the next five years, Kohl's share count should shrink dramatically while earnings and dividends per share skyrocket. I believe that the stock price will rise as a result, rewarding patient long-term investors. Put some in your shopping cart today, Fools. 14

Charly Travers is an associate advisor for *Million Dollar Portfolio* and *Share Advisor (UK)*.

For disclosure information, see page 44.

Lincoln Electric

This welding equipment maker could spark great returns for your portfolio

JASON MOSER
TMFJMO

WHY BUY?

1. Lincoln Electric's razor-and-blade model offers potential for higher margins and profitability.
2. The company has global exposure beyond North America, to the BRIC and other economies.
3. Continued investment in R&D will bring new innovation, keeping Lincoln on the cutting edge.

It's no secret that industrial activity has taken a beating over the past few years. A recession of epic proportions and a sluggish recovery tend to do that. But while activity came to a virtual standstill during the financial crisis, things are starting to slowly pick back up as conditions improve, and I'm convinced a great long-term winner from all of this will be **Lincoln Electric** (Nasdaq: LECO).

THE COMPANY & SECTOR

Founded by John C. Lincoln in 1895, this company has been around for a little while. Originally, Lincoln sold electric motors that John Lincoln himself designed. Fast-forward to today, and Lincoln is a market leader and one of only three companies worldwide that offers both welding equipment and welding consumables. In fact, the company runs 45 manufacturing facilities in 19 countries.

LINCOLN® ELECTRIC

LECO		5 ★★★★★
NASDAQ	INDUSTRIAL	CAPS

$5.8 b	$330 m	$16 m	$70.66	$70
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Lincoln Electric*

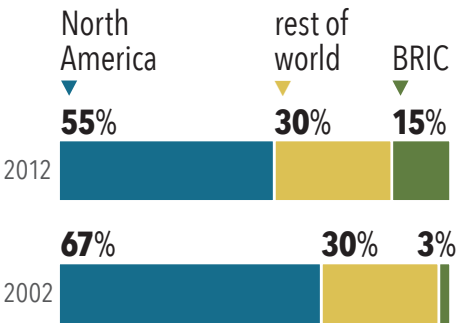
Lincoln is best known for its position as the largest designer and manufacturer of arc welding and cutting products. Arc welding is a process whereby a power supply creates an electric "arc" between the equipment and the base material to melt the metals at the welding point. Thanks to its strength and durability, it's widely used today. The company's end-user markets include structural steel construction (think bridges and buildings), heavy equipment fabrication, power generation, and offshore oil and gas exploration and extraction.

THESIS & OPPORTUNITY

One of the most attractive aspects of this business is its razor-and-blade model. Lincoln sells the welding equipment (the razor) as well as the welding consumables (the blades) that are essential to do the work. The breakdown of the sales today is 35% equipment versus 65% consumables, and the consumables provide a lovely stream of recurring revenue that keeps the cash rolling in.

Lincoln Electric is also expanding globally. In 2002, approximately two-thirds of the company's business came from its North American market, with the other third international, and only 3% of that coming from Brazil, Russia, India, and China (known as the BRIC countries). Today, the split is closer to 50-50, with 15% (and growing) of the company's business coming from the BRIC economies as well as other emerging markets. ▼

SALES SOURCES



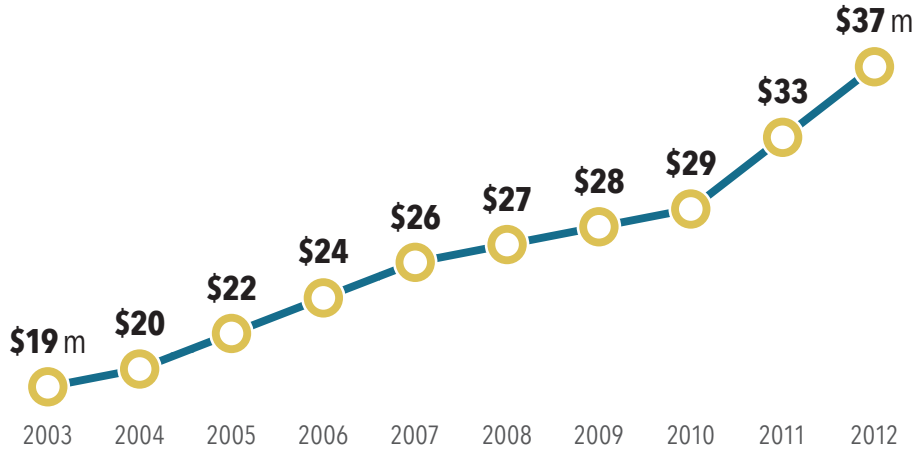
Data from Lincoln Electric.

With such a broad and diverse customer base, Lincoln is in a wonderful position to benefit from both economic recovery in developed nations and continuing industrialization in developing nations — particularly in the Europe, Middle East and Africa, and Asia-Pacific markets, which offer the most room for growth. The global arc welding market opportunity is approximately $20 billion, and Lincoln owns about 14% of that. After the big three players in the space, the market is extremely fragmented with smaller outfits focusing on only one part of the business — either equipment or consumables. With its knowledge and expertise, this puts Lincoln in a great position to continue picking up market share.

Lincoln touts its value proposition for customers as a "one-stop shop," and management will continue to pursue this through focused R&D spending. In fact, the company has doubled its R&D spending over the past decade. ▶

Given that 50% of 2012 equipment sales were new products developed and introduced over the past five years, it's plain to see how important innovation is in this line of work. With the industry's most comprehensive research and development program, Lincoln is sure to stay on the cutting edge.

R&D SPENDING



Data from Lincoln Electric.

FINANCIALS & VALUATION

From its low in the midst of the turmoil in 2009, Lincoln's top-line revenue has come back strong at about 18% annualized while at the same time boosting the operating margin to nearly 14%. The balance sheet today is in great shape with $330 million in cash and equivalents, along with a modest $16 million in debt. Perhaps more impressive is the company's ability to generate copious amounts of free cash flow (more than $250 million over the past 12 months) that the company can reinvest in the business or use to chalk up an acquisition or two as the industry consolidates.

Management's "2020 Vision" goals have the company ringing up greater than $4 billion in sales to go with an operating margin of 15% or higher. If it can get there (and I think this management team can and will), it should bring in close to $450 million in net income, resulting in earnings per share in the neighborhood of $5.35 — even better if management continues to opportunistically buy back shares. Put it all together and throw in a 1.3% yield that should only grow with time, and I can see shares of Lincoln being worth twice as much by 2020, offering investors a sweet long-term 10% annualized return.

RISKS & WHEN TO SELL

The biggest risk for a company like Lincoln is prolonged economic downturn; in 2008 to 2009, revenue fell 30%, taking the company's stock price along with it. The bright side of this risk, however, is that it can provide opportunities for long-term investors to pick up shares on the cheap.

Lincoln's business relies on raw materials including steel, brass, copper, and natural gas. While the company has a diverse number of suppliers, these are commodities, which are always subject to market forces. Increases in production costs could play out in the form of lower margins, and investors should keep an eye on the supply chain.

Finally, while this is a risk that is slowly fading away, Lincoln is a co-defendant in a number of asbestos lawsuits that are still open. This is something that has been going on since 1995, and the overwhelming number of claims against Lincoln have been dismissed with only a handful of plaintiff verdicts. The bottom line here is that asbestos used in welding consumables in the U.S. ceased in 1981, so this risk is decreasing with time.

THE FOOLISH BOTTOM LINE

Fast or slow, global industrialization is a long-term trend that's here to stay, and wise investors will focus on opportunities that take advantage of this. Lincoln Electric isn't the most fascinating business in this report by a long shot. But it's great at what it does, and its razor-and-blade business model should keep the cash flowing and the stock growing for years to come. 14

Jason Moser is an analyst for *Motley Fool One*.

Northfield Bancorp

After its recent demutualization, this bank could fill your portfolio's coffers

JIM ROYAL
TMFROYAL

WHY BUY?

1. A recently completed demutualization should allow the bank to trade for more than tangible book value.
2. The bank is overcapitalized and will likely initiate stock buybacks, increasing book value per share.
3. Significant insider ownership helps align management's interests with outside shareholders'.

An investment in **Northfield Bancorp** (Nasdaq: NFBK) takes advantage of a special situation that investing greats such as Peter Lynch and Seth Klarman used for years before they grew too large: demutualization. As I'll explain, Northfield's recent demutualization left the New York bank vastly overcapitalized but trading below tangible book value. With insiders owning a significant slug of stock, it's a recipe for market-beating returns.

THE COMPANY & SECTOR

Northfield Bancorp engages in plain-vanilla banking, with the vast majority — more than 80% — in multifamily and commercial loans. The bank was organized in 1887 and operates in the New York City metro area, with more than 30 locations in Staten Island, Brooklyn, and the New Jersey counties of Union and Middlesex.

Northfield Bank

NASDAQ

FINANCIAL

CAPS

$739 m	N/A	N/A	$12.84	$13
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Northfield Bancorp*

That puts it in one of the world's most robust municipal economies, keeping operations humming.

Northfield has just $2.7 billion in assets, a nice month's profit for the big boys who inhabit next-door Manhattan. But unlike those power players, Northfield is vastly over-capitalized — it has way more cash than it needs — because of recently raising cash via demutualization, which I'll explain in a moment. Strikingly, equity is nearly 27% of assets, when half that level would still be considered overcapitalized.

The financial sector is still shaky. But a small bank like Northfield isn't one of the large banks that dominate American assets, and it didn't engage in the risky behavior that nearly blew up the world economy. Northfield suffered, too, but its credit metrics have improved rapidly. In 2010, nonperforming assets — mostly a lot of small loans — spiked to 2.7%, but that's modest compared with many. Better still, it's shrunk to just 0.7% in the past year, elevated but fast approaching normalcy.

THESIS & OPPORTUNITY

An investment in Northfield takes advantage of a special situation called demutualization. Mutual banks, or thrifts, are owned by their depositors, but they can demutualize, going public by selling shares to depositors and others. That money is added to the books of a pre-existing and often thriving bank, as was the case with Northfield. Thrifts demutualize for a variety of reasons: to expand their lending, to get more capital, or simply to bail themselves out of a cash crunch.

The best part is that thrifts usually go public at less than tangible book value, meaning there's profit baked into them from the start. In short, you can often buy a solid bank that is discounted for technical rather than fundamental reasons. The best of these banks return the cash to shareholders through buybacks, ideally below book value. It gets sweeter still: About 66% of demutualized banks are acquired, at an average 1.6 times book value, around five years after conversion, according to Sterne Agee. Buy a well-capitalized thrift below book value, and it's tough to lose money. ▼

And that looks to be the situation at Northfield, a profitable bank that completed its demutualization in January. The bank raised $356 million, swelling its coffers. The bank simply doesn't need that much

BUYING A BANK

DEMUTUALIZED BANKS THAT ARE ACQUIRED

1.6
TIMES TANGIBLE BOOK VALUE

AVERAGE BUYOUT MULTIPLE

5
YEARS

AVERAGE TIME, CONVERSION TO ACQUISITION

Data from Sterne Agee.

cash to operate, so it looks set to buy back shares. It has a history of doing just that. Since 2007, the bank has purchased 27% of its original share count. Once the one-year moratorium on buybacks for converted thrifts ends in January, a sizable buyback is possible. Oh, and another sign of shareholder-friendliness: Northfield restarted its dividend earlier this year and paid a special dividend to help make up for its dividend cut last year. The yield comes to 1.9%.

Northfield is also making smart acquisitions. In 2011, the bank bought New Jersey's First State Bank out of receivership from the FDIC and obtained $50.5 million from regulators for taking on FSB's $195 million in assets. Last year, Northfield purchased the $143 million in assets of Flatbush Federal for a knockdown 45% of book value. While small, these buys suggest that Northfield can make smart deals that enhance its value.

And that's great for owners, many of whom are Northfield insiders. Together they own 3.1% of the stock, with Chairman and CEO John Alexander holding 0.7%, or $5 million. Seven other insiders hold more than $1 million in stock. With this type of insider holdings — largely acquired as part of the conversion in January — I expect the bank to continue to do smart things.

As the economy continues its plodding upward course, I expect business conditions to improve for Northfield, and that's particularly important for a bank so dependent on multi-family and commercial lending.

FINANCIALS & VALUATION

One of the unsung benefits of demutualizations is the probability that a thrift is acquired, at an average buyout multiple of 1.6 times book value around five years after converting. That gives a starting point for figuring a valuation. Thrifts cannot be acquired until three years after full conversion — still more than two years away for Northfield.

In the table below, I've assumed the bank increases book value by 4% a year until it's acquired. You can see the type of total returns and annualized returns (CAGR) that are possible, starting from today's market cap of $739 million. ▼

GROWTH POTENTIAL

	Market Cap	Stock Price	Upside	CAGR
today	$ 739 m			
Year 2	$1.22 b	$22.28	80%	34%
Year 3	$1.27 b	$23.17	87%	23%
Year 4	$1.32 b	$24.10	94%	18%
Year 5	$1.39 b	$25.06	102%	15%

Data from analyst's estimates.

In determining its value, it's difficult to gauge the value-creating effect of any buybacks as yet. However, buybacks will improve the bank's return on equity, which initially will look very low from overcapitalization.

RISKS & WHEN TO SELL

The biggest risk in demutualization is that a management team suddenly goes on a spending spree with millions in new shareholder cash, buying more expensive rivals when its own stock trades below book value. So one of my metrics for determining how well a bank is run is to see if it's buying its own stock when it's trading at or below book value. Smart buybacks are the hallmark of good management. If you don't see one here over the next year, if Northfield buys another bank above book value, and if the stock continues to trade below book value, be concerned. I expect inside ownership to help temper reckless impulses, too.

Buybacks will also help Northfield improve its return on equity, which will sag because of all the cash coming onto the balance sheet. Over time, I want to see at least a 6% return on equity, while low double digits would be very nice. If we see low single-digit returns on equity for several years in a normal economy, I'd be interested in selling.

Finally, if price-to-tangible-book value surpasses 1.6, I'd be interested in lightening the position. That's not so much a risk, but a guidepost.

THE FOOLISH BOTTOM LINE

Northfield is a bank trading at a reasonable price in one of the strongest markets on the planet, with the potential for stock buybacks and maybe even a buyout, if history is any guide. Add those to significant insider ownership and you have the potential for outsized returns. 14

Jim Royal is a research analyst for *Special Ops*.

Palo Alto Networks

Palo Alto's disruption of the all-important network security market could capture big returns for your portfolio

BRYAN WHITE
TMFCACCAMISE

WHY BUY?

1. Palo Alto is a leader in the large and growing cybersecurity industry.
2. The company has demonstrated a unique approach to network security that gives it a competitive edge.
3. Rapid customer growth is adding value, thanks to the high switching costs for security solutions.

Cybersecurity has become a very real problem. Increased media attention around security breaches at major companies and institutions has sparked concern at the individual, corporate, and institutional levels. Recent attacks, such as security breaches at the Federal Reserve, have mobilized institutions and corporations to put more money behind their strategies to combat the threats. With the growing threat and the vital importance of keeping your data secure comes demand for the best network security solutions. That's where cybersecurity software disruptor **Palo Alto Networks** (NYSE: PANW) comes in.

I see a lot of momentum behind companies like Palo Alto that can deliver superior solutions. Demand for the very best software and systems to secure critical data should only increase thanks to the proliferation of mobile, cloud, and applications. The trend is certainly your friend when it comes to investing in the network security space.

NYSE

TECHNOLOGY

CAPS

$3.0 b	$419 m	$0	$41.93	$47
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Palo Alto Networks*

THE COMPANY & SECTOR

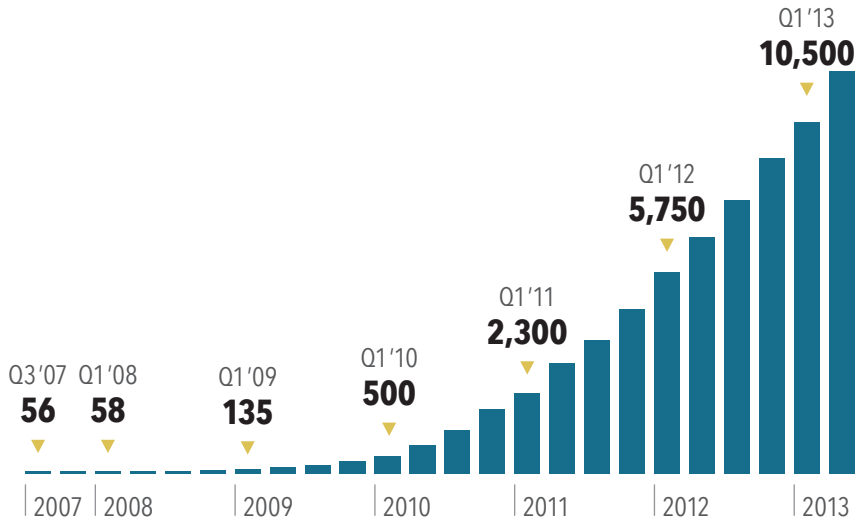
Palo Alto Networks is disrupting the cybersecurity industry, creating a new category of software solutions called Next-Generation Firewall. The company's security platform allows enterprises, service providers, and government entities to secure their networks and enable various applications to run safely on their networks.

CTO Nir Zuk and VP of Engineering Rajiv Batra founded the business in 2005. Zuk is the rebel in this space. He was one of the first employees of **Check Point Software** (Nasdaq: CHKP) — Palo Alto's primary competitor — and helped develop their flagship security product. Several years later, Zuk left Check Point to start a company called OneSecure, which was eventually acquired by another tech company named NetScreen. Zuk stayed on as the company's CTO. Two years later, **Juniper Networks** (NYSE: JNPR)— another competitor of Palo's — acquired NetScreen, and Zuk became the VP of data security. Frustrated with the bureaucracy, he decided to venture out a year later and start his own security company to go head-to-head with Check Point and Juniper.

The core of the company's platform is its Next-Generation Firewall software, which is based on a traffic classification engine that identifies network traffic by application, user, and content. Palo Alto's systems secure the data center, the network perimeter, and the distributed enterprise, which includes branch offices and various mobile devices.

What makes the company's approach to security unique is its focus on tracking applications, which goes beyond your traditional firewall that typically tracks traffic by IP address. In today's mobile world, it's critical that companies protect their networks from hackers that like to use web applications to enter networks. The company's patent-pending technology, App-ID, helps drive Palo Alto's technological edge over its competitors.

CUSTOMER COUNT



Data from Palo Alto Networks.

THESIS & OPPORTUNITY

The leading providers of network security play in a $10 billion market that is expected to grow to $13.4 billion by 2016. This creates a very attractive opportunity for a small, rapidly growing company like Palo Alto with only $400 million in annual revenue.

Zuk and Batra's approach to network security has propelled Palo Alto into the spotlight. Designing security solutions at the very perimeter of the network, rather than modifying legacy security systems, allows these platforms to properly deal with the onslaught of web applications that now run on corporate networks. This technology edge has caught the attention of industry analyst Gartner and new customers.

With only around 4% market share, Palo Alto has an excellent chance to continue to post impressive growth rates as it both takes market share as customers upgrade their security and benefits from a fast-growing overall market — which is expected to grow by a total of 35% by 2016. For investors looking to add exposure to this attractive space, I think Palo Alto has an excellent chance of being a major winner because of rising demand for its products, its unique approach to security, and its experienced management team.

FINANCIALS & VALUATION

Palo Alto has increased its top line at a 100% annual rate over the past three years. Since coming public in 2012, the stock has fallen around 20% but is hardly at bargain prices. The company has a $3 billion market cap and trades for around 33 times free cash flow. That may seem like a steep price to pay, but consider that Palo Alto is still investing heavily back in the business. And investors are certainly paying for the company's future growth.

Sales and marketing expenses have more than tripled in the past two years to keep up with the rising demand and opportunity. The company will always invest in research and development to secure its technology lead. These expenses are very real, but they also offer an opportunity that may not be clear when you look at the income statement. Right now, the financials look like the company is not earning a dime, with a negative operating margin.

To get a sense of Palo Alto's potential, we can take a look at its closest competitor, Check Point Software. The company brings in nearly $1.4 billion in annual revenue and boasts an excellent 55% operating margin. I'm not predicting that high of a margin for Palo Alto, but we can hope for an operating margin around 25% in the next three to five years and closer to 30% in the long term. The stock looks attractive if the company can continue to grow rapidly and begin to gain some scale on its upfront investments in technology, sales support, and marketing.

RISKS & WHEN TO SELL

Technology advantages can change quickly, which poses a very real threat to investors. From the operational side of the business, there's a risk that Palo Alto's technology lead will be fleeting. Investment in network security has increased as the industry grows. **Cisco Systems** (Nasdaq: CSCO) recently acquired one of Palo Alto's close competitors in Sourcefire. Investors can also look forward to constant battles in court over patents. One of Zuk's former employers, Juniper, is suing the company. This poses another risk that, unfortunately, is unavoidable when investing in the tech space.

With the potential upside for Palo Alto comes the very real potential for serious volatility in its share price and ultimately an above-average risk of permanent loss of capital. I would advise keeping an investment in Palo Alto to a relative minimum share of your overall portfolio.

THE FOOLISH BOTTOM LINE

Network security has become a major issue for companies and governments. Reports of breaches in the media are becoming more frequent occurrences, which is sparking more action on the part of corporations. Palo Alto is positioned well to benefit from the capital that corporations will be spending in the years ahead to secure their networks and data. Fools who invest today stand to profit alongside Palo Alto as this trend grows. 14

Bryan White is a senior analyst for *Motley Fool One*.

For disclosure information, see page 44.

Weight Watchers International

There's a long way to go, but patient investors stand to fatten their wallets

CATHERINE BAAB-MUGUIRA
TMFCATB

WHY BUY?

1. Despite serious recent setbacks, Weight Watchers boasts one of the leading global weight-loss brands.
2. A worldwide trend toward increasing heftiness could translate into incredible momentum for the company.
3. Today's cheap stock provides breathing room as the company focuses on improving its own health.

According to the Centers for Disease Control, more than one-third of American adults are obese — a stunning 35.7%. Despite our generous portion sizes and all the clichés about overweight Americans, the trend is global, rather than merely local. According to the World Health Organization, worldwide obesity has more than doubled since 1980. As of 2008, more than 35% of adults over age 20 are overweight, with a further 11% of the world's adult population categorized as obese. The latter figure represents 300 million women and 200 million men.

You could lament the trend, or you could position yourself to profit from a business that helps people accomplish their weight-loss goals. With one of the world's leading weight-loss brands and an ever-expanding potential customer base, **Weight Watchers International** (NYSE: WTW) could make you some sizable returns.

Key to this thesis is the price point Mr. Market is offering us today. After several

weightwatchers

NYSE

SERVICES

CAPS

$1.9 b	$120 m	$2.4 b	$33.38	$38
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Weight Watchers International*

recent setbacks, Weight Watchers has missed a few weigh-ins, so to speak, which sets up a value play for opportunistic investors like you and me.

THE COMPANY & SECTOR

Sensa. Paleo eating. The Hollywood Cookie Fresh Zone No-Carb Dukan One-Weird-Tip Diet. The list of weight-loss fads just never ends, and no wonder — this is a highly valuable market. Marketdata Enterprises estimates that in the United States alone, the overall weight management industry generated $62 billion in revenue in 2011.

Despite the trend-driven nature of the industry, some brands have considerable staying power. Familiar names include **NutriSystem** (Nasdaq: NTRI) and Jenny Craig, soon to be sold by the Swiss giant Nestlé — a purveyor of such health foods as Butterfingers and the flagship Crunch bars.

The heavyweight in this fragmented market, arguably, is Weight Watchers. In 2011 and 2012, some 50 years after the company's founding, Weight Watchers topped *U.S. News and World Report*'s list as the No. 1 commercial diet plan, beating out Jenny Craig. The company's nearly $2 billion market cap is about 4 times that of NutriSystem. More than 1 million Weight Watchers members attend nearly 50,000 meetings all over the globe — and that's each week, not each year.

46%

ADULTS WHO ARE OVERWEIGHT OR OBESE WORLDWIDE

300 m WOMEN
200 m MEN

Even if you've never dieted, you may be passingly familiar with the company's signature "Points Plus" program. Not only is Weight Watchers' program widely known and followed — appearing even on Applebee's menus through a partnership deal — it's also one that's been validated by dozens of clinical studies.

And to think it all began with a terrible social faux pas. In 1961, New Yorker Jean Nidetch was in the grocery store when a well-wisher congratulated Nidetch on her pregnancy. The problem was, Nidetch wasn't pregnant: She was just overweight. Inspired, Nidetch eventually gathered a group of similarly situated friends to meet, cooperate, and commiserate through the dieting process. Weight Watchers was born.

And my, how it's grown. In 2012, annual sales topped $1.8 billion, up from $810 million in 2002, while free cash flow increased from $160 million to more than $300 million. The net margin averaged 15% over this period.

The business makes money several ways, but first and foremost through meeting fees, which accounted for about 58% of sales in 2012 (members can "pay as you go" or buy a monthly all-access pass). The company also rakes in dollars from its own branded food products — representing 14% of sales in 2012 — a magazine, and license fees (from food companies and franchisees). Finally, there is Weight Watchers' popular subscription website and eTools suite, which generated 28% of sales in 2012. Again, this isn't just an American phenomenon. Overall, about a third of revenue comes from outside North America.

▶ *Weight Watchers International*

THESIS & OPPORTUNITY

Between Weight Watchers' brand strength and global scope, the quality of the business, and the trends that should make for a large — and growing — audience of potential customers, shareholders should see smooth sailing, right? Looking at the past 12 months, nothing could be further from the truth.

A series of marketing misses (including pop star Jessica Simpson, who was hired to lose her baby weight but quickly got pregnant again), earnings disappointments in 2013, and lowered guidance for 2014 caused the stock to underperform the S&P 500 by 60 percentage points through early November. Ouch.

Hence today's deep value price tag, amid an otherwise fairly pricey market — and our opportunity. Mr. Market is thinking short term, missing the big picture, and not banking on any turnaround, but Foolish investors like us can take the long view. As new CEO Jim Chambers recently put it, the company has "a clear view of our challenges and a commitment to improve performance," so the longer-term picture is promising.

FINANCIALS & VALUATION

Today, the stock is selling for a little more than 2 times sales (enterprise value to revenue) and 8 times trailing earnings. Such a low price affords us a substantial margin of safety. By my estimates, the stock is worth well north of $40.

Of course, no value play turns around overnight, and Weight Watchers has a lot of work to do to return to growth. Over the next several quarters, expect to see some continuing trouble in new-member recruitment and modest declines in sales and profit.

RISKS & WHEN TO SELL

Speaking of weight, this company is carrying quite a bit of debt. But while the number — $2.4 billion — is eye-popping, there's more to the story. Weight Watchers has been bringing in-house many of its former franchises and also buying back shares. Not all of these moves were well timed, it bears saying; in any case, they've contributed hugely to the debt load. However, the company is well able to cover its obligations. The recent suspension of the dividend frees up some $40 million in cash as well.

Weight Watchers has had a number of owners over the years, including H.J. Heinz from the late 1970s to, more recently, private equity outfit Artal. In 2001, Artal took the company to IPO but has retained a huge chunk of the shares and board seats.

Weight Watchers has also had a bit of bad press lately, with complaints about its payment structure that lavishes millions on celebrity spokespeople — Simpson received $4 million from her deal with Weight Watchers — while the meeting leaders who are the front-line salespeople had until very recently been earning relatively little, and in some cases, just the minimum wage. With recruitment in the spotlight, the company is increasing these key employees' compensation and incentives.

Free apps and websites, such as LoseIt.com, can be alluring alternatives to the subscription-required Weight Watchers website, and the company is feeling the effects, with online paid weeks declining 2.6% in the most recent quarter. It also saw sharply declining meeting attendance — a 15.5% fall — over the same period. Chambers is now feeling the fear, and efforts at cost-cutting and better engagement of potential customers are already under way.

THE FOOLISH BOTTOM LINE

It takes time to lose weight, and it takes time for a deep-value thesis to play out, too. But chances look excellent over the long term in this case. Over the coming years, Weight Watchers should return to growth and capture an increasing portion of the world's weight-loss program market, making good money doing it; most satisfyingly, we're protected from any serious trouble in the execution by today's ultra cheap price. So no need to exercise your self-control now — gorge on Weight Watchers stock while you can. 14

Catherine Baab-Muguira is an analyst for *Share Advisor (Australia)*, the Fool's flagship Australian stock-picking service.

For disclosure information, see page 44.

Winmark

Fans of Warren Buffett will love Winmark's CEO, a shrewd capital allocator who shows no signs of slowing down

JIM GILLIES
TMFCANUCK

WHY BUY?

1. CEO John Morgan is replicating previous success — and it's likely another company will buy Winmark.
2. Winmark is targeting untapped growth markets for gently used goods.
3. This is a long-term investor's dream: dedicated management, great cash flow, and high returns.

A smart capital allocator from Omaha is shrewdly using other people's money to build a great business. While tap dancing to work, our jockey is duplicating his past success for our benefit, is the largest shareholder in his company, treats his employees well, and, now into the (presumed) later stages of his career, is looking to his legacy.

No, I'm not talking about Warren Buffett; instead, I'd like you to meet John Morgan, chairman and CEO of **Winmark** (Nasdaq: WINA), a business that combines retail franchising with business leasing — with great success. And, like Buffett, Morgan is still going strong, which means Fools have a great opportunity to invest today.

WINMARK®

NASDAQ

SERVICES

CAPS

$373 m	$86 m	$0	$72.58	$75
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Winmark*

THE COMPANY & SECTOR

Winmark runs five franchise concepts centered on the resale of gently used goods:

1. Play It Again Sports: sporting goods
2. Plato's Closet: teen clothing
3. Once Upon a Child: children's clothing
4. Music Go Round: musical instruments
5. Style Encore: women's business and casual clothing

As of late September, Winmark had 995 stores — all franchised. This is a very attractive business model: In return for concept branding and operational know-how and systems, the franchisee sends 3% to 5% of gross revenue to Winmark as royalties, in addition to paying initial franchise and annual marketing fees. The result is a high-margin revenue stream flowing to Winmark, while the company shoulders little operational or capital risk.

Winmark's other line is its business-leasing division. Winmark Capital purchases and then leases technology equipment to mid-size and larger businesses — leased items typically cost more than $250,000. Meanwhile, Wirth Business Credit is a small-ticket financing business that serves smaller clients, focusing on assets that cost $5,000 to $100,000.

SEPARATED AT BIRTH?

Warren Buffett

John Morgan

Used shoes, shin guards, and bassoons paired with photocopier leasing isn't the most obvious combination, but with Morgan's history, it makes more sense. The franchise operations are what I like to call a check-cashing machine. Every week, franchisees send their royalty checks to Winmark, providing a continuous and growing source of capital for deployment into the lease business — and leasing is in Morgan's bones.

A truly Foolish leader, Morgan has an interesting history.

In 1982, Morgan and two partners started Winthrop Resources, a (wait for it) equipment-leasing business, putting up $35,000 of his own money. Fifteen years later, they sold the business for $340 million to **TCF Financial** (NYSE: TCB). Morgan had a 15% stake in Winthrop at that time, giving him a payday north of $50 million. A savvy investor, Morgan took his payout in stock, later saying, "The single best business decision of my career was to take all stock. I had looked at that stock over and over again, and said it was undervalued" at the time of the deal. TCF subsequently doubled, split, and then doubled again.

Morgan was appointed chairman and CEO of Winmark in 2000 and immediately bought 700,000 shares (about 13% of the company) at $7 a pop from the departing CEO. He was awarded an uninspiring $50,000 salary alongside a 600,000 option grant — the only grant he's ever received from the company.

It gets better. Since 2000, Morgan has continually purchased shares on the open market (most recently in July, when he grabbed 2,000 shares at $68.55). Today, he owns about 34% of the company. Talk about aligning management's interests with shareholders'!

THESIS & OPPORTUNITY

In Winmark, Morgan is replicating the success he achieved with Winthrop, but don't make the mistake of thinking this is just a leasing business hiding under a portfolio of used-goods retail. In these budget-conscious times, Winmark's "recycle and resale" retail offerings have prospered, driving franchising fees up 8% annually over the past five years. The latest concept, Style Encore, just opened its first store last quarter and has 21 more franchise agreements under contract. If it achieves the scale of its sister concepts, expect 300 to 500 stores over time and a significant boost to franchising income.

The only worry is that Morgan is a spry 72. I love the results he's delivered (I've been a shareholder since 2008), but he's not going to do this forever, and there's no easy exit strategy for a one-third owner. Thus, I think we're set up for the best of two worlds here.

On the one hand, we're investing alongside a skilled capital allocator and businessman who perpetually buys his own stock and who has increased business value more than tenfold in 13 years. We'll benefit from the steady hand increasing the franchise base and thus the capital available for the lease business, and we'll also collect the modest dividend (paid since 2010) and possibly one or more special dividends (Winmark paid a $5 special dividend in 2012).

On the other hand, we'll be on board for Morgan's eventual exit strategy. Given his ownership position, skill set, and history, that likely portends a buyout. (He is on a first-name basis with that other Omaha investor and did once buy Buffett's wallet with a stock tip inside for $210,000.)

FINANCIALS & VALUATION

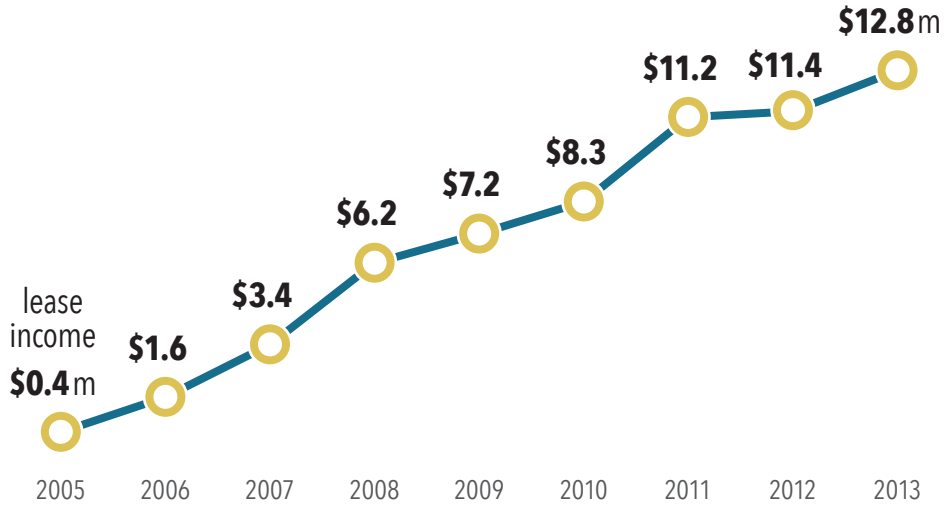
Winmark is a nice of example of slow and steady winning the race. Of course, the favorable dynamics of being a low-capital-spending/low-operational-risk check-cashing machine helps.

Revenue has compounded at more than a 10% clip for the past five years, while the tremendous operating leverage of the business (franchisee/store count grows, but the check-cashing corporate staff need not ▼) has meant that operating profit has compounded at a 30% rate over the same period. The gross margin sits neatly above 92%, while the operating margin is north of 50%. Annual return on capital has averaged nearly 26% since Morgan took the reins, while return on equity has averaged over 30%, and frankly these numbers would be higher if it weren't for write-offs of some ill-made investments a decade ago.

The balance sheet is clean (the most recent borrowings helped finance 2012's $5 special dividend), with net cash of $86 million. The lease portfolio stands at about $37 million.

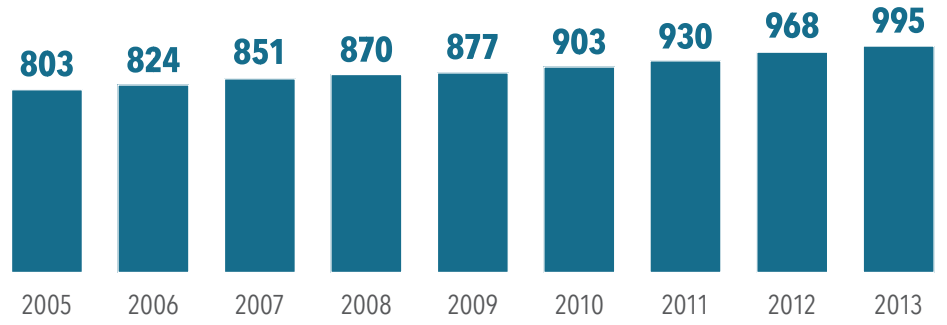
Trading at about 13.2 times EV to EBITDA and 22.5 times normalized earnings, Winmark isn't convention-

LEASE INCOME



Data from Capital IQ.

STORE COUNT



Data from Capital IQ.

ally cheap (a common refrain these days). However, store growth is good with franchising fees rising about 8% annually and with a potential boost from Style Encore going forward. The retail operating margin has increased from 35% to 53% over the past five years, while the smaller (27% of revenue) leasing business is also growing faster (lease revenue is up 18% annually over the past five years). Moreover, the leasing business has passed from an operating loss five years ago to a 52% operating profit margin today.

Operating metrics seem to warrant a premium valuation and on current trajectories, overall growth will appear to be accelerating as leasing overtakes franchising, which could be awarded still higher multiples.

RISKS & WHEN TO SELL

Simply put, no Morgan, no investment. Unlike Buffett at **Berkshire Hathaway** (NYSE: BRK-B), I've seen no evidence that Winmark has a deep bench of superior leaders waiting to step into Morgan's shoes when he leaves. I expect him to stay for years to come and ultimately depart via a sale of the company — but if he surprises us and just walks, I'd leave, too.

A deterioration in company fundamentals — profitability notably sliding; growth on both sides of the business evaporating without stunningly good reason — is likely reason to exit.

Finally, an extreme valuation — north of 35 times normalized earnings with no change in the growth drivers — is probably sufficient to get me to part with my shares.

THE FOOLISH BOTTOM LINE

If you count yourself a Warren Buffett fan, you'll love John Morgan. Buying Winmark is buying a venerable owner-operator business with superior fundamentals run by a guy with a demonstrated track record of savvy investment and oversized gains. Long-term investors rejoice! 14

Jim Gillies is co-advisor of *Motley Fool Options* and an analyst for *Stock Advisor Canada.*

Buffett photo from *Fortune* (Art Streiber); Morgan photo from *Twin Cities Business* (John Mowers).

For disclosure information, see page 44.

Yelp

This mobile advertising leader rates 5 stars as an investment

LYONS GEORGE
TMFNOCEILINGS

WHY BUY?

1. Local businesses are shifting ad dollars online, and no one is better positioned to take a cut than Yelp.
2. Yelp makes nearly $200 million a year in revenue but faces more than $20 billion in market opportunity.
3. Yelp is a solid investment in an increasingly mobile consumer culture.

With less money to find customers, small and medium-sized local businesses have historically been relegated to second- or third-tier advertising platforms: local TV and radio, billboards, neighborhood newspapers, coupon books, and even the dreaded flyer that somehow ends up under your car's windshield wiper twice a month. But with many of those channels becoming irrelevant in a world that's turning more digital by the day, it stands to reason that to grow their business in 2014 and beyond, Mom & Pop's best bet is to shift their ad budget away from the Yellow Pages to the World Wide Web.

That's where **Yelp** (NYSE: YELP) comes in.

NYSE

TECHNOLOGY

CAPS

$4.7 b	$101 m	$0	$67.15	$75
MARKET CAP DATA AS OF 11/1/13	CASH	DEBT	RECENT PRICE	BUY GUIDANCE

▶ *Yelp*

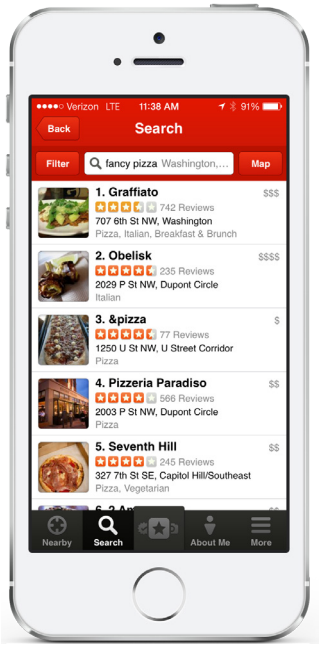
THE COMPANY & SECTOR

Most succinctly described as a local business directory, Yelp is similar to the Yellow Pages but with two distinctly modern twists: Yelp exists strictly online, and it doesn't just include listings of local businesses. It also includes reviews — 42.5 million of them. That's more than any other online local business directory by a long shot.

Since 2004, when a sick Harvard Business School student (Jeremy Stoppelman, co-founder and current CEO) decided there had to be a better way to find a good doctor, Yelp has gone on to achieve the brand-name-as-verb ubiquity that other start-ups can only dream of. Spend 15 minutes on a street corner in any major city around dinner time, and chances are you'll overhear someone saying they've "Yelped" a restaurant nearby.

What does that mean?

Either on a computer or smartphone, they searched for the type of food they're in the mood for, scanned a list of nearby restaurants matching their parameters, and, based on the star rating and reviews of those restaurants, are about to go spend some hard-earned money at whichever one struck their fancy. ▼



Yelped: "Fancy pizza" in Washington, D.C.

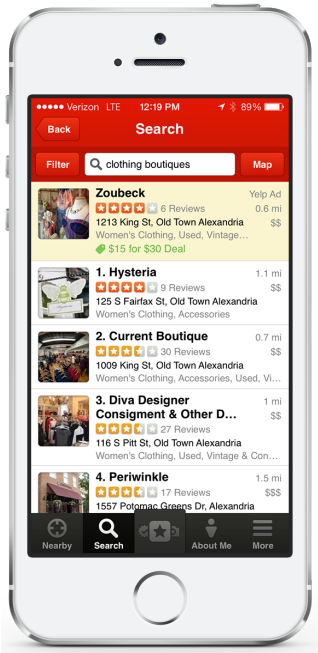
In other words, they're about to make an immediate purchasing decision because of what they saw on Yelp. And that immediacy is what makes advertising with Yelp so attractive to small-business owners. While a radio spot plays at a pre-set time and coupon books show up with the rest of the mail, advertisements on Yelp (which, like Google search ads, show up at the top of the results page) let a business connect with potential customers at the exact moment that the customer has that business's product in mind. In the tech world, that's called intent-based advertising. ▶

It's made Google billions of dollars, and it's about to do the same for Yelp.

THESIS & OPPORTUNITY

Businesses around the world are expected to spend more than $500 billion on advertising and marketing by 2015. And while that number is by no means precise, it sends a crystal-clear message: With only $200 million in annual revenue, Yelp has a heck of a lot of room to run.

This remains the case even when you break the company's opportunity down to its most addressable form, which is the domestic market for online local advertising. In the United States alone, local businesses spent roughly $22 billion to advertise online in 2010; by 2015, that figure



Advertised listings are highlighted at the top of search results.

is projected to reach $42 billion (a 14% compound annual growth rate), courtesy less of net increases in local business ad spending than of outflows of that spending from traditional mediums (like newspapers) to higher-ROI digital ones (like location-based smartphone apps).

Even if that projection is wildly optimistic and domestic online local business ad spend only grows to $25 billion, Yelp's ability to capture even 4% of that pie would result in a nearly sixfold increase in revenue. And again, that's just here in the United States — Yelp is also up and running in 50 international markets.

Another way to look at Yelp's opportunity is in terms of its existing base of listed businesses. Of the tens of millions of businesses that Yelp has indexed (the company licenses listings from third parties when it enters a market), 1.2 million have been claimed by a representative of that business, affording the representative basic control of how the business is presented on the platform. Of that claimed base, however, only 51,000 have opted to fork over $300 per month (the going average) for a premium, or "active," account, which entitles them to more dynamic listing features (such as an embedded video tour of their hotel) and, most importantly, a certain number of ad placements per month.

Altogether, that means Yelp has drawn over 1 million business owners to directly engage with its service but only converted 4.2% of them to paying customers. This translates to an opportunity within its immediate sell-in list for more than 2,200% growth.

FINANCIALS & VALUATION

Make no mistake: at 21 times sales, Yelp is a richly priced stock.

But with only $200 million in revenue and more than $20 billion in market opportunity, this company — like **LinkedIn** (Nasdaq: LNKD), **Google** (Nasdaq: GOOG), and **Amazon.com** (Nasdaq: AMZN) of yesteryear — has enough growth potential to render traditional trading multiples largely irrelevant. Should Yelp manage to convert 100,000 "claimed" businesses to active paying customers, the stock could easily become a 2-bagger — and considering that active local business accounts are increasing at a heady 62% clip, it's a safe bet the company will cross that threshold within the next two years.

RISKS & WHEN TO SELL

Yelp's business boils down to three components: the active business owners who decide to advertise in its directory, the reviews that give the directory its special sauce, and the smartphone-wielding consumers who turn to that directory to figure out where to spend money. Those groups are growing 62%, 41%, and 38% a year. Should any of those numbers — especially the first — go from showing growth to stasis or contraction, it might be time to consider putting a closed sign on this investment.

And then, of course, there's Google. As it stands now, more than half of Yelp's web traffic flows through Google search — meaning that 50% of the time someone looks at the page for Joe's Fancy Pizza Kitchen on Yelp, it's only after they typed "Alexandria fancy pizza" into Google first. Should Google (which attempted to buy Yelp in 2009) change its search algorithm so that Yelp doesn't show up as frequently or prominently in search results, it could mean bad news for Yelp shareholders and customers alike.

THE FOOLISH BOTTOM LINE

Let's face it: The Yellow Pages are dead. By bringing new life to the age-old business of getting new faces — and new wallets — into neighborhood stores, Yelp is offering investors the chance to grab a pretty piece of the advertising world's ongoing shift to digital. Buy shares today. We think it will be a 5-star experience. 14

Lyons George is a research analyst and copywriter for The Motley Fool.

For disclosure information, see page 44.

DISCLOSURES

2014 AND BEYOND: Alex Scherer is short January 2014 $40 puts on Tesla and long January 2014 $40 calls on Tesla; David Gardner owns shares of Amazon.com, Facebook, Netflix, and Tesla; Tom Gardner owns shares of Facebook. The Motley Fool owns shares of Amazon.com, Facebook, Netflix, and Tesla.

CALAMP: David Meier owns shares of LinkedIn; David Gardner owns shares of Facebook and Sierra Wireless; Tom Gardner owns shares of LinkedIn and Facebook. The Motley Fool owns shares of Facebook, LinkedIn, and Sierra Wireless.

CAPITAL ONE FINANCE: Anand Chokkavelu owns shares and warrants in Citigroup, JPMorgan Chase, and Wells Fargo and owns shares of Bank of America. The Motley Fool owns shares of Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo.

COLFAX: Tom Gardner and The Motley Fool own shares of Markel

EXPRESS SCRIPTS: Michael Olsen owns shares of UnitedHealth; David Gardner owns shares of Amazon.com. The Motley Fool owns shares of Amazon.com, Catamaran, Costco Wholesale, and Express Scripts

KOHL'S: Charly Travers owns shares of Kohl's; David Gardner owns shares of Amazon.com. The Motley Fool owns shares of Amazon.com, Berkshire Hathaway, Dillard's, and General Dynamics.

PALO ALTO NETWORKS: The Motley Fool owns shares of Check Point Software Technologies.

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WINMARK: Jim Gillies owns shares of Berkshire Hathaway and Winmark and is short January 2014 $75 puts, long January 2014 $75 calls, and short January 2014 $105 calls on Berkshire Hathaway. The Motley Fool owns shares of Berkshire Hathaway.

YELP: David Gardner owns shares of Google and Amazon.com; Tom Gardner owns shares of Google and LinkedIn. The Motley Fool owns shares of Amazon.com, Google, and LinkedIn.

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