

5 Gifts from the Market Gods — Cashing in on the Subprime Collapse

From The Motley Fool's Top Analysts



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To Educate, Amuse & Enrich™

Contents

INTRODUCTION 3
BY PAUL ELLIOTT

DOLBY LABORATORIES 4
BY TOM GARDNER

CAPITALSOURCE..... 6
BY JAMES EARLY

USG 8
BY PHILIP DURELL

EXELIXIS 10
BY CHARLY TRAVERS

CEMEX 12
BY BILL MANN

Introduction

BY PAUL ELLIOTT

“Be fearful when others are greedy and greedy when others are fearful.”

Dear Fools,

You’ve probably heard that famous advice from legendary investor Warren Buffett before. Timeless as it is, it was never *timelier* than it’s been today!

At least not since April 2002, when David and Tom Gardner launched *Motley Fool Stock Advisor*. What were they thinking? Launching a stock-picking newsletter right in the teeth of the most brutal bear market in history? A few things, really.

First, they saw how individual investors were getting bum advice from their brokers. Second, they suspected that the so-called gurus spouting broad bear market calls on TV were full of hot air — and that quivering on the sidelines was threatening investors’ retirements.

Investors who followed along are glad they did. Since *Stock Advisor*’s start, subscribers — now numbering in the tens of thousands — have earned an annualized 21.8% return on their investments, better than twice the return of the broader market.

In many cases, these folks are well on their way to achieving their dreams of financial independence.

Can Lightning Strike Twice?

The subprime collapse ... liquidity crunch ... housing bubble ... an overextended consumer ... the threats to our stock portfolios seem endless. And just like in 2002, some of this concern is real.

In the past few months, several mortgage lenders have, in fact, tumbled into bankruptcy, while U.S. foreclosures hit an all-time high. The Fed clearly has its eye on an indecisive economy.

And in some cases, the pullbacks in individual stocks were deserved. As an investor, you have every right to be cautious. But a *1,000-plus-point plunge* in the bluest of blue-chip Dow Industrials from mid-July to mid-August?

A 15% to 20% correction in emerging markets whose ties to the U.S. mortgage market are tenuous at best? A 20% plunge in top-notch oil services companies, even as the price of a barrel of crude raced to all-time highs?

Clearly, dark emotions took hold. Folks got fearful. It’s time to get greedy!

5 Gifts From the Market Gods

Many stocks have recovered lost ground, but the fact remains: We still have an amazing and unexpected opportunity to scoop up some of the world’s top businesses at rock-bottom prices. We’d be real fools not to at least consider taking advantage.

In pages that follow, you’ll discover five top stocks identified by The Motley Fool’s best analysts as *the very best bargains* arising in the wake of the credit crunch sell-off. Each was selected for its outstanding business prospects and strong fundamentals, with every expectation it will help you in your quest to thrash the market.

First up is a consumer electronics pioneer whose name you should recognize. It’s a top pick from Motley Fool co-founder Tom Gardner and just a small sample of the quality of research you can expect as a member of *Motley Fool Stock Advisor*.

Fool on!



Paul Elliott
Senior Investment Writer

Dolby Laboratories

BY TOM GARDNER

DOLBY LABORATORIES

NYSE: DLB
www.dolby.com

Headquarters: San Francisco, Calif.

Market Cap: \$3.9 billion
Recent Price: \$35.04
Risk Rating: Medium

I have an incredible investment opportunity that you should know about, a company that has recently gone public after years of private ownership by the founder. It's in your computer speakers. It's in your video games. It provides the best audio experience through your new high-def television. That super-wow sound quality in *Spider-Man 3*? This is the force behind it.

These days, you'd be hard-pressed to find quality audio without seeing the name **Dolby Laboratories** (NYSE: DLB). Furthermore, Dolby has an extremely trusted brand name and is a pioneer in its field — and its stock is ripe for the picking.

SHH ... HEAR THAT?

Ray Dolby conceived the idea for a noise reduction system while meditating on an ashram in India. He was then a precocious graduate from Stanford with a Ph.D. in physics from Cambridge University, working for the Peace Corps. Little did he know that by the mid-1970s, the Dolby brand would become a household name for quality sound systems.

Today, the business is worth almost \$4 billion, making Ray Dolby's stake worth about \$2 billion. (Not a bad return on meditation!) He brought his eponymous company public in February 2005. By the fall of 2006, the stock had slid from \$24 to less than \$20 as investors grew concerned about the company's slowing DVD technology sales. But the pessimism was misplaced.

Dolby is raking in gobs of cash from families spending more of their disposable income on in-house entertainment. Whether it's through MP3 players, laptop computers, portable DVD players, or car stereos, Dolby is working to get a piece of the action — and it's succeeding.

IT'S WHOM YOU KNOW

The company makes its money through two main divisions: (1) technology licensing and (2) products and services. The technology licensing division generates about 80% of Dolby's annual revenue and more than 80% of its pre-tax profits by partnering with the likes of Sony, Electronic Arts, Microsoft, and Apple.

Dolby's products and services group drives the remaining 20% of revenue. This group is responsible for selling professional audio systems to theater chains, recording producers, cable broadcasters, movie studios, and amusement park operators. If a company depends on superior audio technology — think of the amazing surround sound you hear from that well-spent \$10 at the local multiplex — you can bet it works closely with Dolby.

Not only that, Dolby has spent years cultivating relationships with these industry partners who sit at the beginning of what the company calls the "chain of entertainment." It benefits from selling services every step of the way, from the creation of content (the product and services division) to consumer playback (the licensing division).

With all of these irons in the fire, sales are increasing more than 20% per year, while earnings are ticking up more than 50% per year on improving margins. And the stock price? Dolby's shares have surged from \$30 to more than \$50 — and now back to \$35.

MORE ON THE NUMBERS

On the income statement and balance sheet, the financials look fantastic. Strong licensing sales have helped move operating margins to more than 40%. The return on invested capital approaches 30% and speaks to the competitive moat that Dolby is establishing. There is competition from small and large companies, so we like the fact that Dolby can maintain high margins and good returns on its investments.

Dolby's balance sheet carries more than \$481 million of cash and a negligible amount of debt — a combination that brings music to investors' ears. The company will generate more than \$480 million in sales this year by licensing its technology and selling products to electronic manufacturers, software companies, theater chains, broadcast companies, and recording companies.

Dolby operates under a pretty lean capital structure. Current assets represent more than half of Dolby's total assets, and cash is by far the largest piece of the current asset line.

Another important detail: Ray Dolby still maintains a majority stake in the business he built from the ground up. So as Dolby the company goes, so go Ray Dolby's fortunes. What stronger incentive is there to keep the company as profitable as possible?

THE RISKS

Aside from management transition risk (Ray Dolby is now 75), investors need to consider the business risks for a company that is so heavily dependent on its growth in emerging markets and on patents that are scheduled to expire in the next couple of years.

Because Dolby is in large part a licensing company, its huge gross margins are a product of having the patented technology that others must pay for. As more of its products are made and sold in China and other developing nations, it has to spend more time and money making sure that it receives the royalties it is owed. Some players in that field are — ahem — not as forthcoming with licensing payments as they should be.

Also, a number of Dolby's key digital patents will begin to expire in 2008. The company has done an outstanding job of adding new patents over the years, so we're not overly concerned. Still, it reinforces the point that the company must continue to innovate to maintain not only its growth but also its baseline of earnings.

FOOLISH BOTTOM LINE

The audio entertainment market is growing worldwide, and Dolby is perfectly positioned to benefit from more individuals and families spending more money for high quality entertainment.

We estimate the company to deliver patient shareholders around 20% annualized returns over the next five years from today's prices, giving us a market capitalization of nearly \$10 billion. There is a lot of upside for Dolby over the next several years, and we expect it to continue to see significant wins in home entertainment as well as in digital cinema (which will start to bring in revenue this year).

From Ray's early quest to simply reduce the hissing sound of recordings to providing the best surround sound quality to millions of consumers worldwide, Dolby has been a profitable pioneer. But the future sounds very harmonious over the next five, 10, and 20 years for the company and its shareholders.

Tom owns shares of Microsoft.

CapitalSource

BY JAMES EARLY

CAPITALSOURCE

NYSE: CSE

www.capitalsource.com

Headquarters: Chevy Chase, Md.

Market Cap: \$2.8 billion

Recent Price: \$12.36

Risk Rating: High

If there were ever a company set up to pay a monster yield, this is it. **CapitalSource** (NYSE: CSE) is a financial company that specializes in making complicated loans that require special knowledge and attention. I know, “complicated loans” sounds scary, but there’s lucre in complexity. This stock could make a lot of money for you, folks. The company explicitly aims for a big, steady payout, and it even went so far as to convert to a real estate investment trust (REIT) so it could deliver a larger dividend with a lower cost of capital.

The subprime credit crunch has caused investors to dump all stocks that have any relationship to residential mortgages, CapitalSource included. Its shares are down a whopping 55% since last June. But here’s the kicker: The decline in CapitalSource is *largely unjustified*. Although the company owns residential mortgages, they are government-backed or of the highest-quality prime variety only. Furthermore, the majority of its loans are commercial, not residential. If ever there was a case of throwing the baby out with the bathwater, this is it!

I generally think independently of Wall Street analysts, but I have to agree with their collective assessment that this stock is a “buy.” Even better than Wall Street analysts, though, are insiders, and they love CapitalSource as well — enough to own 35% of its shares. I calculate a capital gain potential of 175% in the next few years, on top of the phenomenal 20% payout.

A 20% YIELD!

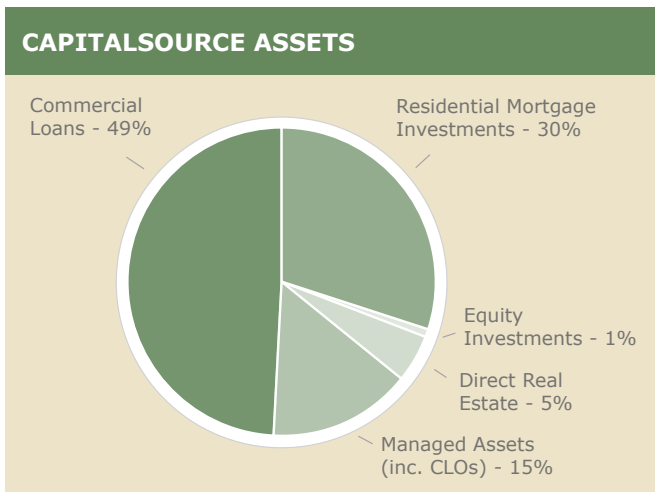
Some investors will take one look at a 20% yield and run like a spooked mouse. And not without cause: High risk tends to accompany a high yield. But this isn’t just any 20% yield. To be sure, CapitalSource isn’t risk-free, but its profitable operations and tax-free REIT structure give it the goods to pay out all that cash.

Let’s start with those operations and how exactly CapitalSource makes money. The company makes specialized and customized loans. The founders created the company in 2000 after selling a previous — and successful — health-care finance company at a tidy profit for shareholders, so they have a special interest in the health-care industry.

Of course, now you’re wondering exactly how profitable this business is. How about an interest spread — the difference between what CapitalSource pays to borrow money and what it receives on its loans — north of 5.3% on its loan portfolio (excluding REIT compliance assets, which I’ll discuss momentarily). That’s virtually two times what many conventional lenders are roping in. CapitalSource pulls in 11.7% from its loans, nearly 90% of which are “senior,” meaning they have stronger recourse provisions than “junior” or “mezzanine” loans. And this beneficial interest spread should widen in the future once the acquisition of Fremont General’s retail bank assets closes in the third quarter of 2008 and provides CapitalSource with billions of dollars in low-cost deposit financing.

In all, CapitalSource has \$20.7 billion in assets (see the nearby pie chart for the breakdown), which includes \$6.3 billion in residential mortgage assets. Added to the \$10.1

billion in real estate loans it makes through its normal lending channels, these residential mortgage assets push CapitalSource's total real estate loans above the 75% of total assets necessary for it to qualify for tax-free REIT status. Although "residential mortgage assets" may sound risky given the current housing market, fear not: The variety that CapitalSource holds — purely for compliance reasons — are the cream of the crop. They're prime and better-than-prime loans with essentially no credit risk. This area of the business was designed to push the company over that 75% mark in as risk-free a way as possible.



At first, this may sound like tiptoeing around the spirit of REIT regulations, but Uncle Sam still gets his cash: To stay on the up-and-up, CapitalSource's non-REIT operations are conducted through a taxable REIT subsidiary (bear with me — it won't get any more complicated), which *does* pay taxes before throwing its cash in for the main company to distribute to shareholders. This "taxable REIT" subsidiary may sound oxymoronic, but such subsidiaries are designed to help REITs dabbling in small-scale taxable operations stay tax-free on the whole by paying up where necessary. Collectively, these subsidiaries can't constitute more than 25% of a REIT's gross income.

Fortunately, CapitalSource has done a good job of breaking down all this stuff in its SEC filings. While clear, straightforward filings are convenient for me, they're more important as an indicator of the tone and candor management has with shareholders.

LOOKING AHEAD

CapitalSource continues to increase its commercial lending and investment assets at a double-digit rate (26% in 2007). Growing assets generally means more interest income, and more interest income means bigger dividends. The company is officially leveraged at six times debt to equity, but stripping out compliance assets — which just sit on the books with minimal risk — leaves us with a modest four times debt to equity; many lenders are leveraged at more than 12 times. Still, its relatively modest

4-to-1 leverage hasn't stopped it from generating an impressive 20%-plus adjusted return on equity.

In addition to lending, CapitalSource manages \$2.6 billion in assets (loans owned by third parties), and so it collects steady fee income. The company is looking to expand this part of its business, and potentially even split its real estate and asset management segments into separate entities to unlock greater market value for shareholders.

VALUATION

In presentations, management focuses on paying a growing, stable dividend. It's important to the company, which works out well for us. In valuing CapitalSource, I use a dividend discount model; you can't argue with cash. I get a value of \$34, which is 175% above the company's current price. We could conceivably have more than a double here in a few years.

RISKS

As a lender, CapitalSource is exposed to credit risk, but with charge-offs of less than 1%, the company is on good footing considering it's taking in nearly 12% on its loans. I wouldn't be surprised to see that charge-off number rise a bit in the next year given that the U.S. economy seems to be entering a period of weakening overall credit quality.

Another risk is plain old slow business. Competition from debt and equity capital providers, interest rates, and sluggish borrowing could reduce the flow of attractive pitches coming across the company's plate. Additionally, as a REIT, it must pay out 90% or more of its income to stay tax-free, so it's beholden to the capital markets for additional financing. As a result, there's a risk of the company needing money when the market isn't in the mood to provide it on favorable terms.

FOOLISH BOTTOM LINE

In my book, CapitalSource is the dividend stock to beat. Its 20% payout will make you nice money standing still, and when you add capital appreciation, I'm expecting annual returns of more than 30% from CapitalSource.

USG

BY PHILIP DURELL

USG

NYSE: USG
www.usg.com

Headquarters: Chicago, Ill.

Market Cap: \$3.6 billion
Recent Price: \$37.65
Risk Rating: Medium-Low

IT'S EVERYWHERE

My wife tells me we'll be renovating our kitchen and dining room this year, and I'm pretty certain our contractors will be bringing in lots of Sheetrock. Such is the ubiquity of **USG's** (NYSE: USG) main product and the reach of its distribution system.

This industry-leading maker of wallboard and ceiling tiles trades today for close to \$0.60 on the dollar. The stock combines low risk and a considerable margin of safety. Although the headwinds are strong these days, we remain confident that housing is one of the few industries likely to outpace GDP over the next 20 years. Just look at the long-term trends:

- » Harvard's Joint Center for Housing Studies forecasts that the demand for new homes will total 19.5 million between 2005 and 2014.
- » The nation's housing stock is aging and will need to be replaced.
- » Immigration will continue to increase housing demand.
- » Wealthy baby boomers will continue to upgrade their homes or buy second homes.

It might be difficult to imagine investing in a housing-related stock during a housing recession, but that's precisely when you should. Once the market shows any semblance of returning to normal, USG's share price should follow, thanks to its strong competitive advantages:

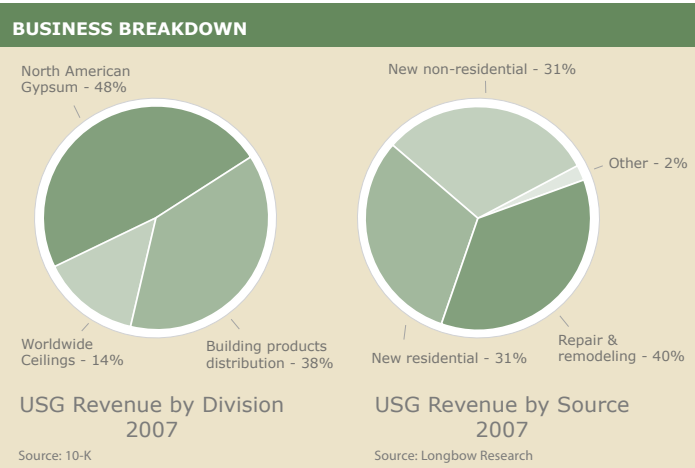
- » Scale is important in industrial commodity businesses, and USG's dominant market share and efficient distribution system make it the low-cost supplier in North America.
- » USG is temporarily shutting down capacity at older, less efficient plants, which adds to its cost advantage.
- » Management guided the company through bankruptcy caused by asbestos litigation, and we're confident it has the ability to weather the housing recession as well as increase USG's dominant position by gaining market share

In a commodity-driven business, controlling distribution and the cost of raw materials is critical. Along with a strong brand, USG can ensure an adequate supply and command higher prices for its products, all while maintaining market share. USG's position as a low-cost provider should allow it to produce above-average returns and increase its market share during the downturn

THE BUSINESS

USG has been in business since 1901, growing to become the largest producer of wallboard and ceiling tiles in North America. Its subsidiaries and business divisions fall into North American Gypsum, Worldwide Ceilings, and Building Products Distribution.

USG is vertically integrated: It owns gypsum mines, paper mills, and 22 wallboard production facilities throughout the United States, Canada, and Mexico. It also owns bulk



ships and distributes products to customers through its L&W Supply network. (L&W also distributes building supplies from other companies.)

A joint venture in China in the ceiling tile business should establish an important foothold for USG. The deal will also bring a significant distribution relationship. While the Chinese economy's torrid expansion may experience some bumps, the market for USG's products seems near boundless, as continued investment in infrastructure should foster demand for many years.

These products' end use covers residential and non-residential construction and new building and renovation.

FINANCIAL SNAPSHOT

(All dollar amounts are in millions except earnings per share)

	FY 2005	FY 2006	FY 2007
Total Revenue	\$5,139	\$5,180	\$5,202
Earnings Per Share	\$8.38*	\$4.15	\$0.78
P/E Ratio	6.9	8.1	46.5
P/B Ratio	1.89	3.17	1.66
Dividend Yield	n/a	n/a	n/a
Total Debt	\$1,006	\$2,504	\$1,238
Total Cash and Investments	\$1,170	\$565	\$297
Return on Equity	n/a	n/a	4.1%
Return on Assets	9.0%	10.3%	2.4%

Sources: Capital IQ and company filings.

* Normalized to account for funding asbestos trust and restructuring costs.

COMPETITIVE LANDSCAPE

Wall Street remains concerned about the housing slowdown, and USG expects overall industry demand for wallboard to decline in the short term, and along with it some erosion in the selling price of wallboard. The key market at risk is new residential building. But in my view, this is a short-term issue, and over the longer term, wallboard shipments will continue to grow at their average

of 4% a year. Through its competitive advantages, USG could see even higher growth.

The barriers to entering the wallboard market are high. Although USG has the largest market share, it's affected by the pricing and capacity additions of competitors, including National Gypsum, BPB, and Georgia-Pacific. Over time, capacity increases in line with demand, but in the short term, capacity and demand imbalances will have an impact on pricing.

VALUATION

USG derived 31% of its revenue in 2007 from residential new building. Let's paint a hypothetical picture: Assume that in the year ahead, half of this residential revenue disappears. Under this scenario, USG would post an enormous operating loss next year and then resume normal growth, with margins rising to normalized levels in the years that follow. Except for bankruptcy, this is pretty close to the worst case — and the stock would still be worth \$36, which just about the current share price.

Now for a circumstance more in tune with reality: We'll assume a bit more of a decline in wallboard pricing, tightening margins as capacity falls, and the housing market malaise to continue for the next few years. In that scenario, operating results are breakeven next year and will gradually recover as pricing climbs. In the years that follow, revenue growth should reach 5% to 7%, and margins should grow at mid-cycle levels. We peg the shares' intrinsic value at \$65.

RISKS

A key concern is the ongoing slowing in the housing market. USG expects the overall industry demand for wallboard to decline in the near term, along with the prices for wallboard. It's possible that the housing bust may be deeper and longer than we've projected, but over the longer term, we believe that annual wallboard shipments in North America will continue to grow at their long-term average of 4% a year and that by virtue of USG's competitive advantages, the company's growth should exceed that 4%.

FOOLISH BOTTOM LINE

USG offers us an excellent opportunity. There will be inevitable volatility as the housing market bumps along, but we believe that management has taken smart steps to maximize productivity. USG's vertically integrated position, low-cost production, motivated management, and compelling valuation have set up a host of advantages for investors. It's no accident that well-known value investors have bought into USG at higher prices than you can get today (including Warren Buffett's Berkshire Hathaway, which owns 17% of the shares). Boring company? Maybe. But USG offers a value opportunity that has plenty of excitement.

Exelixis

BY CHARLY TRAVERS

EXELIXIS

Nasdaq: EXEL
www.exelixis.com

Headquarters: South San Francisco, Calif.

Market Cap: \$795 million
Recent Price: \$7.60
Risk Rating: Medium

It's been an ugly market for biotechs lately; the Nasdaq Biotechnology Index has fallen about 10% before picking up again recently. Shares of my two-time *Rule Breakers* recommendation **Exelixis** (Nasdaq: EXEL) are down nearly 40% since last June on *no* negative news. That's just how it goes with small-cap biotechs and their volatility.

It's no secret that Exelixis is one of my favorite biotech companies, and I feel strongly that it's a shrewd move to take advantage of the current weakness in the stock to pick up shares if you don't own them yet, or to add to your position if you already do. This is a drug stock you want to own for years — sit on the shares and forget them, because this is a company on its way to great things.

WHY NOW?

Exelixis has an incredibly deep drug pipeline, with 11 drugs in clinical trials. It's also struck some great partnerships with important drug developers, including **Genentech** (NYSE: DNA), **GlaxoSmithKline** (NYSE: GSK), **Bristol Myers Squibb** (NYSE: BMY), and **Wyeth** (NYSE: WYE).

Critics argue that Exelixis doesn't have a clear winner in its pipeline and that even though it has a lot of drugs in the clinic, it will be many years before any will hit the market. Both those points are true, but I don't think they matter.

It takes about three years for a cancer drug entering Phase 3 trials to complete the studies and go through the FDA review process. Exelixis' most advanced drugs haven't reached that point yet. Realistically, we're looking at three or four years before one of these drugs could launch. That's discounting any accelerated approval after Phase 2, which could happen for certain cancers, but I don't want to count on it.

The knock against investing in Exelixis today is, "Why should we put money into the company now if it won't launch a drug for years?" My answer is that as an investor, you don't have to wait until a drug debuts for the stock to appreciate significantly. In fact, if you look at other small biotechs that have successfully launched cancer drugs, you'll see that the big jumps in the share price came not upon FDA approval but after Phase 2 data were released. This is the critical turning point — Phase 2 trials give us the first hard evidence of whether a drug works.

Exelixis is in the process of releasing Phase 2 data for several of its drugs, which is a big part of why I think the stock is attractive now. Three of the company's partners have recently decided to in-license compounds. In December, GlaxoSmithKline opted in to further develop and commercialize cancer treatment drug XL880 in exchange for \$35 million upfront and additional milestone payments down the line. In January, Bristol Myers Squibb similarly opted in to develop early-stage cancer drug XL139 for \$20 million, and in March, Genentech opted in for XL518 for \$3 million up front. If these and other drugs that get picked up continue to progress to the market, these partners will potentially have to pay hundreds of millions of dollars to Exelixis. Without a

doubt, these three recent opt-ins from big pharma send a strong signal that these products are the real deal.

Exelixis' partnership with GlaxoSmithKline in particular is the right deal at the right time. GlaxoSmithKline is in the midst of a major push into oncology markets, and I'm pleased to have Exelixis riding the coattails of one of the largest pharmaceutical companies in the world. Also, GlaxoSmithKline received FDA approval in March for its breast cancer drug, Tykerb, and its human papillomavirus vaccine, Cervarix, to prevent cervical cancer should be approved within a year or two (it's already approved in Europe). The company is becoming a major player in oncology, and any drugs it licenses from Exelixis will be in very good hands.

Commercially successful drugs generate hefty revenue. Just one drug with annual sales in the hundreds of millions (depending on how much of the profits are shared with a partner) could skyrocket Exelixis to a \$2 billion to \$4 billion company. That's several times more than its current value.

SOUND FINANCIAL FOOTING

In its 2007 earnings release, management gave guidance for between \$100 million and \$130 million in revenue and \$290 million to \$320 million in expenses. The bulk of those expenses will go toward R&D; more than 80% of last year's expenses went to R&D. Exelixis has a deep pipeline, and developing these drugs is very expensive. This is hardly cause for concern, though, since it's an investment in the future.

Despite all of this research investment, Exelixis still boasts a strong balance sheet. It ended last year with almost \$300 million in cash and expects to end 2008 with more than \$200 million, a figure that excludes any milestone payments it might receive from GlaxoSmithKline or other partners.

FOOLISH BOTTOM LINE

Even with these short-term value drivers, my motivation for selecting Exelixis again is much bigger. I see long-term success from its deep pipeline of cancer treatments, support from larger players, and continuing research on new prospects. If I could only buy one small-cap biotech company to hold for 10 years, that stock would be Exelixis.

Charly owns shares of Exelixis.

Cemex

BY BILL MANN

CEMEX

NYSE: CX
www.cemex.com

Headquarters: Garza Garcia, Mexico

Market Cap: \$19.6 billion
ADR Ratio: 10 common : 1 ADR
Recent Price: \$26.04
Risk Rating: Medium

PAVING THE WAY TO SUCCESS

Cemex (NYSE: CX) is the world's largest building materials company and the world's third-largest cement company by volume. Founded in 1906, it completely dominates the Mexican cement business, is the one of the largest in the United States, and has operations in more than 50 countries covering four continents. All told, the company has more than 93 million metric tons of cement production capacity.

In Cemex, you basically get the Wal-Mart of cement companies. They're both big bullies, and, like Wal-Mart, Cemex has succeeded through ruthless pricing and wicked supply chain efficiency. Its geographic breadth pays dividends to shareholders in ways beyond its actual 2.7% yield.

Because of high transportation costs, local cement production usually has a cost advantage over imported material, but countless operators in this fractured business have miserable economics. Cemex has proved its mastery at buying up poor producers with great infrastructure and improving the financials. In 2005, it bought British cement company RMC in a transaction valued at \$6.5 billion. Through the end of 2006, the company had wrung nearly \$420 million in operating improvements from the combination.

But there's another important factor in Cemex's strength: It is protected from cyclical-ity. In the past quarter, for example, while the U.S. residential market languished, its Mexican operations increased 3% over last year, Spanish operations were up 9%, and Central and South America operations rose 20%.

And because governments tend to step in with big projects (often cement-heavy) at the first sign of economic weakness, cement producers don't have as much exposure to economic swings as you might think. But you still need to be good at it. Cemex turned in 10% returns on capital employed from 2004 to 2006.

THE FINANCIALS

A look at Cemex's financial metrics nearly obscures the fact that this is a commodity producer. You wouldn't expect net profit margins to be in the low double digits and returns on equity consistently above 15% from a cement purveyor, but that's exactly what you're getting here. Credit much of this to stellar management, but a little of it is tailwind (a fact management freely concedes). Cement production has very high fixed costs, so once those costs are covered, the profits on each additional dollar (or peso, I should say) of sales can be enormous.

Cemex generates copious cash flow, and accordingly has a healthy cash position and decent interest coverage. Although its debt position has ballooned with the recent purchase of Australian cement company Rinker, management expects to use \$400 million in operating improvements (with \$200 million coming in 2008) to rapidly reduce the debt load.

THE VALUATION

Cemex's shares seem almost inconceivably cheap. My valuation takes into account continued weakness attributable to declining U.S. demand, increased interest spending from the Rinker acquisition, and whatever other maelstrom a slowing U.S. economy can conjure — which has clearly had some impact. But that doesn't take into account the historical relationship between demand and pricing for cement. Sales growth has usually approximated the host country's rate of GDP growth. Given Cemex's high fixed-cost structure, even single-digit top-line growth can translate into double-digit earnings and cash flow growth. Even so, the current valuation prices Cemex as if it won't grow at all.

THE RISKS

Of course, all the happy talk can't ignore the fact that a company that grows so much through acquisition is, all else being equal, riskier than one that grows organically. Shareholder pain is as near as an overlooked land mine in the next acquired company. Cemex's leadership, headed by Lorenzo Zambrano, has been excellent at managing this risk, and its communications with and treatment of minority shareholders is consistently outstanding. In addition, about 40% of Cemex's business takes place in developing markets, which tend to be less stable, so we could see dislocations. While Cemex tends to pay down its debt aggressively, its Rinker acquisition was financed entirely with debt, meaning that the company will sport considerably higher debt for the next few years. However, expect Cemex to continue to pay this amount down as aggressively as possible.

FOOLISH BOTTOM LINE

Sometimes your best bet is one that you've already made. When I first highlighted Cemex in 2002, few people seriously considered the possibility of investing long term in the Mexican economy. But this company is probably safer than the country in which it resides. And while Mexico has come a long way from its default days of yore, Cemex has done even more, transforming itself from a domestic near-monopoly into an international powerhouse. With its recently completed takeover of Rinker, the company is once again reinventing itself, pushing into even more markets. By using debt, it's able to make these moves without increasing share count. This means that management is confident that the combined entity will continue to generate rivers of cash. I think it will as well. I expect that this \$20 billion company will be worth \$50 billion or more within three years.