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## INTERNATIONAL HIGH DIVIDEND STRATEGY

### ANNUAL LETTER 2006

Thank you for your continued interest in Cheswold Lane's international value equity strategy. We are pleased with the firm's first calendar year investment performance. Our investment strategy composite returned 30.14% on a gross basis compared with a rise of 26.34% in the MSCI EAFE (Morgan Stanley Capital International Europe, Australasia and Far East Index) including income, net of withholding taxes and expressed in US dollars. In the 4<sup>th</sup> quarter of 2006, the portfolio increased 11.83% on a gross basis compared with a rise of 10.35% for the MSCI EAFE index.

#### ***Market Review - 2006***

2006 was a year dominated by events related to the energy sector. In the first half of the year, oil prices rose dramatically due to geopolitical fears, strong product demand and significant financial contract speculation in the oil futures market. Cyclical stocks including energy, materials, industrials, and transportation all moved significantly higher; everything cyclical was working in the market, except for technology stocks. But market sentiment changed abruptly during the early summer, as oil prices peaked coincidentally with the cease-fire agreement between the Israelis and Palestinians. Market focus shifted away from the cyclical industries towards sectors that usually perform well in decelerating economic environments. The impending 2007 US recession and its effects on the global economy were the topics du jour by mid-to-late summer. At this time, consumer oriented stocks, which had suffered earlier in the year, started to lead the market higher. Throughout the year, the utility and financial sectors were stalwart performers. Telecom stocks, particularly in Europe, surprised the market by rebounding sharply after a dreadful first half of 2006. Technology showed some spark in the 4<sup>th</sup> quarter, but overall 2006 was yet another disappointing year for the tech sector.

On a regional basis, emerging markets, especially Latin America, the ASEAN countries and China, were the star performers of 2006; followed by continental Europe, Asia x-Japan, the UK, US and finally, Japan. Emerging markets' stellar performance was not without trepidation, however, as the stocks experienced a significant downdraft in late spring, only to rebound sharply in the 2<sup>nd</sup> half of the year. Both the Euro and British

Sterling appreciated more than 10% versus the US Dollar, while the Japanese Yen was essentially flat versus the US Dollar in 2006.

Small and mid capitalization stocks within the MSCI EAFE index continued to outperform large capitalization stocks. But a more circumspect look at the numbers, uncovers the dreadful performance of the mega-caps as being the root cause of the poor relative performance of the large capitalization segment. Large cap value outperformed large cap growth within the MSCI EAFE index by more than 500 bps in the year.

### ***Portfolio Review – 4<sup>th</sup> Quarter***

During the 4<sup>th</sup> quarter, we continued to shift the portfolio from a strong cyclical position, held throughout most of 2006, to a more balanced weighting of cyclical and non-cyclical sectors. This decision was predicated on our belief that the major global economies had peaked in terms of growth rates, especially the US, combined with valuation multiples in many of these cyclical industries that were relatively unattractive. More specifically, we reduced the portfolio's weight in the industrials, materials and energy sectors. Positions eliminated include: Taisei, Orient Overseas, Sumitomo Metal & Mining, and Repsol. Balancing these sales were purchases in the consumer staples, consumer discretionary and healthcare sectors. New positions were initiated in Henkel, Heineken, Richemont, Honda Motor, Nissan Motor, Eisai Company and AstraZeneca. The portfolio's largest sector overweight is telecom, followed by the energy sector; the largest underweight sectors are industrials and materials. Our country allocations have not changed significantly. We remain overweight continental Europe, especially Norway, neutral to the UK, and underweight Asia, which is almost entirely Japan. We have no foreign exchange hedges or cross hedges in place.

This quarter's investment results were bolstered by two M&A announcements. The first was financial in nature, the private equity arm of the Ontario Teachers' Pension Plan of Canada acquired four ship container ports in the US and Canada owned by Orient Overseas, a Hong Kong based transportation company. The price announced for the transaction represented 82% of the market capitalization of the total company prior to the announcement. The private equity fund's expected return implies a capitalization rate of 5.25% or approximately 18-20x's 2006 cash flow - Quite an attractive price for a utility-like business. Post the revaluation of the parent company, Cheswold Lane sold its position in Orient Overseas. The second M&A transaction during the quarter was strategic in nature. Statoil ASA, the former Norwegian state controlled integrated oil company, agreed to acquire the oil and gas business of its sister company, Norsk Hydro ASA. The combined entity will be able to compete, on a global scale, with the leading international energy players such as ExxonMobil, BP, Royal Dutch/Shell, Total and ENI. Norsk Hydro shareholders will receive shares in the NewCo, as well as retain their shares of the continuing aluminum company, Norsk Hydro. Statoil shareholders will exchange their current shares for NewCo shares. Cheswold Lane has significant holdings in Statoil and Norsk Hydro, both of which we have retained in the portfolio. Norsk Hydro's share price increased approximately 22% post the announcement of the transaction, while Statoil's share price declined by 3-4%.

## *Investment Outlook – 2007*

We remain constructive on the investment outlook for 2007, especially in continental Europe. The positives in Europe remain strong economic growth, excellent profit margins, attractive valuations and increased M&A activity. The German economy, Europe's largest, appears to have turned; fueled by improving consumer confidence, low interest rates, moderate inflation and accelerating construction and manufacturing sectors. The combination of high unemployment and significant labor work-rule changes is keeping wage inflation modest and allowing productivity improvements to flow to European corporations' bottom lines. While clearly lagging their US counterparts, European companies are accelerating their plans for productivity improvement, outsourcing and restructuring.

In 2006, most European stock markets experienced mid-teens investment returns, in local currencies, driven predominantly by earnings per share growth. Valuation multiples did not increase much during 2006 and remain very attractive at 12-14x's 2007 earnings for most European markets. With inflation concerns waning, we expect forward valuation multiples to expand in Europe during 2007. Our assumption for earnings growth is 6-8%, which combined with modest multiple expansion supports our total market return expectation in Europe of 10-12%, in local currencies.

With respect to Japan, 2006 should be characterized as another year of disappointment. In hindsight, economic and market expectations were clearly ahead of themselves in the 2<sup>nd</sup> half of 2005. Reality set in during the 1<sup>st</sup> half of 2006, as the Japanese economy failed to accelerate to the level required for most Japanese firms to meet or exceed the market's earnings expectations. The Japanese domestic economy remains sluggish while the exporters' outlook is mixed. The Japanese automakers continue to benefit from organic growth in the emerging markets combined with market share gains in the developed markets. The consumer electronics exporters are struggling due to their high cost structures combined with an extremely competitive pricing environment. The industrial exporters' earnings growth rates have declined significantly, as order strength in China is being offset by reduced demand in the US. Our assumption for the market's 2007 earnings growth is 5-6%, which is slower than 2006, due to the impact of the decelerating global economy. We expect the autos, pharmaceuticals, and regional banks, segments of the market where Cheswold Lane's portfolio has significant exposure, to exceed the growth rate of the market. Valuation multiples in Japan are neutral, neither cheap nor excessive, in our opinion. The direction, in which, will be swayed by inflation expectations, the BOJ's monetary policy as well as the degree of deceleration in the global economies; a hard or soft landing.

## THE VIEW FROM CHESWOLD LANE...

### ***The “Old” New Thing of 2007***

*“New organizations are emerging...organizations that are corporate in form but have no public shareholders and are not listed or traded on organized exchanges. These organizations use public and private debt, rather than public equity, as their major source of capital...Despite the protests, this organizational innovation should be encouraged. By resolving the central weakness of the public corporation – the conflict between owners and managers over the control and use of corporate resources – these new organizations are making remarkable gains in operating efficiency, employee productivity, and shareholder value”*

No, this is not an excerpt from last week’s lead story in *BusinessWeek* or the *Economist*, although it could be. This is a passage from Harvard Business School Professor, Michael Jensen’s *Eclipse of the Public Corporation* published in the Harvard Business Review, October 1989. It’s an interesting perspective, detailing the rise of the private equity industry in the mid 1980’s, more often referred to then as the LBO business. Michael Milken and Drexel Burnham Lambert are the two names most closely associated with the modern leverage buyout, although its origin dates back, at least, to the early 1900’s with legendary financier, JP Morgan. The modern LBO is considered one of the most significant capital market innovations of the last 40 years.

Twenty years later, the financial markets have come full circle, as private equity, once again, is the dominant theme in the global markets. The resurgence of private equity has been driven by a number of factors. The most important being, private equity firms identifying a growing financial market inefficiency to exploit – money to be made! Second, the conflict over corporate resources between management and shareholders appears extreme; and while today’s CEO compensation, perquisites and stock options back-dating receive the majority of headlines, it’s corporations’ inefficient capital structures which destroy the most equity shareholder value. And third, the capital, both equity and debt, required to facilitate these transactions is readily available and inexpensive.

Professor Jensen argued that private organizational structures should not be necessary; board oversight and market forces should provide the proper discipline required to manage shareholders’ assets effectively. Clearly, this is not always the case. We do find it ironic that the vast majority of monies raised by private equity funds to acquire public companies are derived from the same institutions – state and local pensions, corporate pensions, endowments, foundations, etc., that currently own the bulk of the public company equity shares.

To put this capital raise in perspective, over the last 3 years the global private equity industry has gathered \$750 billion to buy public companies and divisions of public companies (Exhibit 1). In 2006 alone, the industry amassed more than \$350 billion, of which, \$200 billion was raised for acquisitions outside of the US. But to properly assess the true market impact, one must remember that this is equity money, which private equity

firms then lever more than 5 - 6x's with debt. So, the total buying power of the private equity industry is several trillion dollars on a global basis. The industry is back, and currently, the biggest exogenous factor in the global financial markets today. We believe this continues to be a major positive for investment returns of public equities, especially in more insulated markets such as continental Europe and Japan.

***What does this mean for Cheswold Lane's clients?***

Besides the obvious direct benefit of private equity firms buying one or more of our portfolio holdings at significant premiums to their current market value, we believe the private equity industry has the power to change the landscape of an industry or company, which could create significantly more shareholder value over time. Michael Milken recently said that LBOs have regained momentum "because management remains unresponsive to their shareholders, the rightful owners of corporate resources." We agree. And today, LBO firms have the capital to acquire these underperforming and undervalued businesses around the globe. This in turn, is putting tremendous pressure on CEOs to act; to make the difficult strategic decisions to create value for their shareholders. Management will consider selling non-core assets, raising their dividends, repurchasing shares, optimizing their capital structures and looking for a strategic M&A transaction. This is when current shareholders can participate in substantial value creation.

With respect to strategic versus private equity M&A, while both can be positive market place events in a competitive industry, generally there is more value creation capacity from strategic M&A than LBO/private equity M&A. Another way of saying this is there are considerably more synergies available to share between two strategic players, in an industry, than can be achieved from a stand-alone private equity transaction. Admittedly, how the value-creation is shared is often the complaint of the acquiring company's shareholders. However, in consolidating industries where operating margins are depressed due to significant competitive pressures, strategic buyers can often create considerable value for their own shareholders by acquiring a weak competitor, which is depressing the margins of the entire industry. Strategic buyers can effectively "cure" market competition through acquisition. The European wireless telecom market is a current example of this strategy. While not as powerful, LBO firms can also provide stability to an unstable competitive marketplace because their incentive is to generate cash flow, not to gain market share. LBO firms which buy assets in businesses with competitive pricing want to stabilize industry pricing, not instigate or continue price wars. What has changed is that control of shareholder assets, by CEOs and boards, is now under significant threat from LBO firms, thus forcing management to make strategic decisions to benefit shareholders. This story is especially true in continental Europe and is just arriving on the shores of Japan.

***So, which CEOs' doors are private equity firms literally knocking on?***

Private equity firms like businesses with fundamental characteristics similar to those found in the Cheswold Lane International High Dividend Strategy. More specifically, we are both attracted to businesses that generate significant and stable cash flows, require modest capital expenditures, are underleveraged and trade at attractive valuations (Exhibit 2 and 3). Historically, the only real difference in the type of companies we invest in versus private equity firms was the market capitalization size. Cheswold Lane's strategy

invests in medium to large capitalization stocks while private equity firms have historically acquired small to mid capitalization companies.

But the financial markets have shifted, and today, the most attractively valued stocks are not small or mid caps, but rather large capitalization stocks. Additionally, global interest rates are very low and high yield credit spreads are extremely narrow compared to their historical averages (Exhibit 4). In general, we see yield demand as high and risk aversion low in the global fixed income markets. These market factors make it very attractive to finance larger private equity deals. Also, private equity firms have started to pool their equity in what is called “club deals” to buy larger targets. And so, for the first time in history, large capitalization companies, \$10-\$40 billion, have become attractive and realistic targets of private equity firms on a global basis. We expect to see further private equity and strategic M&A in the global utilities, telecom, industrials, real estate, transportation and media industries.

In conclusion, we believe the return of the leverage buyout as a financial structure will have far reaching and very positive effects in the global financial markets. Management will be forced to act, while they still control their fate, and this is good for shareholders and we think, especially good for you, our clients of the Cheswold Lane International High Dividend Strategy.

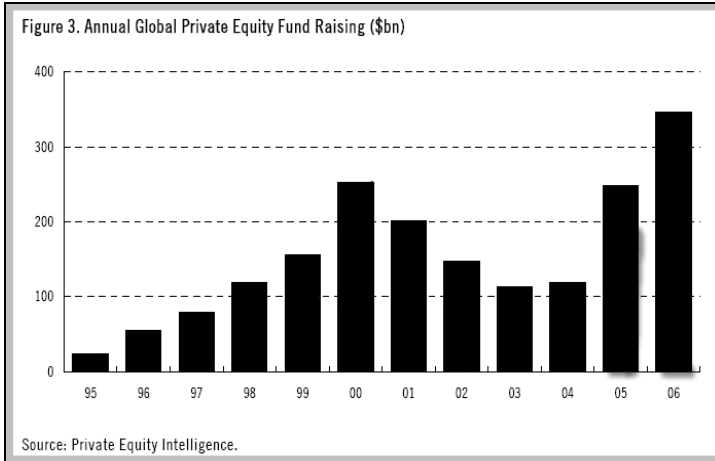
As always, we appreciate your support and welcome your thoughts and ideas.

Best regards,

Colleen Quinn Scharpf  
Eric Scharpf  
Matt Taylor

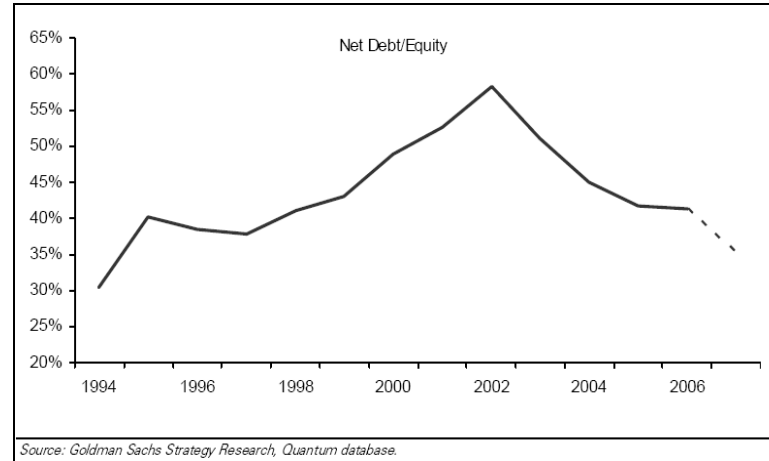
## EQUITY CAPITAL

Exhibit 1



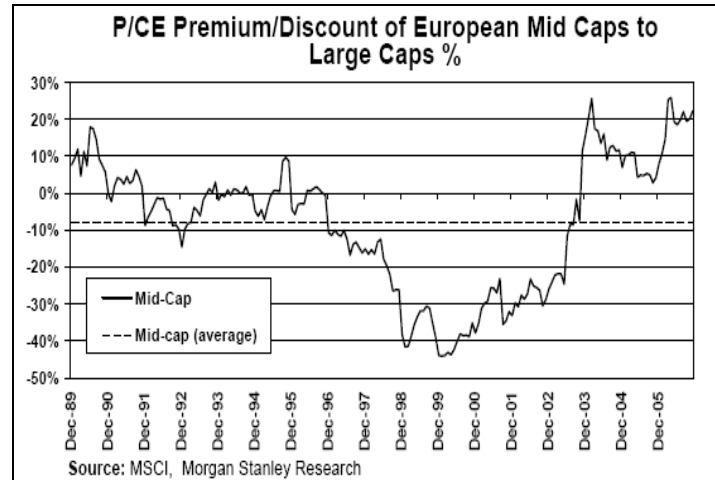
## LEVERAGE CAPACITY

Exhibit 2



## VALUATION

Exhibit 3



## BOND SPREADS

Exhibit 4

