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## INTERNATIONAL HIGH DIVIDEND STRATEGY

### 1<sup>ST</sup> QUARTER 2007 INVESTMENT LETTER

Thank you for your continued interest in Cheswold Lane's international value equity strategy. During the 1<sup>st</sup> quarter 2007, our investment strategy composite returned 3.43% on a gross basis compared with a rise of 4.08% 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.

#### *Market Review – 1Q 2007*

The first quarter of 2007 saw an increase in market volatility as economic and geopolitical fears increased sharply. After a quiet January, the global markets were jolted in late February by an abrupt policy change by the Chinese government aimed at tightening local bank credit standards. The market viewed this as an attempt to reign in potentially inflationary economic growth in China. The Chinese stock market reacted very negatively, dropping 9% that day. This led to a global market sell off – 4% in most developed countries and 5-7% in many emerging markets. Fears of a global economic slowdown and reduced global liquidity swept through the markets. The knee jerk reaction to decrease leverage in the global markets, shifted the markets' focus to the "yen carry trade." Hedge funds have been using the yen carry trade as a cheap source of liquidity, increasing leverage and fueling global asset appreciation. By the end of the first week of March, even the casual investor had seen at least 6 or 7 stories about the yen carry trade and why it's unwinding was causing such indigestion in the global markets.

Additional market turbulence was caused by the unraveling of the US subprime lending market – highlighted by the liquidity crisis and eventual bankruptcy filing of one of the industry's high-flyers, New Century Financial. Market nail-biters were then crowing about both the imminent Chinese slowdown and the collapse of the US consumer. For more than a week, global stock markets continued to decline. However, in the latter weeks of March, fresh economic data from the US and Europe helped ease market concerns regarding the macro economic picture. The Federal Reserve also calmed the markets, at least temporarily; by relaxing the central bank's tightening bias and reiterating a relatively healthy US economic outlook for the rest of 2007.

Despite the market turbulence exhibited during the quarter, international stock markets managed to post positive returns, 2-3% in local currencies and approximately 4% in US dollar terms. Towards the end of the quarter, some familiar trends of the last 18-24 months reappeared – weakness in the US dollar and Japanese yen, and strength in the high yielding currencies such as the Australian and New Zealand dollars as well as the Norwegian and Swedish Kronor. Commodity prices, especially metals such as copper, iron ore and aluminum, rebounded from last year's sell off. Strong economic growth continued in continental Europe, China, and South East Asia, while the US and UK showed moderating growth. The Japanese economy exhibited improving but inconsistent growth (domestic versus export driven). On a sector basis, industrials, basic materials, and consumer staples sectors outperformed, while energy, technology and telecom lagged the MSCI-EAFE index. International small cap stocks outperformed large cap stocks by approximately 3% during the quarter, while the performance disparity between large cap growth and value stocks was relatively modest. One market theme that did not change during the quarter was the increase in M&A activity – fueled by increasing pools of Private Equity monies.

### ***Portfolio Review – 1st Quarter***

We expect this market turbulence to continue in the 2<sup>nd</sup> quarter. The rally in global equities since last July has been very impressive, but with the global economy slowing in 2007, we expect to see some dislocation in the markets as growth shifts into a lower gear. As discussed in our 2006 annual letter, we think it is prudent to balance the cyclical and non-cyclical weights of the portfolio, based on our outlook for the macro economy and more importantly, our assessment of the poor risk/reward opportunity set in many of the deeper cyclical sectors. Profit margins are at all time highs, and while the absolute P/E or Firm Value/ Cash Flow multiples may not seem too high today, if the next move in the global economy is down, these valuation multiples will turn out to be much higher than the market currently implies. The portfolio continues to have a large capitalization bias versus the index and our peers. This is primarily a function of the valuation disparities between small and large capitalization stocks. Positions eliminated during the quarter include: Tele2, Cattles, Matsushita Electric and Makita. Balancing these sales were new purchases in the financials and technology sectors. New positions were initiated in: UBS, Unicredito, Bank of Kyoto and Konami. The portfolio's largest overweight sector is energy, followed by telecom. The largest underweight sectors are industrials and materials. Our country allocations have not changed significantly. We remain overweight continental Europe, particularly Norway, modestly underweight the UK, and underweight Asia, which is almost entirely Japan. We have no foreign exchange hedges or cross hedges in place.

In *The View From Cheswold Lane* section of our annual letter, we discussed the positive impact Private Equity was having on the holdings in our international high dividend strategy. More specifically, we stated our belief that Private Equity firms were attracted to the same characteristics of stocks held in our portfolio – quality companies with high and stable cash flows, moderate capital expenditure requirements, leading market share positions and underleveraged balance sheets – trading at attractive prices. We believed Private Equity would force corporate management to be more accountable to shareholders; to manage shareholder assets with more rigor and discipline or be at risk of a take-over bid. We also discussed our view that strategic buyers should be able to pay

more for an asset than Private Equity firms due to the increased synergies afforded to an existing industry participant. As such, we expected to see more strategic transactions – jump started indirectly by the fear of an initial advance from a Private Equity firm.

During the 1<sup>st</sup> quarter, the Franco-Spanish tobacco company, Altadis, a stock Cheswold Lane purchased last September, was approached by Imperial Tobacco with an all cash bid of 45 euros per share, an 18% premium. So far, Altadis' management and board have spurned Imperial, looking for ways to remain independent, even contacting Private Equity firms in hopes of turning the transaction for Altadis into a management buyout. Imperial has since raised its bid to 47 euros per share which was, yet again, rejected by Altadis' board. Ultimately, we believe Altadis will be sold for 50 euros per share or more, and with better cooperation/information from Altadis' board, Imperial will likely be the new owner of the asset. But the true victors, either way, are the Altadis shareholders. We continue to see a healthy M&A/Private Equity market providing a bid to the global equity markets.

Best regards,

Colleen Quinn Scharpf  
Eric Scharpf  
Matt Taylor

## THE VIEW FROM CHESWOLD LANE...

### ***An Unexpected Retirement Party – Lord Browne’s Farewell Annual Meeting***

On April 12, 2007, Lord John Browne will host his final annual meeting as CEO of British Petroleum (BP). The company recently announced the new date of Lord Browne’s retirement – July 31, 2007, a full eighteen months earlier than previously stated. While not unexpected, it’s still a shock for those of us who have followed BP and its legendary CEO for the last 12 years. The company has suffered through a number of tragic events in the recent past, the most serious being the fatal explosion at its Texas City refinery, which killed 15 people and injured hundreds more. Additionally, Hurricane Katrina destroyed the company’s *Thunder Horse* offshore production platform and delayed the installation of its *Atlantis* platform costing BP billions of dollars in repairs and lost oil production. In early 2006, BP encountered a major leak in its North Slope Alaska pipeline, spilling almost 1 million gallons of oil into the environment. During the summer, the Justice Department and the CFTC accused BP of trading manipulation in the US propane market. In the fall, the Russian government coerced Royal Dutch /Shell to sell 50% of its \$20 billion *Sakhalin* oil project to Gazprom which lead the market to speculate about the security of BP’s Russian investment, TNK-BP. And most recently, the report of the Baker Panel, commissioned by BP to investigate the Texas City refinery incident, leveled very harsh criticism of BP management, all the way up the chain of command – from plant manager to CEO.

These are indeed tragic events, and responsibility rightly falls on management and the CEO. However, I am also sympathetic to John Browne, who is retiring on what must be considered an extreme low-point in an otherwise very distinguished career. With the most recent events, it’s easy to brandish BP a bad company and it’s CEO, even worse. Last week, *Barron’s* even dropped Lord Browne from its annual “*Most Respected CEOs*” list. But I believe it is somewhat obtuse to take only the most recent past into consideration when painting a picture – whether it’s the reputation of a company or its CEO or even, its valuation in the market place. I think there is merit in looking at the whole landscape before making enduring judgments. Having followed BP since 1997, first as an energy research analyst and later as a portfolio manager, I have been analyzing the company’s performance for more than a decade. Additionally, I have met John Browne several times in my investment career, even hosting a one-on-one meeting here in West Conshohocken while an investor with Miller Anderson & Sherrerd, LP. John Browne is, without a doubt, one of the most impressive chief executives I have interviewed. He has tremendous knowledge of the company and the energy industry. His distinct and clear vision of where he was driving the company was matched only by his confidence that BP would reach its destination.

In my opinion, BP’s long term performance has only been surpassed by ExxonMobil in the global energy business; and in some ways, BP has been more forward-thinking than its US counterpart. In the last 10 years, there have been 4 or 5 major strategic themes in the energy industry: consolidation, US natural gas, US refining & marketing, deepwater exploration and Russian oil and gas. The more a major oil company participated in these

themes, the better they performed. BP, under the stewardship of John Browne, has successfully executed every one of these major industry themes. John Browne and BP started the era of the “Super-Major” oil company in 1998 with the merger of BP-Amoco. BP bought Amoco’s core asset – US natural gas reserves when natural gas prices were just \$2.25 a metric cubic foot (mcf). Over the last 7 years, US natural gas prices have averaged more than \$5.00 per mcf and are trading in the futures market at more than \$8.00 per mcf for the foreseeable future. In 2000, BP acquired the Atlantic Richfield Company (ARCO) for its West Coast refining and marketing system, Alaskan oil reserves and its deepwater Gulf of Mexico exploration portfolio. Since 2000, the margins for US refining have doubled, oil prices have tripled and BP has had several billion barrel discoveries in the deepwater Gulf of Mexico. And finally in 2003, when every major oil company in the world including Exxon, Chevron, Total and Royal Dutch were trying to buy oil and gas assets in Russia, only one, BP, was able to consummate a major transaction. BP paid \$7 billion to acquire a 50% partnership stake in TNK, renamed TNK-BP, which today is Russia’s 2<sup>nd</sup> largest integrated oil and gas company. In retrospect, BP acquired several billion barrels of oil and gas reserves in 2003 at close to \$2.00 per barrel and has the potential to find and develop several billion more barrels in Russia over the next decade.

While the short term news at BP has been quite poor, I have a much more balanced view based on a longer timeframe than the current media and financial market consensus. In my opinion, Lord Browne should be proud of his record at BP and should be remembered for transforming an “also-ran” UK oil company into a “Super-Major” global integrated oil company.

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

BP is our portfolio’s largest energy holding. The stock is a strong example of our investment philosophy – a quality company trading at an attractive valuation. The shares trade for less than 10x’s earnings and 6x’s cash flow. BP generates high returns on capital, which support a consistently growing and currently, high dividend yield (3.8%). Admittedly, everything that could go wrong for BP in the last 18-24 months did. Some of it was under management’s control, but much of it was simply bad luck. The economic impact to BP has been severe – depressing its ROIC in 2006-2007 and its absolute and relative valuation multiples; however, the company should see a strong lift in returns during 2008 and beyond.

***What about marginal returns on capital and capital discipline?***

To give some context to the expected lift in returns – due to downtime and recommissioning required at the Texas City refinery, BP anticipates losing \$1 billion at the refinery in 2007. This should reverse the following year, as management expects Texas City to earn \$1 billion of profits in 2008. This is roughly a 10% swing in corporate profits year to year. With respect to the *Thunder Horse* and *Atlantis* deepwater Gulf of Mexico oil projects affected by Hurricane Katrina, BP still expects to produce up to 300k barrels a day from these fields, representing 8% of BP’s total daily production. The reconstruction of the floating production platforms is well underway, with *Atlantis* rescheduled to start at the end of 2007 while *Thunder Horse* is set to ramp production at the end of 2008. This will provide significant production growth from 2008-2010. More

importantly, due to the scale benefits of the project and the favorable US tax regime, the profits per barrel of oil from these fields will be almost 2x's the profitability of the company's current base production. Hence, the positive financial impact will be far greater than a simple 8% increase in production over 3 years.

With respect to capital discipline, in 2004 John Browne publicly committed to return all excess cash flow, due to high commodity prices, to shareholders in the form of higher dividends and significant share repurchases. In the last 3 years, BP generated approximately \$90 billion of cash flow – reinvesting \$35 billion and returning \$55 billion in dividends and share repurchases. During 2006 alone, BP returned more than \$23 billion back to shareholders, of which, almost \$16 billion was in the form of share repurchases. The company took advantage of its depressed share price to buyback 6% of its shares in 2006. Capital discipline remains the hallmark of BP's business model.

At Cheswold Lane we are fond of saying, “we buy good businesses at good prices.” In the case of BP, we think we've purchased a great company at very good prices. It's a rare opportunity, but one we're pleased to take advantage of in the international markets.

### ***What is Cheswold Lane's view of the Energy sector?***

We believe the energy sector represents excellent value versus the broader international markets. The energy sector trades at a 30-40% discount to the market on a P/E and Firm Value/Cash Flow basis. This is, by far, the cheapest sector in the EAFE index. The energy sector represents 13.5% of our strategy's assets. This is a significant overweight versus the MSCI-EAFE's energy sector weight of 7.2%. The sector has been de-rated due to the sharp drop in oil prices since last spring's peak of \$78 per barrel; but we remain very constructive on the outlook of the energy sector.

Global oil demand continues to outstrip Non-OPEC supply growth leaving the OPEC cartel in control of the price. Without significant change in global GDP or gasoline consumption trends, we expect OPEC to continue to support a Brent/UK oil price above \$55 per barrel. Refining & Marketing margins will also remain robust due to tight supply/demand fundamentals. Government mandates for cleaner fuels are reducing supply and diverting capacity expansion capital to environmental projects. After an extremely mild winter in the US and Western Europe, we expect natural gas prices to strengthen going into the 2<sup>nd</sup> half of 2007. The geopolitical wildcards remain Iraq and Iran. Any disruptions from their current export capacity will have a dramatic effect on the spot price of oil. Iraq will be challenged to keep production flowing if US troops withdraw in 2008 and the current civil war escalates. As for Iran, their desire to produce weapons grade nuclear material puts them on a near term collision course with the West.

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

Best regards,

Eric Scharpf  
Portfolio Manager  
Cheswold Lane International High Dividend Strategy