Caterpillar's aQuantive
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Dear Fellow Investors:

One of our eight proprietary criteria for stock selection is shareholder friendliness. Buying another company whose industry has enjoyed unusual prosperity is not shareholder friendly. Recently, as an example, Microsoft (MSFT) admitted what most of us already knew. Microsoft's online business is a massive destroyer of capital and shareholder value. They wrote down the value of their acquisition of aQuantive by $6.2 billion. Here is how writer, Shira Ovide, explained the write down on the Wall Street Journal's online news site:

Microsoft Corp. is booking a $6.2 billion charge for its money-losing Internet division, an admission that a business anchored by the Bing search engine has failed to live up to its expectations. The software giant's chief executive, Steve Ballmer, has spent a decade and billions trying to build a Web unit that could compete with Google Inc. in selling online ads and delivering search results.

But Microsoft has failed to dent Google's dominance of Web searches, despite an alliance with Yahoo Inc., and heavy spending on its Bing service. It has struggled to sell online ads for the same prices that Google fetches. Microsoft also continues to spend on its MSN portal.

On Monday, the company admitted its online businesses won't grow as quickly or be as profitable as it has forecast, so it will book a $6.2 billion charge. The move would wipe out Microsoft's profit for its fiscal fourth quarter ended June 30, according to Wall Street estimates for quarterly results.

The charge mostly reflects a write-down of goodwill related to Microsoft's 2007 acquisition of aQuantive Inc., a $6.3 billion all-cash deal that Microsoft hoped would catapult it into brokering more ads across the Web.

Stepping back to November of 2010, we can see that we predicted the same kind of result for Caterpillar's (CAT) acquisition of Bucyrus International. We believed that it was going to be a capital destroying event as we wrote in a missive called "Swallowing the Myth" (http://www.smeadblog.com/investor-relations/missives/swallowing-the-myth). This is how the Wall Street Journal's reporters James R. Hagerty and Bob Tita explained the transaction on November 16th of 2010:

Placing a giant bet on a long-term boom in global demand for coal and minerals, Caterpillar Inc. agreed to buy Bucyrus International Inc., a maker of mining equipment, for $7.6 billion. Rapid growth from China, India, Brazil and other emerging markets will "push demand" over the next decade for coal, copper, iron ore and "everything that comes out of the ground," Doug Oberhelman, Caterpillar's chief executive, said during an interview Monday after announcing the company's largest acquisition to date. Mr. Oberhelman cited the growth of cities, as well as infrastructure needs in developing countries.

As Patriot Coal (PCX) and numerous competitors either declare bankruptcy or consider it, one look at coal prices tells you everything you need to know about Caterpillar's acquisition. The November of 2010 price of coal was $114.81 per metric ton and today trades around $88.05.

To determine how much capital the CEO of Caterpillar has destroyed by acquiring Bucyrus International, we look to a comparison with the other large US-based mining equipment company, Joy Global (JOY). Bucyrus International was trading at $67 per share the Friday before the deal was announced and Joy Global was trading at around $75. CAT paid $92 for Bucyrus, a substantial premium (23 times earnings). We will call $92 the private market value of Bucyrus. To determine the private market value of JOY, we looked forward to its price at the peak in the commodity markets in April/May of 2011. Joy Global's stock peaked at around $102.

Today, JOY trades around $53 per share, a 48% discount to its peak in April of 2011 which we, for the sake of argument, will call the private market value. We believe that Bucyrus International would be trading somewhere around $48 per share based on the comps with JOY. A 48% decline in value of a $7.6 billion acquisition would be a $3.65 billion write down. Caterpillar's consensus estimate for 2012 is to earn $6.2 billion, so instead of wiping out one quarter of profits at Microsoft, Caterpillar has blown over half of this year's profits.

In case you are wondering, we think the losses will mount as China, Brazil and India suffer normal business cycles. Any bets on when CAT takes the write down?

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.