



The Blessing of Hitting the Skids First

August 30, 2011



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Dear Fellow Investors:

They say that to make significant improvements or permanently change behavior you have to hit bottom. Once you hit bottom, you have to want to change. There is a special blessing in hitting bottom in the business world earlier than your competitors. This is true for companies and it is also true for national economies.

Home Depot was created by Arthur Blank, Bernie Marcus, Ron Brill and Pat Farrah. The leader of the company for years was Bernie Marcus. He had a passion for the business and for employees which was infectious. When he stepped back from the company in the year 2000, a former GE executive named Robert Nardelli became the CEO and attempted to improve the company through financial engineering. The attention to merchandising detail and customer service suffered once Bernie's enthusiasm was removed from operational management of the company. Frank Blake was hired in 2007 with the morale and the performance of the company in a deep struggle. Home Depot's number one competitor, Lowe's, was running rings around them.

Frank Blake went to work on a company which in many ways hit bottom in 2007. By the time the "Great Recession" was in full force in 2008, Home Depot was already working on improvements which other businesses would make at the depth of the recession. In the most recent quarter of 2011, Lowe's and Home Depot reported results which effectively were the reverse of 2007. Lowe's earnings stagnated and Home Depot is growing again and appears to be gaining market share. Hitting bottom early was a competitive blessing for Home Depot.

Another example of this occurred in 2007 when it became obvious to Howard Schultz that he needed to retake the reins as CEO of Starbucks. The company had over-expanded and lost the attention to detail and efficiency, which was one of its hallmarks. Soon after taking over in mid-2008, Schultz announced that 600 stores would be closed and that earnings would be damaged by charges and lower sales. Starbucks corporate performance hit bottom in late 2007 and early 2008.

By 2008, Starbucks was well on its way to improving almost every aspect of their business. Then the "Great Recession" hit with full force. This caused all the businesses around Starbucks to deal with some of the same forces that their own stumble had forced them to address. In the fiscal year 2011 ended September 30th,

Starbucks will have nearly doubled its peak fiscal earnings record prior to the great “reset”. Hitting bottom before most all the other businesses was a blessing.

This is not only true for companies, but it is also true for countries. It was obvious to our firm in late 2005 that residential real estate prices were nuts. We wrote endlessly about this topic during that time. The residential real estate market started to crash in the hottest markets in the US in late 2005 and in the rest of the country in 2006 and 2007. In turn, the market for mortgage loans blew up in 2007 and 2008 leading to the financial crisis of 2008 and early-2009. The US hit bottom in the economy in the first quarter of 2009 and the stock market bottomed on March 9th of 2009.

The US economy has been attempting to cleanse itself of these over-priced properties and bad loans for five years. We’ve had to recapitalize our banks through the TARP program. Businesses had to right-size their employment levels and get their balance sheets in order. Households had to aggressively attack their over-spending ways, turning Dave Ramsey into the high priest of debt reduction and have made massive improvement in their household debt service ratio.

While the US economy has hit bottom and has been cleansing itself for five years, Europe and Japan have been slow to get their act together. Japan never has cleaned their system of the loan problems of their late 1980’s bubble. Europe has a common currency and uncommon problems which they have been hesitant and reluctant to address.

Brazil, Russia, India and China have boomed and caused Australia and Canada to boom with them. The economies of Brazil and India are already showing severe cracks. Australia’s housing market is crashing. Lower oil prices could lead to major problems for Canada and its hot residential real estate markets. Bank loans that are going bad are haunting the economies of the BRIC nations. Here is how Bloomberg Business Week’s Michael Patterson explained what is going on in the emerging market world in their August 15th-28th issue:

“Loans to Brazilian shoppers, Chinese infrastructure projects, and Indian property developers have fueled the global economic recovery and turned emerging-market banks into some of the world’s biggest firms by market value. The party may be ending. Worrisome inflation rates in Brazil, Russia, India, and China have local monetary authorities raising interest rates and tightening credit conditions. That, plus evidence nonperforming loans are on the rise, has investors rethinking their enthusiasm for BRIC bank stocks.”

China has an even nuttier residential real estate bubble than we had in the US, in our opinion. China has more bad real estate and infrastructure development loans in their banking system today than the US did back in the late 1980’s, when we had the Savings & Loan debacle. The US banking crisis in the late 1980’s ended in the Resolution Trust Corporation handling bad development loans at taxpayer expense. It looks to us like a \$1.5 trillion black hole waiting to be filled by the Chinese government. In other words, these other countries like China are at the beginning of their skid and nowhere near the bottom as yet.

Fraser Howie, the co-author of “Red Capitalism”, expounds on China specifically in a piece in Barron’s August 29th. He sees, “more problem loans ahead for China’s big banks, with negative consequences for global economic growth.” Here is how he details the problem loans:

“China’s banks issued a record \$2.8 trillion in new loans, of which \$1.7 trillion went to local governments. While the big four banks— Industrial & Commercial Bank of China (ticker: 1398.Hong Kong), Agricultural Bank of China (1288.Hong Kong), China Construction Bank (939.Hong Kong) and Bank of China (3988.Hong Kong)—reported nice first-half earnings gains last week, as well as limited impact from local-government lending, fresh problem loans are likely to surface in the future, says Howie, a Singapore-based executive at the investment bank CLSA Asia Pacific Markets.

Worse, the banks are ill-equipped to handle them, he said in an interview last week.”

Summing up the investment landscape from the angle of banking weakness in the BRIC countries Howie said:

“But weakness in China and the knock-on effects will surely hit a raft of investments premised on breakneck growth, among them mining stocks, commodities, construction plays and retailers. China ultimately has an unsustainable banking system.”

We believe that the first country to hit bottom, the first to confess its mistakes the way Frank Blake and Howard Schultz did for their companies, and the first to cleanse the banks, corporations and households will lead to lasting prosperity long before any other country in the world does. We also believe that the investment rewards of US non-cyclical large cap common stock investing has rarely looked more attractive because of the willingness of investors to underestimate the benefit of hitting the skids before everyone else does.

Best Wishes,

William Smead

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