ValueInvestor INSIGHT

The Leading Authority on Value Investing

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Ideas That Won't Die

Given how hard Fairholme Capital's Bruce Berkowitz works to discredit his own ideas, it's not surprising that the investments he does make often win big.

After 15 years at brand-name brokerage houses, Bruce Berkowitz saw starting his own money-management firm in 1997 as a badly needed change of pace. "Asset management at big Wall Street firms can be very blah," he says. "Too many meetings with 12 people, reaching the level of intelligence groups that size usually reach."

Berkowitz's performance since starting Fairholme Capital has been anything but blah. He now manages $3.7 billion and his flagship Fairholme Fund has returned 18.7% per year – vs. a 0.4% annual loss for the S&P 500 – since its launch in 1999.

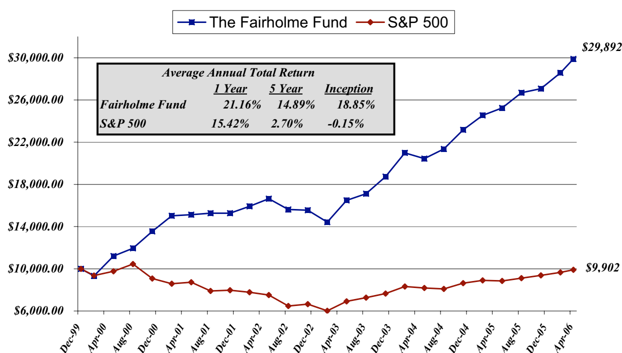
Often betting more on the "jockey than the horse," Berkowitz sees opportunity today in cyclical businesses such as energy, insurance, media and telecom. See page 2

INVESTOR INSIGHT

Bruce Berkowitz
Fairholme Capital Management

Investment Focus: Seeks companies trading at low multiples to free cash flow that are also "genetically engineered" to prosper through adversity.

Value of $10,000 Invested at Inception to April 30, 2006
The Fairholme Fund vs. The S&P 500



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Investor Insight: Bruce Berkowitz

Bruce Berkowitz, Larry Pitkowsky and Keith Trauner of Fairholme Capital Management explain why they favor companies that thrive in downturns, how investing is like investigative reporting, why it *is* different this time in energy and why they believe Canadian Natural Resources, EchoStar Communications, Berkshire Hathaway and IDT Corp. are undervalued.

You've described a central element of your strategy as being a "silent partner" with great management. Explain that.

Bruce Berkowitz: We're focused on a few basic principles. We look for companies generating or holding a lot of cash, trading at reasonable prices, where we can't figure out how we can fundamentally lose, and that are run by smart, honest people with great records who have their money where their mouth is.

We do tend to be more about the jockey than the horse. It's important to understand how people are going to behave under stress. You don't have to predict the future if you know the company has the assets and management to do well in difficult times. I believe that's when the seeds for exceptional performance are planted. This all may mean we don't make as much in roaring bull markets, but that's fine with me.

Berkshire Hathaway is our largest holding because of Warren Buffett. Leucadia National is a large holding because of Ian Cumming and Joseph Steinberg. We think Eddie Lampert at Sears is a young member of that group. If you can convince yourself that the real estate values are there and the Sears brand is sufficiently strong that you're getting Lampert's skill for free, that's a pretty good deal. In real estate, Michael Ashner is one of those guys and the world doesn't know it yet. [*Note*: Ashner is CEO of both Winthrop Realty Trust, of which Bruce Berkowitz is a Trustee, and Newkirk Realty Trust.] He's genetically engineered for that business and for difficult times.

You seem to be describing the traits of great value investors – contrarian, seeing opportunity in uncertainty and chaos.

BB: Yes, but these are also people who are great operators and managers, with excellent people skills – not qualities value investors are necessarily known for.

How are the companies you buy engineered for difficult times?

Larry Pitkowsky: EchoStar is an example, which we'll talk more about later. Charles Dolan at Cablevision, who is a brilliant guy, decided a few years ago that satellite was the best way to deliver national high-definition TV, so he put up a beautiful satellite and created a subsidiary called Voom to make it happen. But after a disagreement with his board, the company decided to dump the idea. EchoStar swooped in and bought Voom's $300 million satellite, with no launch risk, for $200 million. You either run your business that way or you don't – there's a genetic element to it.

On the last conference call, [EchoStar Chairman] Charlie Ergen talked about his poker-playing days – he played professionally for a few years – and how he'd start playing at 5 p.m. and might fold every hand until 5 o'clock in the morning, when he'd have a great hand and bet it all. That's just how someone like that exists.

BB: For the big energy positions we've taken, we looked very carefully at whether they were able to build value when oil was at $20 per barrel. There are different things you do in a lower-price

Bruce Berkowitz

Larry Pitkowsky

Keith Trauner

Learning by Doing

Having recruited two long-time industry associates, Keith Trauner and Larry Pitkowsky, to join Fairholme Capital in 1999, Bruce Berkowitz was ready to launch the firm's first mutual fund – but on the cheap. He bought fund management software for $700 from someone in Pennsylvania running his mutual fund operation out of his house. For support, he hired a no-name accounting firm from Cleveland and a sole-practitioner lawyer in Texas. Marketing? "Not a dollar," says Berkowitz.

Why the frugality? "Given that we were trying to figure out if there was a business there, we thought this was the right way to go," he says. "If it didn't work, it wouldn't be a big deal. It's not dissimilar to the type of thinking we like to see in managers of the companies we invest in."

With the Fairholme Fund now highly successful, Berkowitz, of course, has long since upgraded the fund's systems and support. "You know, a lot of business success comes from knowing both what to invest in and when to invest in it," he says. "I've found that applying the investment principles you learn as an investor can make you a better business person, and becoming a better business person should make you a better investor."

environment and they built incredible value then.

Canadian Natural Resources has accumulated gross interests in more than 14 million square acres of resource land. Where did they get it from, who did they get it from and when? The paper trail of good decisions is very important to us.

Describe how you try to "kill" your ideas.

BB: Energy is a great example. Our original thesis was that certain oil companies, because of hedges they'd made, were still earning as if oil were at $20 per barrel, even through oil was at $40. As the hedges came off, earnings would go way up and so would the stock prices.

We got particularly interested in Canadian companies, which we found to have more impressive management than most U.S. firms. They were engineers, more down-to-earth and more long-term, strategic thinkers. While the big majors were talking about how they couldn't replenish reserves fast enough, you had these Canadian companies that appeared to have endless resources.

Not only that, but you could buy them for 5x free cash flow! That's how we look at everything: What kind of cash can you pull out of the business if your goal is just to keep the franchise humming at the same level forever? Every dollar spent beyond maintaining the franchise we add back because it's a capital-allocation decision. Then you have to ask yourself whether they're good capital allocators.

We didn't believe these companies could possibly be that cheap, so we worked very hard to figure out what would make us wrong. We talked with geologists and hired consultants – one a former employee of the Department of Energy – anyone who could help us better understand the industry and the risks. That's what I mean by trying to kill the idea.

What did you conclude in this case?

Keith Trauner: Our only macro view about energy was that the supply of cheap oil was disappearing. There's plenty of oil, but you just can't find it and produce it cheaply. That makes the likelihood we return to $20-per-barrel oil very low.

BB: The physics make sense to us that this is a resource that's being used up. Every major field outside of Saudi Arabia is in decline. Those people who talk about this endless supply of oil regenerating and bubbling up from the center of the earth, where is it?

ON ENERGY PRICES:

Other than a deep U.S. recession, it's hard to see what would make prices go down much over the next five to ten years.

Then we started working through the alternatives: nuclear power, solar, wind, oil shale, coal-to-gas. I made myself crazy one weekend trying to figure out the potential for ethanol. All of these have their own problems – from safety, to capacity constraints, to cost, to lead times – and it's going to be hard for any of these to compete with oil even at today's prices.

We were lucky to have had a relatively mild winter. There was the potential for a real gas shortage this winter – forget what the price would have been. There are so many scenarios that would take us off that knife-edge of supply and demand. Can you imagine if Al Qaeda succeeds in taking out a Saudi pumping facility or sinks an oil tanker in port?

KT: The only scenario we see where you get excess supply is a deep U.S. recession, which probably also slows down China and would temporarily decrease demand. Other than that, it's hard to see what creates enough supply over the next five to ten years to make prices go down much.

What types of valuations generally attract your attention?

BB: We're looking to pay 10x free cash flow or less, period. If you find those and you can't kill the business, you should be buying all day long.

So the high-quality big caps many value investors like today, such as McDonald's, Anheuser-Busch or Wal-Mart, are too pricey for you?

BB: Yes, we're going to miss them for now. The only way we might get more flexible is to develop a better appreciation for how to calculate free cash flow in businesses that are growing. If the returns on investment are high, the free cash flow could come out a lot higher in a few years than we typically model.

A lot of smart guys are buying CarMax, for example, and we've been trying to figure out why, given its multiple. If CarMax stopped growing, arriving at a free cash flow number goes way beyond looking at depreciation, amortization and maintenance capital spending. You have to figure out how marketing spending would change, how SG&A would change. We're still honing in on the correct concept of free cash flow in such cases.

KT: We're not at the point where we'd look at something trading at 20x free cash and think it's cheap because the reinvestment rate is so high. Businesses that are changing quickly, like Google, are tough for us to get our hands around.

BB: We've always done very well when we can use sixth-grade math on the back of a postcard to show how inexpensive something is relative to its free cash. Once we start getting more sophisticated – trying to prove something rather than see if we can disprove it by killing the business – we get into trouble.

Where do your ideas come from?

BB: We don't have a rigid process, but there are always linkages. My first investment 20 years ago was Fireman's Fund. Studying Jack Byrne's resuscitation of GEICO before going to Fireman's Fund led me to Berkshire Hathaway and this guy Warren Buffett. Then during the

banking crisis in the early 1990s I looked at many banks, but chose Wells Fargo because Warren Buffett owned it.

We also use a lot of grapevine ideas, asking people what they have finished buying that might be interesting. Why wouldn't you look at what other great investors have found? That's how we found Penn West Energy, which then led us to Canadian Natural.

Once you identify a possible idea, where do you focus your research?

BB: Most of it is just investigative reporting. When we first starting researching WilTel Communications, we found in the bankruptcy documents, attached to an affidavit, the master contract the company had with SBC Communications, giving them all of SBC's long-distance business for the next 17 years. It was publicly available, but not easy to find.

At the time, SBC only had long distance in Texas and a few other states, but they were going into California, Michigan, Illinois, Indiana, Ohio and Wisconsin, which was going to expand their long-distance business by five or six times. That made it pretty easy to think about WilTel's future revenues. So for an $800 million market cap, you had guaranteed growth for a state-of-the-art network that needed more traffic, $7 billion worth of tax benefits and modest debt after coming out of bankruptcy. We figured how could you go wrong?

KT: There was also a provision in the SBC contract with WilTel laying out what happened if SBC bought another nationwide long-distance carrier – which they did in buying AT&T – and it didn't say SBC could walk. By the way, knowing that gave us the opportunity to buy Leucadia shares when its stock tanked after the AT&T announcement [Leucadia then owned 100% of WilTel], because the market thought WilTel's main revenue stream was going away. We knew it wasn't, or that they'd have to be well compensated if it did. Leucadia went to the low $30s per share at the beginning of 2005, and now it's almost double that.

Are you big on financial modeling?

KT: We try at a very basic level to understand the nature of the transactions in the business, which isn't always obvious. We spent an incredible amount of time, for example, thinking through how property and casualty insurance is sold and how the money flows through the process. We try to keep our spreadsheets manageable, but have found that the right model – where you're able to see how a change in one variable affects everything else – can often trigger a better understanding of the business than you had before.

Tell us more about your largest energy holding, Canadian Natural Resources [CNQ].

BB: This is a diversified oil and gas company that I'd never heard of before we started looking into it, even though it had about a $10 billion market cap at the time. As I said earlier, we're very impressed with the management, which has an outstanding track record of success across several market cycles and now has over $1 billion invested in the company. We think this will be a household name one day.

INVESTMENT SNAPSHOT

Canadian Natural Resources Ltd.
(NYSE: CNQ)

Business: Vertically integrated energy company with primary oil and natural gas reserves located in Canada, the North Sea and off the coast of western Africa.

Share Information
(@4/27/06)

Price	**60.02**
52-Week Range	24.59 – 64.38
Dividend Yield	0.4%
Market Cap	$32.19 billion

Financials (TTM):

Revenue	$7.69 billion
Operating Profit Margin	19.3%
Net Profit Margin	12.0%

Valuation Metrics
(Current Price vs. TTM):

	CNQ	S&P 500
P/E	35.5	21.5
P/CF	11.9	14.8

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Capital Research & Mgmt	8.1%
Fidelity Mgmt & Research	7.4%
Barclays Global Inv	3.7%
Wellington Mgmt	3.0%
Neuberger Berman	2.5%

Short Interest (As of 3/8/06):

Shares Short/Float	1.8%

THE BOTTOM LINE

Enormous proven oil-sands reserves and first-rate management give the company the potential to double production and triple free cash flow generation over the next eight years, says Bruce Berkowitz. Applying multiples on proven reserves at which other energy companies have recently been sold, the share upside "gets crazy," he says.

Sources: Company reports, other publicly available information

The company is moving from a reliance on natural gas and heavy oil to being a light, sweet-grade oil company. That will happen as they continue to develop their Horizon oil-sands project in Alberta, which has no exploration risk. The upgraded oil from the sands will be a light synthetic crude oil that will get a premium price to West Texas intermediate.

Right now Canadian Natural produces more than 500,000 barrel equivalents per day in traditional production, which will roughly double over the next seven years as Horizon starts up and they develop other conventional assets.

Doesn't the sheer magnitude of the Horizon project scare you?

BB: It is an enormous project. The first stage will cost $6 billion to begin producing synthetic crude in three years. They'll spend more than $15 billion on the entire project by the time they're done. But the amazing thing is that it will all be funded from free cash flow, with no additional debt. We also like that they're not sacrificing any of their conventional business – they just had a nice find off the coast of West Africa and they have other promising development projects in South Africa.

KT: The market does seem concerned by the execution risk, which is not ridiculous given some of the disasters others have had with time delays and cost overruns on oil-sands projects. But we're very comfortable with these guys' track record of delivering on exactly what they say they're going to do.

Do the oil-sands economics only work at high oil prices?

KT: They're looking at an operating cost of less than $18 per barrel coming out of Horizon. They've based the economics of the project on $28 oil, and at that level expect to earn a double-digit IRR.

BB: We've already talked about our macro view of the price of oil, but we bought here into a management and at prices that made us not worry too much about the price of oil. We certainly don't need prices to stay at current levels for this to be a great investment.

We'd argue now that further oil-price increases wouldn't be welcome. You don't want to push the world into recession, or to prompt governments to start slapping tariffs and surcharges on oil.

CNQ stock, now around $60, has been on a bit of a tear. How are you thinking about valuation?

BB: It still trades at less than 10x free cash flow of about $6.50 per share, for a company with the ability to double production and triple free cash flow over the next eight years without having to add any new assets.

ON TELECOM "BUNDLES":

Years ago in financial services everybody also thought you had to offer everything to win. The concept was pretty much a bust.

This is one where we don't really have an upward value range on it, because the numbers get crazy. They have six billion barrels of recoverable reserves in the oil sands and another three billion barrels in heavy oil/bitumen properties. That's nine billion barrels of oil before you even talk about their conventional oil and gas reserves, which are approaching the equivalent of 2.5 billion barrels.

KT: The assets aren't exactly the same, but Chevron bought Unocal in 2005, on average, for $12 per barrel in the ground, although much of that related to lower-value gas reserves. Apache Corp. announced just last week that it paid the equivalent of $22 per barrel in the ground to buy 18 Gulf of Mexico properties from BP. Applying anything like those numbers to Canadian Natural's assets, and, as Bruce said, the upside does get crazy.

BB: We know that if oil goes down to $40, this stock probably gets hit hard. But based on our long view on the price of oil and the company, that will be a hell of buying opportunity.

Your next idea, EchoStar [DISH], is in a much less popular sector at the moment.

BB: The market basically went from thinking Charlie Ergen could do no wrong to saying he doesn't know what he's doing and that EchoStar is the odd man out.

LP: But through all that the company has continued to grow profitably, when almost no one else in the business has. They're now the third-largest pay-TV provider after Comcast and DirecTV. They added over a million net subscribers last year and the subscriber base has tripled since 2000, to just over 12 million at the end of last year. You can't get better proof of the value proposition than that.

Isn't a big knock on EchoStar that it's vulnerable to competition from voice, Internet and TV packages being rolled out by cable and phone companies?

BB: Yes, but we've seen this before. Years ago in financial services everybody thought to win you had to offer everything – banking, insurance, credit cards, brokerage. It turned out the financial supermarket concept was pretty much a bust.

Now you see the same argument in the media and telecom business – you have to offer telephone, broadband and TV in one package or your business is going to hell. I just don't believe that's how people buy. They want the best TV experience, product and service. They want the best broadband offer. They want value for money. They don't care if it all comes from one place. Just look at who's growing and who isn't growing. Old ways are much stickier than you think.

LP: EchoStar has worked very hard to be the low-cost television provider. A basic package, with local channels, from

EchoStar is about $35 per month, while the comparable package from Comcast or Cablevision is over $50. In mid-tier and high-end packages, EchoStar consistently has a $20 per month price advantage over cable – and the cable offers aren't even all digital.

KT: One of Wall Street's fears about pay television is a rate war, led by the phone companies. But amid all this concern, everybody in the industry raised prices a few months ago. We just don't believe the cable or phone companies can afford a price war, especially against the satellite companies.

Jim Chanos (*VII*, July 29, 2005) says that in a digital world, content distributors are at risk of being disintermediated by the Internet. Does that concern you?

LP: The flaw in that argument is that the content still has to get there somehow and the content providers have to make money. There's no way an HBO or an ESPN is going to make as much money on an a la carte basis as they do under the current system. That wouldn't at all be good news for them. We actually think the more the industry moves toward a la carte pricing, distributors get stronger and the content providers weaker.

How important is management in your appraisal of EchoStar?

BB: We think Charlie Ergen is a great jockey who has done an unbelievable job, who clearly has skin in the game with 240 million shares. He was the last guy into the business and he's now got 12 million subscribers.

LP: They've been excellent operators. They're always looking at the math of adding subscribers and, if at some point it doesn't make sense, they'll do something else. It's rare to hear management say that, but it's even rarer that they actually do it.

EchoStar has been great about upselling. They have the most attractive introductory package, but their average revenue per subscriber shows that they've done a good job of gradually inching people up through attractive offers.

What else gives you confidence he's positioned the company well for the future?

LP: They have very nice options on the upside. They're great engineers and make their own set-top boxes, with technology not unlike what Cisco just paid billions for in buying Scientific-Atlanta. While they sell some boxes to a Canadian pay-TV operator, they have more potential here. They'll also certainly have a broadband Internet solution, as soon as it's economical enough to provide it.

In many ways we believe satellite technology is superior. It's better for providing high-definition TV on a national basis. Look at how the capital expenses scale: a few $200 million satellites in the sky allow you to deliver video programming to the entire nation, which is quite compelling vs. the cost of laying fiber to reach fewer people. In an increasingly wireless world, with 14 satellites now up, we think they have very valuable real estate in space. They just for the first time named an executive vice president of fixed-satellite services and are talking about providing wholesale satellite service to other companies. This makes sense to us as a natural add-on business.

INVESTMENT SNAPSHOT

EchoStar Communications
(Nasdaq: DISH)

Business: Pay television service under the DISH Network brand, delivered by 14 owned or leased satellites to just over 12 million subscribers in the U.S.

Share Information
(@4/27/06)

Price	**30.92**
52-Week Range	24.44 – 32.33
Dividend Yield	0.0%
Market Cap	$13.74 billion

Financials (TTM):

Revenue	$8.43 billion
Operating Profit Margin	13.8%
Net Profit Margin	18.0%

Valuation Metrics
(Current Price vs. TTM):

	DISH	S&P 500
P/E	9.6	21.5
P/CF	6.4	14.8

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Fidelity Mgmt & Research	5.3%
Barclays Global Inv	4.4%
Harris Assoc	2.9%
HBK Inv	1.5%
Fairholme Cap Mgmt	1.5%

Short Interest (As of 3/8/06):

Shares Short/Float	6.9%

THE BOTTOM LINE

At only 6x his estimate of 2007 per-share cash flow, the company's shares are priced as if it will be the "odd man out" in a changing media/telecom industry, says Bruce Berkowitz. But he expects strong technology, disciplined management and "interesting upside options" to result in a doubled share price in the next two to three years.

Sources: Company reports, other publicly available information

How troubling was the recent court ruling that EchoStar had infringed on Tivo's digital video recorder patents?

LP: It doesn't change our thesis at all. In the doomsday scenario, EchoStar has to pay treble damages on the $73 million award, and then pay some sort of licensing fee going forward. Even if that happens, they can easily absorb the cost without missing a beat.

But there are a lot of reasons to believe the end result of all this will be very different from that first ruling. EchoStar has a lot of experience with intellectual property and technology development, and we think they're right when they say the ruling is just the beginning of a very long process.

EchoStar shares, at just under $31, are at the same level they were five years ago. What do you see as the upside?

BB: If they continue to grow as they are, we expect them to generate free cash flow of around $4 per share this year and over $5 per share, pre-tax, next year. (By the end of next year they will have used up their remaining net operating loss carry-forwards.)

So for 6x next year's free cash flow, you get a company growing nicely, buying back stock and with some interesting upside options. We would not at all be surprised to see the share price double in the next couple of years.

Another stock that's done next to nothing for several years is Berkshire Hathaway. What's going to change that?

BB: The market's not going to react until they see it all coming together. One day before long – maybe it's this quarter – everything's going to hit on all cylinders and earnings are going to explode.

We're focused simply on the fact that this should be a great year for Berkshire Hathaway. They're earning significantly more on their cash hoard. The acquisitions they've continued to make, such as PacifiCorp in the utility business, will start showing up in a bigger way in earnings. Investments per share should go up nicely. We also think the property/casualty insurance business, given the historic amount of losses last year, is going to improve significantly. They're going to be able to write as much business as they want at higher prices.

KT: It's really quite remarkable that during a year with the largest insured catastrophe ever [Hurricane Katrina], Berkshire still made money on its float in 2005.

BB: Another thing people don't seem to realize is the earnings leverage Berkshire has. If they ever took the pedal off the metal of some of the businesses they're investing in, like NetJets and GEICO, you'd see the operating earnings jump significantly. They spent $500 million – more than $300 per share – just in GEICO advertising last year.

Do you think the fear of Buffett's mortality at all weighs on the stock?

BB: Perhaps, but he still looks and acts like he's at the top of his game, and there are a lot of smart, talented people there. He basically keeps the key players happy and does the capital allocation. How else could he spend so much time playing

INVESTMENT SNAPSHOT

Berkshire Hathaway
(NYSE: BRKA)

Business: Holding company for operating businesses and extensive investment portfolio. Primary operations in insurance, utilities, finance and building products.

Share Information
(@4/27/06)

Price	**88,000**
52-Week Range	78,800 – 91,200
Dividend Yield	0.0%
Market Cap	$135.52 billion

Financials (TTM):

Revenue	$81.66 billion
Operating Profit Margin	15.2%
Net Profit Margin	10.4%

Valuation Metrics
(Current Price vs. TTM):

	BRKA	S&P 500
P/E	15.9	21.5
P/B	1.5	4.1

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Ruane, Cunniff & Co.	2.9%
Fidelity Mgmt & Research	1.7%
Davis Selected Adv	1.6%
Capital Research and Mgmt	1.4%
Barclays Global Inv	0.8%

Short Interest (As of 3/8/06):

Shares Short/Float	0.2%

BRKA PRICE HISTORY

THE BOTTOM LINE

"One day, before long, everything's going to hit on all cylinders and earnings are going to explode," says Bruce Berkowitz. Making what he believes are conservative assumptions about investment returns, underwriting profitability and float growth, he believes a reasonable target price for each A share is $150,000, 70% above today's level.

Sources: Company reports, other publicly available information

bridge and talking to college students, if he didn't have excellent people running his businesses? Who allocates the capital when he's gone will obviously be an issue one day, but you have no idea when that will be – and how much higher the stock price might be by then.

You can also look at it another way. If on the day Buffett left, Berkshire announced it was selling itself in pieces, I'm very confident that the stock would do very well.

Do you think they should start returning some of their cash hoard to shareholders?

BB: In general, it's a very good policy that if a company can't use its money productively, it should give it back to the owners and let them use it. That's possible here, but we're not focused on that.

Berkshire is the perfect example of a company genetically engineered for adversity. The liquidity they have to take advantage of opportunities created by a crisis is really unique. I truly believe the big money in Berkshire will be made after some sort of blow up. I can sleep pretty well with that.

Do you value Berkshire, now trading at $88,000 per A share, the same way you do other companies?

BB: If you normalize results for low-yielding cash and investments, and make some adjustments for growth spending, Berkshire actually trades at a reasonable multiple to free cash flow. I'll admit, though, that we're not as diligent about how we calculate free cash flow here, because of who it is and the strength of the balance sheet.

Historically, you've done very well to buy Berkshire when its price gets below its investments per share plus 10x the earnings per share of the operating businesses, which currently comes out to $98,500 per share. That's with no franchise value and basically assuming nothing really improves.

KT: We take the valuation further by making some conservative assumptions. We assume they break even on underwriting, and they've done better than that for a long time. We assume their current investments are worth no more than market value. We estimate a 2% after-tax return better than 10-year Treasuries on the investments, which we don't think is a crazy number. We also assume float grows by 3% per year, which is wildly low compared to what they've done historically. Under those assumptions, we arrive at a target share price of $150,000.

LP: Berkshire is one of those cases where if it continues to build value and we're paying an attractive price, it's not worth the effort to worry much about catalysts. The value will eventually come out.

Now for something completely different – tell us about IDT Corp. [IDT].

KT: IDT is an example of the type of special situation we look look for, in which something has had the crap kicked out of it, there's some good protection of our value, and maybe some very good things can happen.

IDT's basic business is selling 400 million calling cards per year, largely to the Hispanic community in the U.S. That's a great business, which we think is more

INVESTMENT SNAPSHOT

IDT Corp.
(NYSE: IDT)

Business: Telecommunications services, primarily through sale of prepaid calling cards. Significant secondary operations in entertainment production and distribution.

Share Information
(@4/27/06)

Price	**11.14**
52-Week Range	10.69 – 14.23
Dividend Yield	0.0%
Market Cap	$1.07 billion

Financials (TTM):

Revenue	$2.48 billion
Operating Profit Margin	(-6.9%)
Net Profit Margin	(-4.0%)

Valuation Metrics
(Current Price vs. TTM):

	IDT	S&P 500
P/E	n/a	21.5
P/CF	n/a	14.8

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Oppenheimer Funds	10.6%
Dimensional Fund Adv	5.9%
Fairholme Cap Mgmt	4.7%
Third Avenue Mgmt	4.0%
Jennison Assoc	3.1%

Short Interest (As of 3/8/06):

Shares Short/Float	4.6%

THE BOTTOM LINE

With a healthy core calling-card business, $850 million in cash and a dynamic management team investing in several new businesses, Keith Trauner sees the company as the type of special situation for which "very good things can happen." Just one new entrepreneurial success, he says, could double the share price from today's $11.14.

Sources: Company reports, other publicly available information

resistant to disintermediation than some people think. The buyers of these cards are not going to be making calls using the Internet. It's a very local, distribution business and IDT has strong control over that. They have a strong private-label business, doing calling cards for companies like 7-Eleven and Walgreens. They own or lease their own network assets, which are relatively low cost, with gateways into some 60 different countries.

Beyond that, the company has what is basically a venture-capital business that throws a lot of things at the wall and tries to see what sticks. They have a tremendous amount of cash – about $850 million – which came from the partial sale of Net2Phone to AT&T. The cash comes to more than $8 per share, for a company trading at around $11.15.

Why has the stock been such a bust?

KT: Historically, the operating cash flow of the basic calling-card business was sufficient to fund all the extraneous investments. In the last year, though, they entered a major investment cycle and they're now spending more than the cash flow. The market is understandably concerned with that, given that IDT is eroding its safety net.

BB: There are some other negatives. They bought network assets of Winstar Communications out of bankruptcy, which looked like a tremendous bargan at the time but turned out to be a disaster. The corporate governance is suspect and in the past they've given out stock options like drunken sailors. They're now offering to buy all the options back at $2 per option, no matter what the strike price is, which is ridiculous.

But you know what, with all that we actually like Howard Jonas, the founder and chairman. He's a quirky, Howard Hughes-type of character who doesn't even show up at his own annual meeting. But he loves business and is a real entrepreneur, and unless I'm being totally snowed – which could happen – I think he surrounds himself with very high-energy, intelligent people.

What is the company investing in?

KT: They have a major push right now on pre-paid cell phones, also to the Hispanic community. They rolled out last quarter in Washington, D.C. and New York City and will launch in other major markets in the next few quarters. The international rates on these phones are very cheap and they've found that people with phones double or triple their minutes of use over calling cards. This effort will cost about $25 million this year.

In Europe, they're spending another $25 million on a telephone/Internet business called Toucan in the U.K. and the Netherlands. They also recently bought Net2Phone back, for next to nothing. Net2Phone essentially invented the Voice over Internet Protocol [VoIP] business and they have some 40 patents for the technology. We're not patent experts, but we think they have some valuable technology in a business that's growing very rapidly.

ON IDT ENTERTAINMENT:

You can't make this stuff up. The first film is based on a story [IDT founder] Howard Jonas told his kids when they were young.

One of the biggest bets IDT is making is on entertainment. Two or three years ago they put money into a software company that allowed computer animators to work in physically disparate locations and collaborate on the same project. Out of that and through acquisitions, they've built a full entertainment distribution and production company doing about $200 million in revenues per year. They have a DVD distribution business, are the back room for some well-known animated shows like *The Simpsons* and have produced an original series for Showtime.

Now they're building out the entertainment company centered on computer-generated animated films and live-action productions. They've attracted very good people to run the business. Neil Braun, who is president of feature films and television, was the president of the NBC television network. Janet Healy, the president of animation, built the first computer-generated animation studio in Los Angeles for DreamWorks. Chris McGurk, who just came on as a senior advisor for new ventures, was the vice chairman of MGM.

The company's first animated feature, *Everyone's Hero*, is coming out in September. They're doing the animation work for a *Simpsons*' movie coming out in 2007 and keep adding to the production slate.

BB: You can't make this stuff up. The first feature film they're doing is based on a story Howard Jonas told to his kids when they were young.

What upside do you see for the stock?

KT: We basically look at this as having a decent core business, which generates about 80 cents per share in free cash flow, with options on several promising venture businesses. At the current share price, net of the $8 per share in cash, you're paying less than 4.5x free cash flow. The trick will be how quickly the new businesses stop eating into cash and start paying off. We're also encouraged by the fact they seem to be watching overhead more carefully, have been buying back stock and have slowed options issuance.

This is one that's hard to value, but we think if they have any real success in entertainment alone, the stock is worth at least double the current price. If some of the other investments hit also, there's a lot of upside.

BB: The fact that they're eating into cash for the investments obviously worries us, but if you've got the right guy doing it, we're OK with the model of using a cash-cow business to fund venture-capital investments. At the current stock price, we like the odds of something good happening here.

Switching gears, tell us about some mistakes you've made.

BB: Most of them have been errors of omission rather than commission. We completely blew it on USG, for example. We counted the cash, the cash was there, and we valued the business perfectly when the stock was only in the single-digits. But we didn't buy for a couple of reasons. For one, we were naïve about the bankruptcy process and couldn't get our brains around the asbestos litigation. We also lost faith in management.

KT: In this case our read on management led us to the wrong conclusion. We couldn't get over the CEO coming out in the annual report and saying he thought the equity might be worthless.

So that one hurts, with USG now at $106.

BB: It's pretty bad. But you know, the psychology set in and we were paralyzed. It doubles and you think you can still get in, but then talk yourself out of it because it's already doubled.

They did us one favor. We had no knowledge worth talking about in bankruptcy and, because of how badly we screwed up with USG, we made ourselves understand the entire process. That helped us get in early to both WilTel and MCI.

Are there sectors you avoid based on bad experience?

BB: I'm starting to feel the catastrophic reinsurance business is one to avoid down the road. To do it, you have to be able to do what Berkshire Hathaway does, be very diversified and always walk away when you don't get the price you want. To be a monoline catastrophic reinsurer makes no sense over any reasonable period of time.

All the actuarial work in insurance is based on the assumption that over a long enough period, the numbers work in your favor. But as last year showed, catastrophic reinsurance is a business that can be killed. But if you go into a business that can be killed, you may either be forced out or have to double down to stay in the game before it works out. That whole thing is just such a distasteful process.

ON HOLDING CASH:

The older I get, the more I see it as a strategic asset. We're just behaving like the companies we like to invest in.

You've gravitated in the past to sectors under cyclical stress, such as insurance and telecom. Cyclicality doesn't bother you?

BB: We don't have a problem with cyclicality. Wall Street still looks for certainty in areas that are uncertain. We feel good about lumpiness. We just try to be cash counters – if you can buy something at 5x free cash with limited chance of permanent impairment, even if it earns only half of what we thought, that's okay.

What cyclically stressed areas are you currently exploring?

BB: When Alan Greenspan came out and said anyone who hadn't prepared for a rise in interest rates was desirous of losing money, we started paying a lot of attention to financial institutions that might get hurt as rates rose. But we really haven't seen the stress there yet. You would think the consumer-finance operations of banks would start to be under stress. But the share prices just don't reflect that. In the late 1980s and early 1990s, many banks were trading far below book value. I'm not saying the periods are directly comparable, but banks aren't close to that now.

KT: We are seeing stress in homebuilders, which appear somewhat priced to fail.

Traditionally, this group was like it was with General Motors: the time to buy was when they were losing money and the time to sell was when they were at 5x earnings. Some people think homebuilders' business models have changed and things are different now. We're looking at it, but we're still not clear on how much free cash flow these firms can really generate in a downturn. Even when the markets were going up, they kept pouring money back into lots at higher prices.

You typically hold 20-30% of your portfolio in cash. Why?

BB: We have 65,000 to 70,000 investors in our mutual fund. We usually hold less than 20 positions at a time, so no one would ever say we're a place to put all your money, but we behave as if that's what people have done. So we think it's reasonable to have some cash around for emergencies – as Buffett says, why risk what you need for that which you don't need?

We used to think having cash was a byproduct of not having enough to do. But the older I get, the more I see it as a strategic asset. It allows us to take advantage of those great opportunities that come up from time to time. We're just behaving like the companies we like to invest in.

Many smart investors are paying more attention to international opportunities. Are you?

BB: We keep heading more toward direct international investing, but worry that we're going to be the patsy. We looked at South Korea, but kept asking ourselves what edge we really had there. How do we understand the culture, the management?

The U.S. is going through the same decline faced by all past great civilizations. It's in the nature of things. It takes a very long time and happens in 10,000 different ways. All smart companies and investors need to respond to that. We actually look at our energy bets as more of a global play on the fact that three billion new capitalists in Asia are going to have a significant impact on future energy demand.

The good thing about investing is that you don't have to do everything to be successful. There are plenty of different ways to make money. VII

For additional information, please visit our website at: **www.fairholmefunds.com**

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