FIDUCIARY MANAGEMENT, INC.
Investment Counsel

100 East Wisconsin Avenue, Suite 2200
Milwaukee, Wisconsin 53202
414-226-4545

# INVESTMENT STRATEGY OUTLOOK - LARGE CAP VALUE

Quarter Ended September 30, 2004

The September quarter was down slightly, modestly better than the benchmark Standard & Poor's 500 Index. The largest contributor to the relative performance was the underweight position in technology, a group that declined significantly in the quarter. The materials sector outperformed the benchmark considerably as strong cyclical demand prevailed. The energy sector was up notably in absolute terms, although we slightly underperformed the S&P Energy sector for the quarter. Oil tripped $50 per barrel at the end of the quarter. Concern about slowing economic growth was reflected in the bond market, with the 10 Year Treasury Bond rallying to 4.1% from 4.6%.

Although the government recently revised its second quarter Gross Domestic Product (GDP) to 3.3% from the 2.8% figure originally reported, there was widespread belief that the economy had hit a proverbial "soft patch." Several high profile earnings misses seemed to remind investors that the elevated growth rates experienced over the last few quarters were not sustainable. This was especially true in the technology arena. High raw material prices, particularly steel and energy, caused additional earnings problems. High gasoline prices were cited as a significant factor in the numerous earnings misses among retailers. The U.S. consumer is loaded with debt. Furthermore, the market appeared to be rattled by continuing problems in Iraq.

Despite this litany of negatives, the economy still appears to be growing. China and India continue to grow rapidly and worldwide GDP growth has improved. The International Monetary Fund's recently published economic survey predicts 5% worldwide GDP growth in 2004, the fastest rate in 20 years. Employment numbers, while choppy, have generally been better. Real wages, which have been weak for a few years, are showing nascent signs of improvement. Corporate balance sheets continued to improve in the September quarter. The reported "core" inflation rate is under control, but as we have discussed in the past, the official measurement may significantly understate true inflation.

Last quarter's letter articulates our current thinking on some of these big picture issues. Quickly summarizing, the consumer remains stretched due to a weak balance sheet. Housing prices look inflated and the refinancing wave, which positively impacted consumer spending in recent years, appears to be largely over. Additionally, and perhaps most importantly, stock market valuations are high by historical standards. This, along with the aforementioned factors, lead us to remain cautious and careful.

As is our custom, we offer some comments on a few of the holdings in the portfolio. Below are two new additions to the portfolio, ARAMARK Corporation and Cardinal Health.

## ARAMARK CORPORATION

*Description:*

ARAMARK is leading business outsourcing company, providing managed food, facility support, and uniform rental services in the United States and internationally. The company's business is segmented into two primary divisions, Food & Support Services, and Uniform. The Food &

Support division (85% of revenues) includes the management of cafeterias, food courts, hotels and conferencing centers, and providing custodial and maintenance services. The Uniform division includes the rental and sale of uniforms, mats and safety equipment. ARAMARK has approximately 200,000 employees serving clients in 18 countries.

*Good Business:*

- ARAMARK enjoys a recurring revenue business model and is a leader in the majority of the markets it serves.
- The company should continue to benefit from the trend to outsource non-strategic business functions. The markets ARAMARK serves are largely under-penetrated.
- ARAMARK is a very strong cash generator, with free cash flow at net income or above.
- Return on invested capital (ROIC) approximates 11%.
- An estimated 50% of the company's end-customers are recession resilient.

*Valuation:*

- At current prices, the shares trade at 18x 2004 fiscal year end (September) earnings per share (EPS) estimates and 15x 2005 estimates. The enterprise value to earnings before interest, taxes, depreciation, and amortization (EV/EBITDA) multiple is currently about 8x.
- As the company is able to increase the profitability of newer contracts, and lever recent revenue growth to the bottom-line, the shares should obtain a higher multiple on next year's EPS. An 18x to 20x price-to-earnings (P/E) multiple on 2005 puts the shares at $30 or higher.

*Management:*

- Joseph Neubauer, chief executive officer and chairman, recently regained the CEO title following the ouster of William Leonard. Mr. Neubauer held the CEO position from 1983-2003, while Mr. Leonard had been president for years prior to his appointment as CEO last year. The board of directors has been disappointed with the execution and profitability of recent large health care contracts. ARAMARK performed well under Mr. Neubauer before — and his stake in the company, at 25 million shares, aligns his interests with ours.
- Fred Sutherland, chief financial officer, has been with the company since 1980.

*Investment Thesis:*

The recent disappointment in profit growth relative to revenue growth has concerned investors. We believe the company will improve its margins over the next few years as the mix improves, and start-up contracts mature. The valuation is attractive for a company with good growth prospects, high recurring revenue, strong cash flow and double-digit ROIC.

## CARDINAL HEALTH, INC.

*Description:*

Cardinal Health is the second largest drug distributor (45% of income), largest medical products distributor (26% of income), largest pharmacy automation supplier (17% of income), and a niche player in numerous healthcare products and services. Cardinal is a highly diversified health care company with an outstanding track record of profitability, growth and financial strength.

*Good Business:*

- Cardinal is a leader in important and enduring health care markets.
- Although drug distribution is in the midst of a transition, the inherent nature of this - and most of their businesses - is that of very good recurring revenue, and relatively inelastic demand.
- The ROIC has averaged 14-16% over the past 10 years, and is currently approximately 14%.
- Very little of Cardinal's revenue is related to capital goods. Most of their products and services are modestly priced and the businesses are not terribly difficult to understand.
- The balance sheet is good, and operating cash flow is strong.

*Valuation:*

- On a P/E basis, the stock is 13.6x fiscal 2005 (June) earnings. The 10-year mean P/E range is 14x to 44x. The price-to-sales ratio is .36x, in a 10-year range of .36x to .77x.
- The stock is near historic lows in valuation, from both an absolute and relative standpoint.
- The sum-of-the-parts valuation is approximately $66.
- Cardinal Health is trading at a significant discount to other health care companies with similar financial characteristics.

*Management:*

- Bob Walter has been chairman and chief executive officer since the company was formed in 1979. Cardinal has been built through a combination of internal growth and acquisitions. While we do not prefer a strategy of growth via acquisition, management's track record has been good.
- The leadership of the four divisions appears to have a good grasp of the challenges and opportunities in their areas.
- A recent investigation by the Securities and Exchange Commision (SEC) and U.S. Attorney's Office, and the recent resignation of the Chief Financial Officer, cast a cloud over management; however, we believe the fallout from this will be manageable.

*Investment Thesis:*

Cardinal's stock has fallen from the mid-$70s to the mid-$40s due to both the SEC and U.S. Attorney's Office investigation, and significant changes in the drug distribution model — which have negatively impacted results, and may continue to do so. Furthermore, Cardinal has experienced setbacks in their sterile technologies unit. We believe the investigations and the sterile technologies problems will have little long term impact. The biggest uncertainty is the ultimate profitability and growth of drug distribution, as the business model changes. The risk versus reward appears attractive at this level.

Thank you for your continued confidence in Fiduciary Management, Inc.