

permanently impaired?

Samberg: Yes. The infrastructure was ripped apart [by Hurricane Katrina]. One reason Tenaris and others have done well is there's a big replacement market. The only way to restore the Gulf fully is to spend a lot of money. But companies have been reluctant to spend it because they know they're not going to find much.

MacAllaster: Chesapeake insiders have been buying a lot of stock.

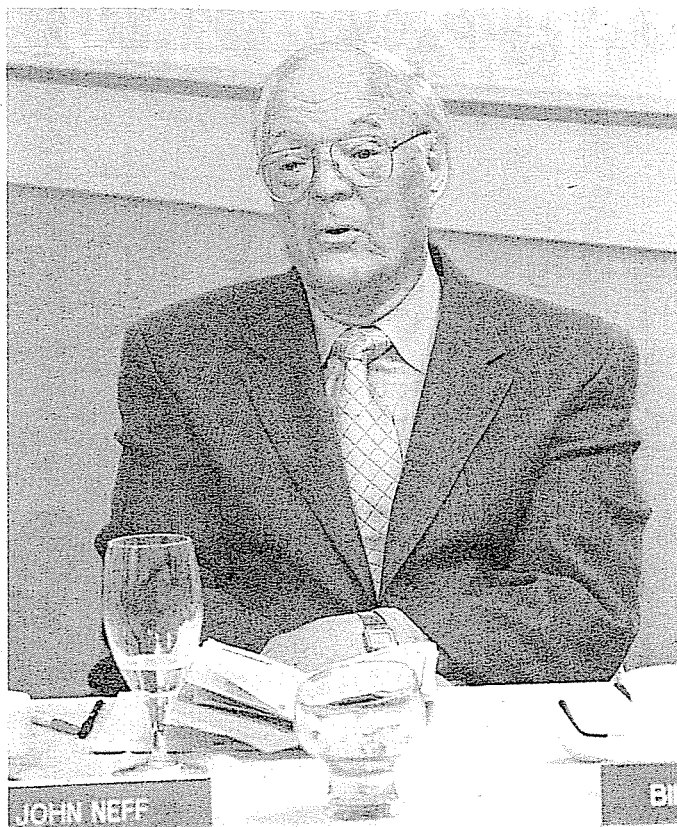
Samberg: The chairman bought \$100 million of stock last year, including \$72 million in December. Cross Timbers, now XTO, does not hedge. It has extremely good management, and has been able to increase organic production by 10% a year. The company's finding and drilling costs run about a dollar per Mcf [thousand cubic feet]. Others' are about \$1.30-\$1.50. When the company makes an acquisition, it increases reserves by 85%, on average. So, you can buy high-quality producers at about 6.5 times Ebitda [earnings before interest, taxes, depreciation and amortization].

Lastly, people don't realize how much the hurricanes have changed the reinsurance industry. About \$50 billion of losses have been reported so far, and they could climb to \$80 billion. That's 19% of the industry's regulatory equity. That compares with 7% after 9/11. As a result, rating agencies are forcing insurers to have more capital, and applying other standards that are causing rates to rise dramatically. Marine rates are up 400%. The price increases will be revealed as we go through this quarter. At the end of the quarter, people will realize the earnings power of these companies is a lot higher. We like Everest Re, and Axis Capital Holdings, a start-up after 9/11. Everest Re is one of only six reinsurers that has a double-A rating. If they were to write \$500 million to \$700 million in policies just in the dislocated classes, they'd get an incremental \$3 to \$4 a share of earnings. The Street is estimating \$12, and we think they can earn \$15-\$16. The stock trades for about 100. Axis has a clean book of business, and its earnings also should exceed estimates.

Thank you. Scott, you're last, not least.

Black: We try to buy deep value, high return on equity, low P/E and strong free cash flow. It doesn't matter whether the broad market is high, low or medium. I agree with Abby that technology looks good on a macro basis, but we can't find anything cheap. So I'll start with two consumer stocks. American Eagle Outfitters appeals to the 15-to-25-year-old. The company has consistently done 25% to 30% on book, with no debt. Last year it generated over \$180 million in free cash. The stock is 24, and the market cap is \$3.76 billion. It pays 30 cents a share in dividends. American Eagle has 868 stores, including 71 in Canada. It expects to add 40 to 50 new stores a year. The average store is about 5,800 square feet and does \$510 per square foot, which is pretty good. Their December comps [same-store sales] were up 9.8%.

In price positioning, they are below Abercrombie & Fitch [ANF], but higher than Aeropostale [ARO]. They'll probably finish this year with \$2.28 billion in revenue, a 20% increase. Operating margins will be about 19.3%, and net earnings will be \$320 million, or \$2.05 a share. The stock is selling at 11.8 times earnings. Return on



Neff: "The market is overlooking Citigroup's participation in emerging economies."

capital is 25%; there is no debt. When the stock got down to \$21-\$22, the founder was buying. They're also coming out with a new concept for people 25 to 35.

Neff: Will they card you when you walk in?

Black: I don't shop there. If they earn a little over \$2, there's no reason the stock doesn't go to 35 or 40. My next stock

CCA Industries, is based in East Rutherford, N.J. The stock is 8.95, and it's a \$66 million micro-cap. The company had a straight-up record until this year, earning over 20% on book, with absolutely no debt. They took on the Denise Austin line of skincare and cosmetics but it didn't do well. CCA sells diet aids, teeth-whitening products, skin-care products and depilatories. The biggest customer is Wal-Mart, at 32.7% of sales. The balance sheet is clean. They have \$5.6 million in cash and equivalents and \$8.3 million in marketable securities. That's \$1.90 a share. There is no debt.

This fiscal year CCA will make \$6.2 million, or 84 cents a share. The stock sells for roughly 11 times earnings. Return on capital will be 20.5%, and free cash flow will be \$7 million to \$8 million. The stock is down from almost 14 and is due for a rebound.

What else do you like?

Black: I, too, like commodities. My next stock is Georgia Gulf. It's trading for 31.42 and has a market cap of \$1.1 billion. It pays a 32-cent dividend. The company has two divisions. One turns out things like chlorine and vinyl, and the other turns out phenol and acetone. We estimate '05 earnings will be \$2.85 a share. This year they'll do \$129 million, or \$3.80. The stock is reasonable at 32, or 8.4 times earnings. Return on capital is just under

20%, which is especially good. There isn't a lot of tangible book value—only \$7.77 per share. The company should generate approximately \$106 million, or \$3.10 a share, in free cash. If Georgia can earn \$3.80, the stock could trade for 12 times earnings, or 45 a share. Some 48% of PVC [polyvinyl chloride] piping is used for infrastructure, such as highways and conduits. Georgia Gulf also supplies the resin for your credit cards.

My next pick, Gerdau AmeriSteel, also relates to infrastructure. It trades in New York and is 67% owned by Brazil's Gerdau [GGB]. The stock is selling for \$6.12, the market cap is \$1.86 billion and they pay a dividend of eight cents a share. This is the No. 2 mini-mill operator in North America, second to Nucor [NUE]. They're at 85%-90% of theoretical capacity of 8.4 million tons a year. The company has 15 mini-mills, 16 scrap-recycling facilities and 42 downstream fabrication centers. They sell to steel service centers and original-equipment manufacturers such as Caterpillar [CAT] and Deere [DE]. They try to manage the spread between scrap steel and what they charge.

Scott Black's Picks

Company	Ticker	Price 1/6/06
American Eagle Outfitters	AEOS	\$24.09
CCA Industries	CAW	8.95
Georgia Gulf	GGC	31.42
Gerdau AmeriSteel	GNA	6.12
DryShips	DRYS	13.65
Whiting Petroleum	WLL	42.78

Source: Bloomberg

How much is scrap these days?

Black: My estimated weighted average selling price this year is \$550 per ton. Last year they sold 7.35 million tons. This year we see \$4.15 billion in revenue, gross margins of about 18% and operating income of \$519 million. Without assuming any change with a Dofasco joint venture this year, we see \$571 million in pretax income, and \$360 million, or \$1.18 a share, in net. The stock is cheap, at 5.2 times earnings. Return on equity is 20.6%. Book value is \$5.18 cents. Free cash flow will be \$195 million, or 64 cents a share.

My next pick is DryShips. It's probably going to be controversial. If you believe China is going to continue to grow at 8½%, those natural resources have to be transported from places like Brazil and Australia. DryShips is a dry-bulk shipper. The stock was as high as 23.90 after it came public last year and is now down at 13.65. It has a \$414 million market cap and a nice yield: 5.9%. After it came public, the CEO bought a fleet of 27 ships of different sizes. The gross value of these ships is \$1.072 billion and the net replacement cost is \$548 million, or roughly \$18 a share. So the stock is selling at about 75% of the knock-down value. People are worried too much supply is coming on. Day rates have fallen from last year.

Zulauf: By about 60%.

Black: This is also a seasonal low. Even with depressed rates, we have them earning \$3.40 to \$3.50 this year.

Schafer: In the last three to four years, rates have gone through the roof. They're not depressed.

Black: Year over year they are.

They're depressed if you own the stock.

Black: Every \$1,000-a-day change in day rates adds 31 cents a share to earnings.

Schafer: Or subtracts.

Black: I said this was controversial. It is cheap on price to book value; tangible book is \$11.68 a share. The debt/equity ratio is about 1.58, but the latest quarter's Ebitda coverage ratio was 9.8. The cost of financing is 5.4%. Iron ore and coal account for more than half their cargo, and 50% of the route structure goes to China.

Finally, we too own XTO, but Whiting Petroleum sells at a lower price to cash flow and a lower P/E. It keeps buying assets and growing its reserve base, now equivalent to 1.64 trillion cubic feet [Tcf]. Reserves are roughly two-thirds oil, equal to 2.03 billion barrels. Ascribing to them a net present value of \$10 gets you \$2.03 billion of value. There are 421 Bcf of gas, which at \$2.50 per Mcf suggests a gross value of \$3.09 billion. All told, the net breakup value is \$2.15 billion or 58.45 a share, and the stock is 42.78. It's selling at 73 cents on the dollar. Though we still own U.S. oil and gas stocks, most have appreciated beyond a conservative breakup value.

What is Whiting's P/E?

Black: The company will earn \$4.60 a share this year, so it's selling for 9.3 times earnings. Price to cash flow is 3.9. The reserve life is in excess of 19 years. Their finding and development costs over the last two years have been roughly \$1.35 to \$1.40 per Mcf. And their reserves aren't located in Algeria or Yemen, but in the Permian Basin and the Rocky Mountains.

That's a plus. Thank you, Scott, and everyone. Let's go to dinner. ■