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REAL-TIME REPORTING FROM BLUE HERON RESEARCH PARTNERS

## Fields of Irrational Dreams

CAN POTASH PRICES—AND SHARES OF PRODUCERS—REMAIN SKY-HIGH?

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### ABOUT BLUE HERON RESEARCH PARTNERS

Blue Heron Research Partners is an independent firm that provides fundamental analysis to institutional investors on an exclusive, real-time basis. Our focus is on issues that drive performance, ranging from the strategic and execution skills of a management team to trends taking shape at the sales and operational levels. Our methodology combines investigative journalism and classic value investing tools.

Most of the housing, credit, and commodity bubbles of this decade have now been sharply and painfully popped. But some items remain at what appear to be inflated levels, at least versus long-term pricing trends.

Take potash, a key fertilizer for the world's crops. For a quarter-century, the spot price for potash stayed in a fairly tight range of \$100 to \$150 per ton. It finally nudged above \$200 in early 2007. Then it spiked to nearly \$1,000 in the manic summer of 2008, even as the global production/demand ratio remained relatively constant. Most of the world's foodstuffs followed a similar, dizzying climb. (See chart, right, for how potash and corn prices usually track each other).

Today, the potash spot price has fallen back to around \$650. A dropoff, to be sure, but not nearly the collapse that many other commodities have suffered. And while there are valid arguments to be made about insatiable Asian

usage and capacity constraints, the current price still floats way above the historic figure.

As you'd expect, the share prices of the major potash producers, such as POT, CF, MOS, and AGU, have gone through their own boom-and-bust cycle. Even so, **investors might want to look more closely at whether the underlying commodity price is signaling a disconnect to the share values.** If potash falls back toward more normal long-term levels, the producers are going to be squeezed.

**BULGING BELTS:** In August, we checked in with a dozen sources in the U.S. grain belt to find out where potash demand and prices are headed. The U.S. remains the biggest supplier of corn and other grains to a hungry world, so the farmers' outlook is a good "tell" for the potash market.

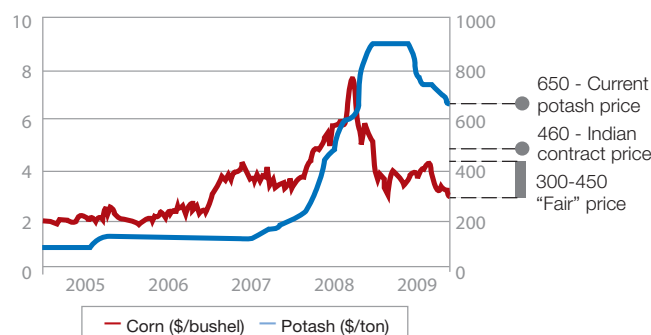
And what they see is corn as high as an elephant's eye. The USDA forecast for corn in 2009 is about 12.8 billion bushels, close to an all-time record. This bumper crop has depressed corn prices to about \$3 per bushel. In turn, **farmers say the price of potash has to come down further before they'll start buying a lot more of it for their fields** (applications can last through several growing cycles).

Here's what several sources had to say:

*Continued on page 3*

#### Look Out Below

In 2008, potash prices spiked five-fold from historic levels. Corn and other agricultural commodities also soared higher—but have now fallen back more than potash. U.S. farmers await a lower price before they'll buy heavily.



Sources: USDA, FT Markets Data

IN THE NEWS: TRUE RELIGION

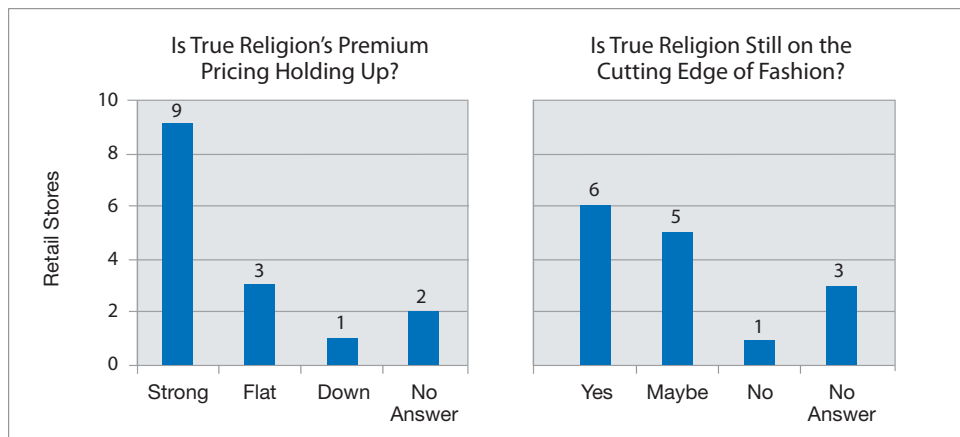
# True Religion Preaching More Directly to Faithful

## EXPENSIVE TASTE

Befitting its status as a hot retailer, True Religion (TRLG) sells for nearly twice its revenue per share. This is typical for a high-flying name, but can come quickly back down to earth if it loses affection among its 20something and teen audience. Note the price-to-sales ratios below of some other once-heralded fashion retailers.

Urban Outfitters (URBN)	2.54
True Religion (TRLG)	1.85
Guess (GES)	1.52
Buckle (BKE)	1.44
Aerospostale (ARO)	1.27
American Eagle (AEO)	1.15
Bebe Stores (BEBE)	1.06
Gap (GPS)	0.98
Abercrombie & Fitch (ANF)	0.88
Wet Seal (WTSLA)	0.55

Data as of 9/15/2009



**THE BUZZ:** Customers still believe in True Religion's high-priced jeans—for now.

**THE REALITY CHECK:** While most fashion chains have been clobbered by the recession, True Religion has been a notable exception. The California-based retailer reported sales of \$72.1 million for its second quarter, up an impressive 12.4% in a tough climate. True Religion's mainstay are its "embellished" jeans, which sell for an average ticket price of \$256 to young women who can't get enough of its flashy stitching, buttons, bling, and other design features.

To check on True Religion's staying power, we called 15 sources—sales associates at outlets that carry its jeans, as well as at competing stores. In general, they reported that its premium pricing is holding up. **"People who had enough money to buy True Religion jeans before still have enough money to continue to buy them,"** said a sales associate in Charlotte, NC. Nine of the sources said prices remained strong; only one said customers were looking at cheaper lines.

On other hand, fewer sources said True Religion is maintaining its cutting-edge position. Six said it's still a trendsetter, while five said "maybe". Now that True Religion has been on the market for several years, it's harder to maintain its iconoclastic look. Other brands like Rock & Republic, MEK, and Nudie were mentioned as rivals.

Perhaps that's why **True Religion is aggressively adding its own stores.** It will open 27 new stores this year, up from 42 locations in 2008—a 60% expansion rate in the teeth of the worst retailing year in decades. This quarter, company outlets will produce more revenue than the wholesale business for the first time. **While this strategy gives True Religion more control and better margins, it's also often a sign of a retailer pushing on the gas pedal a bit too hard.** We'd look closely at any new locations announced for 2010 to see how far TRLG is moving beyond its fashionista base of California, Florida, and Texas, and major cities. The \$250 jeans phenomenon may be hard to preach to the heartland. ■

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## RESEARCH BRIEFS: FINANCE

## A Tarnished Penny That Could Turn Up Good

EXCERPTS AND UPDATES FROM OUR FIELDWORK ON MANAGEMENT AND COMPANIES

It's understandable that investors shied away from the debut of **PennyMac Mortgage Investment Trust (PMT)** on July 30. The IPO market has been largely frozen all year, and PMT trades in a sector—residential mortgages—that had blown up many market participants over the past two years. The IPO, in fact, busted, finishing the day below the offering price of \$20, even after the number of shares offered was cut by more than half.

No doubt some of the disdain reflected the heritage of the company's management. All of the senior executives come from Countrywide Financial, the poster child for the hyper-aggressive, and ultimately toxic, sales and underwriting practices of the housing bubble. But investors might give PMT a second look, if they want a smart play on distressed mortgages. ***We did due diligence on the CEO, Stanford Kurland, in spring 2008 on behalf of a***

**client.** Kurland had been pushed out of Countrywide in 2006, and was then laying the groundwork for PennyMac.

Our sources had nearly uniform praise for Kurland—a contrary view to prevailing news about him as damaged goods. He was described as highly analytical, innovative, and intensely focused on risk. He was seen as the one executive at Countrywide with his foot on the brake when others were driving it over the cliff. If anyone could bid for and then manage a portfolio of dodgy subprime paper, it would be Kurland and the other talented former Countrywide executives now at PennyMac.

“Stan is very familiar with the good, the bad and the ugly at Countrywide,” said one source. “Now he has a new operation. My guess is that he is going to learn from the good, the bad and the ugly. I think it is a heck of an opportunity.” Another source told us that Kurland had

created the macro-hedge program for Countrywide's servicing portfolio, a skill that will be critical to PennyMac's plans to take on loan servicing and modifications. And given the sour taste left by Countrywide, we asked every source about Kurland's reputation. The consensus: he and his other PennyMac recruits have “very high standards and solid ethics... they are extremely diligent.”

Until PennyMac reports its first quarter in October, investors won't be able to see in depth what sort of assets Kurland has been buying and judge how they may perform. But with the stock trading below its offering price, the time could be right to pocket some PMT coins on the cheap—you're getting an IPO discount on highly discounted paper. It's also worth noting that PMT's backers include Highfields Capital, BlackRock, and Blue Ridge Capital. ■

## POTASH PRICES (continued from page 1)

- ▶ “There's been a significant dropoff in [potash] application over the last two years. In 2007 I sold 11,075 tons of potash. So far this year I've sold 323 tons. You can figure out the percentage on that one.” —*farmer co-op manager, Shelbyville, TN*
- ▶ “I expect an increase [in usage] for the fall only if the price goes down, otherwise it will be about the same. When I say down I mean more than \$100 or so. I had guys who put zero on last year and right now, with the price we're at, they are still thinking about not putting it on.” —*crop agronomist, Maquikete, IA*
- ▶ “We could have another drop because there ain't nobody buying any. India

just signed that contract for \$450 and that's still too high. I'm telling you, nobody is taking a position on potash right now.” —*fertilizer supplier, Benton, AK*

- ▶ “When corn is at \$3 a bushel, it's questionable whether \$450 is low enough. What is a real grain market? I'm not sure anybody really knows.” —*VP fertilizer distributor, Kansas City, MO*
  - ▶ “I don't believe this [price] is as low as it's going to go, because I think the importing of the Russian product is going to push it down even further.” —*fertilizer distributor, Cleveland, MS*
- Notice how these Midwest farm

sources are keenly aware of the global contract prices for potash. When India signed its deal this summer with a major potash producer, the price was about 30% below spot—another sign that the trend is headed down. China is now negotiating its main contracts, which will be another key indicator.

Our sources told us that a “fair” price for potash would be \$300 to \$450 per ton. And these are primarily the sellers and distributors, so they have no incentive to lowball their estimates. If potash indeed drifts back to that level, a lot of the rosy assumptions of the potash producers may wither. We'll keep our ears to the planting ground for investors who want to know more. ■

## VIEWPOINT

## How to Talk to Your Sources

WHAT INVESTORS CAN DO TO GET BETTER INFORMATION



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An interview isn't a cross-examination. You asked the source for the interview specifically because you didn't understand an issue. So don't worry about not sounding smart.

One of the best things about my job is that I get to talk to a lot of different people. On any given day, I might interview the CEO of an aggregates company about demand for tiny pieces of rock, a salesman in a bedding store about the newest technology in mattresses, or the former senior vice president of a media company about how his old boss allocates capital. Despite their varied backgrounds, they all help me gain knowledge that has a positive impact on investment decisions.

What brings this to mind is a conversation I had recently with an investor who wanted to know how he could become a better interviewer. While he excelled at financial calculations, this investor realized he lacked sufficient skills to draw information out of sources. So he asked me if I could give him some advice on how to improve his on-the-phone technique. Here's what I told him:

**Develop trust.** Investors often ask me how much they should tell a source about what they are doing. To be clear, an investor should rarely give away trading plans. However, being evasive with someone you want to open up to you is not a great strategy. I've run across analysts who think the trick is to create some sort of facade, such as pretending to be a customer. That might work once or twice. But if you want a source to be honest with you, you must first be honest with the source.

**Don't get so hung up on your own intelligence.** Most people want to sound like they know what they are talking about. Like the old law school adage, they never ask a question for which they don't already know the answer. But the difference here is that an interview isn't a cross-examination. You asked the source for the interview specifically because you didn't understand an issue. So don't worry about not sounding smart. People like to talk about themselves, and the more you encourage them to become your "expert," the more they will want to tell you.

**Be patient.** I know this can be excruciating, especially for time-pressed investors. But there is no telling how much you can learn just from

getting to know sources before you shower them with questions. As a cub reporter in Alabama, one of my first assignments was to figure out whether Mercedes-Benz was going to build a plant in a small town near Tuscaloosa. I found myself sitting on a porch talking to an 80-year-old man about his tin-roofed barn and whether 'Bama might repeat the championship that year. I didn't bring up the question about the plant for nearly an hour. When I finally did, he told me he'd sold an option on his property to a man just that morning. One thing led to another, and I learned the exact spot where Mercedes was going to build its first U.S. plant.

**Don't be afraid to ask a personal question.** To be clear, we don't pry into people's lives without cause. But when your money is involved, you have every right to ask any question. Take the example of a beauty products company we once examined. The CEO tried to brush off some personal financial difficulties as youthful mistakes. But when we dug deeper, we learned that these "lapses" did not stop years earlier, as the CEO had claimed. When the CEO was picked up for DUI and cops discovered cocaine in his back seat—soon after closing the sale of the company—we knew we were right to probe deeper.

**Ask sources what they would ask.** A lot of investors go into conversations with a list of prepared questions. Once they ask the last question, they end the call. I make sure our researchers always ask one final question: "Is there anything I'm not asking that I should ask?" You can't believe how often this triggers a blizzard of relevant information.

**Be polite.** One final note: A lot of investors are spoiled by expert networks that make it easy to reach a source but don't penalize bad manners. I've seen situations where an investor who is in a hurry gets the information he needs and then simply hangs up. That's okay for paid sources, but when engaging your own network of sources, express your gratitude. They'll remember it—and they'll take your next call. ■