

# QUANTUM CAPITAL MANAGEMENT, L.L.C.

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Conditions in the global capital markets remain strained. The heretofore complacency of market participants ignorant of its now all-too-apparent peril has given way to a pervasive fear of financial assets. There is now a mass exodus from the equity markets. We suggest that this indiscriminate purge is providing and will continue to provide opportunities to take possession of fractional interests in valuable franchises at prices that we have not seen in a generation.

The current phase of this cycle is marked by the presence of a large number of urgent sellers who would dispose of equity securities for reasons—few of which—reflect the underlying economics of the companies being sold. When market expectations are acutely negative and economic fear grips the marketplace, maniacal sentiment encourages the sale of assets to avoid the emotional pain of further decreases in price. Recognizing this condition, the intelligent investor performs the work to identify the growing disparity between market prices of securities and the private market value of their underlying businesses.

Giri Reddy and I remain encouraged at this restoration of value and simply go about our day doing what we have always done, which is to work to identify the price/value discrepancies described above. We do, however, remain a bit surprised at the rapidity of the coincident down-draft in prices of all asset classes throughout the global economy despite the fact that we have written of this interdependence often.

In a November of 2007 essay we posited two notions in the form of a question , “ Can a debt-laden economy continue to thrive as a renewed appreciation for risk works its way into the cost and availability of credit?” and “Will monetary policy prove as effective for the current federal reserve chairman as it did for the last?” The answers are now painfully clear and thankfully we listened to our own prose and have succeeded, so far, in protecting our valuable capital. We have done so on both a relative and absolute basis depending on our investment mandate.

We continue to believe that macroeconomics are inextricably tied to microeconomics, meaning, that total factor productivity—or the investment in productive assets—and the availability, cost and velocity of capital flows, ultimately affect company operating earnings and the interest rate used to discount those earnings when determining market value. As capital markets eventually equilibrate, we believe that steady - state operating margins and valuation multiples of most companies will be materially impacted.

*Now what?*

We deploy our capital judiciously and we have an underweighted long exposure to the equity markets thus leaving an abundance of dry powder to take advantage of developing opportunity. However, we have made selective acquisitions as of this writing and continue to build positions in quality companies as the price/value equation evolves in our favor. We make our acquisitions without regard to how our actions will be judged at the end of next month or next quarter. Our motivation is to build a portfolio of capital compounding machines that will enable us to meet our ambitious total return objectives over the next five and ten year periods.

Quality, like value is a relative term. Certainly no-one buys companies which are perceived to be of poor quality. However we define quality companies as those enterprises that enjoy the attributes necessary to provide reliable and sustainable cash flows from operations. These

attributes are both quantitative and qualitative in general and strategic in particular. Simply put, our ideal holding is a company, with economic advantages so favorable, that a potential new entrant to the industry would—from a rational economic perspective—invest in it or acquire it, rather than compete with it.

As we said in a recent report, “Our portfolio companies exhibit the qualities that one would expect (and desire for their own privately held enterprise); strategic competitive advantage, understandable unit economics, (sustainable) cash flow generation and sensible balance sheets.”

Quality franchises are being sold indiscriminately. Given the nature of the current global recapitalization—asset re-pricing process, we don’t have to take risks with less than excellent companies and time is on our side. As we have indicated in the past, we will be imperfect in the timing of our acquisitions. We make no assurances of near term post-acquisition prices but we make every assurance regarding exceptional value at the time of acquisition.

As prices continue to fall relative to value, and if we are correct in our analysis of the sustainability of normalized cash flows, the expected total return of our current and targeted holdings is greater than at any time since our inception. We find compelling values in both the domestic and emerging markets. Giri is off to India in November and if our suspicion is confirmed regarding a company that we are interested in, I will join him in January on a return trip to extend our fieldwork.

We recognize the palpable fear among the general public as well as our partner-investors and we are sympathetic. We are saddened by the criminally negligent actions of a few and the ignorance of many who, in the developed markets, have set free market capitalism back decades. The Scottish philosopher, David Hume, once said “Seldom is liberty of any kind lost all at once.”

Unfettered markets are integral to democratic capitalism and represent the essence of personal liberty. Markets will eventually equilibrate, however. They always do. Investor fear will subside and the focus will shift towards fundamentals. We suspect that re-focused investors will see a global embrace of market capitalism, albeit a hybrid form. They will witness anomalies in valuation and companies with total return yields that far outstrip elevating bond yields. As hard as it may be to believe at this moment, Giri Reddy and I are now more optimistic about our investment prospects than we have ever been.

Best regards,

John Hughes

President - Quantum Capital Management, LLC and  
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