CUBIC ASSET MANAGEMENT, LLC

2013 4th Quarter Stock Market Commentary

COMPARING APPLES AND NON-APPLES

"I think it's wrong that only one company makes the game Monopoly."
– Steven Wright

LeBron James is a basketball superstar who plays for the Miami Heat. He is the greatest player in the game today and one of the greatest of all time. At 6' 8" and 250 pounds he is an amazing blend of speed and power. King James, as he is sometimes called, has won two NBA championships, four NBA Most Valuable Player Awards and two Olympic Gold Medals. He was NBA Rookie of the Year, won the NBA scoring title, and has been selected to the NBA All-Star Team nine times.

Not surprisingly, his basketball prowess has brought him considerable fame, and has led to a series of product endorsement deals which have made him spectacularly wealthy. According to *Forbes* magazine James earned $60 million last year, of which $42 million was from endorsements. His most lucrative contract is with Nike, where sales of his signature LeBron James basketball shoes exceeded $300 million last year. He is featured in commercials for McDonald's, Samsung and Coca-Cola, to name but a few.

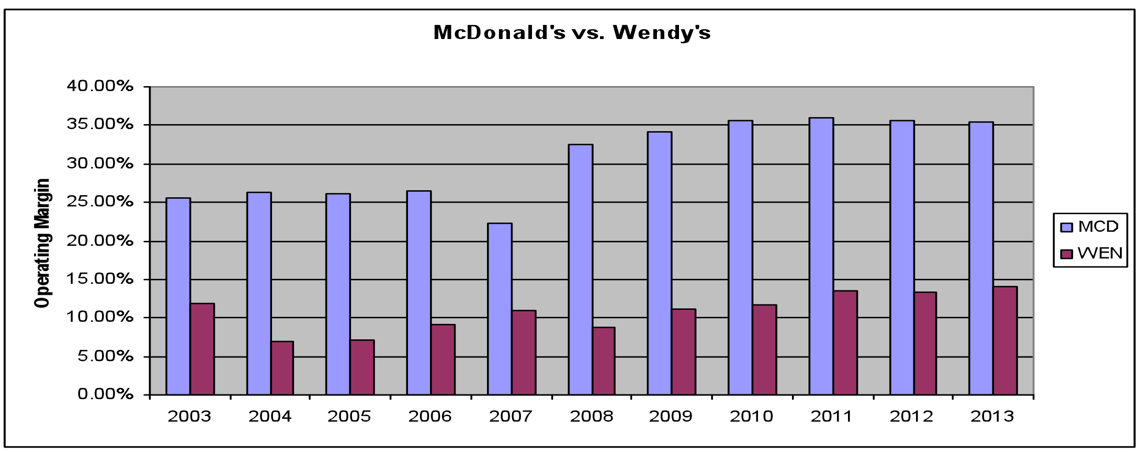
But there is at least one product bearing his name and likeness from which he does not receive any royalties, and with which he undoubtedly does not wish to be associated. Last year an undercover police officer in Philadelphia arrested 19 year-old Marlon Guess after the latter sold him 140 packets of heroin stamped with a silhouette of LeBron James dunking a basketball and stamped with his name. Apparently even street dealers understand that a brand name can engender customer loyalty and command a premium price.

These musings about brand value were prompted by the September 30 publication of *The 100 Best Global Brands*, an annual ranking by Interbrands, a leading global brand consultancy. This year Apple Inc. was deemed number one, displacing Coca-Cola, which had held the top spot for thirteen straight years. Coke actually dropped to third place, while Google rose to number two. Rounding out the top ten were IBM, Microsoft, GE, McDonalds, Samsung, Intel and Toyota.

Great brands all share certain characteristics. They deliver a consistent product which meets or exceeds customer expectations, the product is delivered through a distinctive design which evokes the feelings the manufacturer is trying to engender, and the product creates an emotional connection with the consumer. Apple has built a reputation for creating cutting-edge products. Its corporate mission statement reflects this objective: "Apple is committed to bringing the best personal computing experience to students, educators, creative professionals and consumers around the world through its innovative hardware, software and Internet offerings." The popularity of Apple's phones, computers and tablets certainly do not derive from low prices, as they tend to be among the most expensive offerings in each category, but from the company's ability to make its customers feel young and cool.

By contrast, McDonald's is not trying to sell the "best" of anything. It's mission statement reads, in part: "We place the customer experience at the core of all we do. Our customers are the reason for our existence. We demonstrate our appreciation by providing them with high quality food and superior service in a clean, welcoming environment, at a great value. Our goal is quality, service, cleanliness and value (QSC&V) for each and every customer, each and every time." As one example of the company's success at delivering on the message, consider the fact that its second biggest market after the United States is France. Even in the home of numerous Michelin starred restaurants, where the average Frenchman still spends more than two hours per day dining, McDonald's has successfully opened more than 1,200 restaurants. Its message of good food in a clean restaurant at a reasonable price resonates in 123 countries worldwide.

For shareholders, whose interests may diverge from those of customers, a good brand is generally associated with superior financial characteristics. Consider the graph below, which shows the operating margin for McDonald's (ticker: MCD) compared to that of its closest publicly traded competitor, Wendy's (WEN), over more than a decade. McDonald's generally earns three times as much from each dollar of sales, a potent indicator of the financial power of its brand.

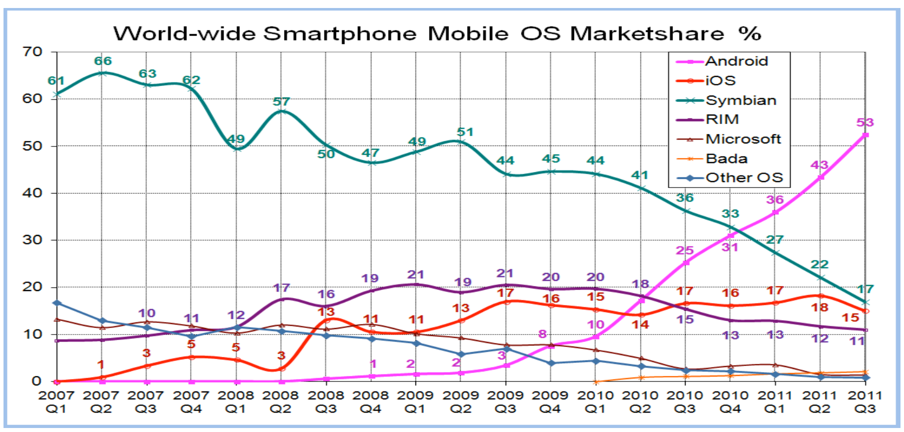


Despite the fact that for most consumer-oriented companies the value of their brands is the largest asset of the company, that value is generally not found on the balance sheet (with one exception that we will discuss below). For example, Coca-Cola's 2012 year end balance sheet shows current assets (like cash, accounts receivable and inventory) of roughly $30 billion, and long-term assets (such as property plant and equipment net of depreciation) of $56 billion. Nowhere is there a line item for the Coca-Cola brand itself, which Interbrands estimate to be worth a whopping $79.2 billion. The power of a good brand was well known over a century ago. John Stuart, the Chairman of Quaker Oats in the early 1900s (and son of the founder) was famously quoted as saying: "If this business were split up, I would give you the land and bricks and mortar and I would keep the brands and trademarks, and I would fare better than you."

Unfortunately, there is no single accepted method for brand valuation. Numerous companies have proprietary approaches to computing this value, and these methods do not generally yield the same results. Most valuations are based upon capitalizing the excess profitability that might be anticipated (see the McDonald's vs. Wendy's graph above) over a multi-year period and discounting that back to a present value. Different time horizons and different discount rates produce different values. Other valuations are based upon the fact that the intangible value of a brand is put on the balance sheet when a brand is purchased. This allows every competitor to use the purchase as a benchmark for determining the value of their own brand, which they inevitably view as superior. This creates a game of corporate leapfrog, similar to how every free agent in sports always thinks they deserve more than what other players received for signing.

But whatever the methodology, brand names represent an enormous off-balance sheet asset. Interbrands has estimated that the name Disney is worth roughly $28 billion, the Nike swoosh has an estimated value of $17 billion, and the McDonald's arches are worth $42 billion. But the shocker was the stunning valuation of $98 billion for Apple, displacing perennial leader Coca-Cola. We respectfully disagree.

First of all, technology consumers are notoriously fickle. Consider the following graph, which shows the market share of the leading smart phone manufacturers for the five years from the start of 2007 through the end of 2011. It is hard to believe, but during that period not so long ago, Apple was not only NOT the world's leading brand, it was not even the leading smart phone. In fact, it ranked 3rd, 4th or 5th. For most of that period the market leader was Nokia (developer of the Sybian operating system. For a while it sold two thirds of all smart phones worldwide. It had



nearly 20% operating margins. In only a few years its market share has fallen to only 5%, and it is unprofitable. Earlier this year Nokia agreed to sell its smart phone business to Microsoft. The second hottest brand was Research-In-Motion (RIM), whose flagship device is the Blackberry. Its customers were so addicted to its unique design that it was dubbed Crackberry. Its 21% market share in 2009 has now dwindled to only 1.5%, and management has put the company up for sale.

While Apple is a great company, it is not immune to the fickleness of the consumer technology market. In tablet computers, its various iterations of the iPad had industry leading market share at the end of the third quarter, shipping more 14.25 million units for a 29.7% market share. But this was down from its 14.62 million units in the second quarter, which represented a 33.5% share. It would be hard to imagine Coca-Cola losing 3.8 percentage points of its share of the carbonated beverage market in only a three month period.

Only a few short years ago Sony was synonymous with Japanese dominance of high-end consumer electronics. The Walkman was the iPod of its day. The Sony Playstation was the first game console to sell 100 million units, but now trails Nintendo worldwide and both Nintendo and Xbox in the US. Sony TVs were widely considered highest quality, with dominant market share, although Sony now trails Samsung and LG Electronics. It has been close to impossible to maintain dominance in consumer electronics for any extended period.

In today's stock market, the estimation of the value of a company's brands is a key factor in the decision as to the price an investor should be willing to buy or sell. It is not a coincidence that Warren Buffett's Berkshire Hathaway counts among its biggest holdings shares of Coca-Cola, Proctor & Gamble, General Motors and American Express, whose iconic brands are among the world's most valuable. The fickleness of tech consumers notwithstanding, the Apple brand is obviously extremely valuable, too. But more so than Coca-Cola? We don't think so.