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# ❖ Contrarian Research Report ❖

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## ❖ The Ultimate *ULTRA* Contrarian ❖

*A Tour of the Nasdaq 100 Via Lebanon  
A Study of Risk and Reward*

### Banque du Liban et d'Outre-Mer

<b>Price (5/29/02):</b>	\$17.12	<b>Ticker:</b>	BLBD*
<b>52-wk. range:</b>	\$15.28-\$20.30	<b>Dividend:</b>	\$1.98
<b>Shares out:</b>	18.31 million	<b>Yield:</b>	15.6%
<b>Market Cap.:</b>	\$314 million		

\* GDR symbol on London International Stock Exchange

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## I. - Introduction

Readers may well wonder whether Lebanon has any relevance to the Nasdaq 100. This essay does not deal with this question directly. However, it does deal with this question indirectly. An investment in Lebanon must appear to many to be an act of madness. The chances of a successful outcome must be very low. No reasonable person would say that an investment in the various firms that comprise the Nasdaq 100 is an act of madness. Indeed, almost every reasonable observer would maintain that the chances of a successful outcome are very high.

This last belief follows quite logically as a consequence of modern portfolio theory. This notion, which is universally accepted by investment academicians and almost universally accepted by investment professionals, is that high reward is achieved by the acceptance of high risk. It is difficult to imagine higher risk and more varied risk than in the unfortunate nation of Lebanon. Viewed in this sense, the logical foundations of the Nasdaq 100 tracking stock (QQQ) can best be viewed at ground level in the city of Beirut.

## II. - The Fact Pattern

If reward is in any manner associated with risk, then the Banque du Liban et d'Outre-Mer must be an intriguing investment. This happens to be the largest bank in Lebanon. In light of current events as well as geography, the mind of the reader will undoubtedly conjure images. Indeed, these are not mere images, since the risk of investing in Lebanon is obvious.

However, before proceeding with the question of risk, it is interesting to observe that, in a reported earnings sense, the BLOM, as it is known by its acronym, has been surprisingly successful. This success, such as it is, is best represented by the following historical table.

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**Banque du Libon et d'Outre-Mer**  
**Assets, Net Profits and Shareholders Equity 1992 – 2001**  
 (US\$ in Millions)

	<u>Assets</u>	<u>Net Profits</u>	<u>Shareholders' Equity</u>
1992	693	3.8	13.9
1993	1,037	8.9	40.0
1994	1,431	14.1	54.4
1995	1,879	17.6	77.7
1996	3,043	27.1	153.6
1997	3,830	47.8	266.3
1998	4,580	58.9	308.9
1999	5,082	70.7	354.6
2000	5,770	78.5	405.0
2001	6,285	80.2	450.0

As is well understood, earnings at any financial institution can be created in an illusory manner. Generally accepted accounting principles have, at best, been only liberally applied in the United States. Lebanon has experienced civil war. It is still under the occupation of Syria, which the U.S. State Department suspects as a supporter of international terrorism. The Bekaa Valley in Lebanon functions as a base of operations for a variety of terrorist groups. Terrorist groups participate in the Lebanese Parliament as representatives. Consequently, given the ability of interested parties to apply pressure to any institution, the formally presented accounting statements may be a very poor guide to reality.

A slightly more reliable guide might be dividend payments. A dividend payment has a tangible reality that exceeds any amount of retained earnings. Dividends are substantial and have been regularly increased.

**Banque du Libon et d'Outre-Mer**  
**Recent Dividend History 1998 – 2002**  
 (US\$ per Share)

<i>Dividend Record Date*</i>	<i>Dividend per Share (GDR) Net of Withholding Tax</i>	<i>Dividend per Share (GDR) Gross of Withholding Tax</i>
03/18/02	1.8618	1.9808
04/09/01	1.5547	1.7497
04/16/99	1.1722	1.2549
04/16/98	0.9309	1.0009

\* No dividends were paid in 2000.

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The yield in dollars of a Global Depository Receipt that trades in London is now 11.28% on a net annual basis. Each GDR represents one ordinary Class B share. All that can be said is that the firm has sufficient funds with which to pay a dividend. The stated earnings for the most recently concluded fiscal year are \$4.34 per share. Thus, the shares trade at 3.8x earnings and have a dividend payout ratio of 45.64%, which is conservative.

The company has also repurchased a very small quantity of its own stock in the past year. This amounts to only \$1,243,000. However, it is 0.4% of the market capitalization of what is clearly a very small company. The mere repurchase of shares at 67% of book value is accretive to shareholder wealth based upon the questionable assumption that the book value is indeed accurate.

Conventional loans are only 19.05% of assets. Ordinarily, this would be an element of comfort. However, 12.4% of assets are in cash on deposit at the Central Bank of Lebanon. Similarly, 36.2% of assets are held in Lebanese Treasury Bills and the treasury bills of other governments. Holdings of Lebanese Treasury Bills or deposits at the Central Bank of Lebanon might be rather worrisome. Yet, the company maintains that 50.17% of its deposits are held in foreign currencies.

If this last statement is true, it might well explain much of the success of BLOM during the past few decades. BLOM became the largest bank in Lebanon in 1981, which was the height of the Lebanese Civil War. It has maintained this position since that time. That war was not its only problem. In 1983, the government of Saudi Arabia decided to nationalize the BLOM branch in Jeddah. In the terminology of the Saudi government, the nationalization was called a “Saudization.” In any case, the BLOM lost an important branch office. However, at the same time it established a London office. This is an example of the strategy of BLOM. The company seems disposed to function as a facilitator for Lebanese nationals to hold wealth outside of Lebanon.

The religious factional fighting by militias might be said to have commenced in 1976. In that same year BLOM founded La Banque de L’Orient Arabe et d’Outre-Mer (Banorabe) in Paris. This holding in 1992 acquired 100% of Banque Banorient in Switzerland. In 1993, BLOM opened an offshore banking unit in Limassol, Cyprus. Thus, in slightly more than one and one half decades, BLOM established the leading presence in Europe of all of the geographic areas preferred by wealthy expatriate Lebanese.

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## III. Theoretical Considerations

Ultimately, there can only be two possibilities. These are either that the financial statements do not appropriately reflect reality or that these do appropriately reflect reality. If the former is the case then quite obviously the BLOM will be a poor investment. We cannot assign a certainty to the first possibility. After all, BLOM does pay a substantial cash dividend and this cash should have its origin in some tangible reality. Let us assume two arbitrarily designed scenarios that would represent the success or the failure of BLOM.

Since the latter is more likely, let us presuppose this eventuality: the situation in Lebanon deteriorates further and the BLOM is forced to realize substantial losses to its capital. The equity market seems to be somewhat discounting this possibility. In the past three years the shares have declined by 42.1% exclusive of dividends. Inclusive of dividends, the loss of an investor in these shares would not be very substantial. In any event, in order to simulate deterioration from the current state of affairs, let us presume that in the next three years the return is negative 50% and let us ignore dividends.

In the unlikely but nevertheless positive case, let us assume that profits grow by 15% per annum, since the situation in Lebanon would improve. In this case the dividend would be paid. Let us further assume that in three years' time the shares of BLOM would trade at a P/E ratio of 15X, which would reflect its now improved circumstances. In this case it would earn \$6.60 three years hence. Its shares would trade at \$99.00. The return exclusive of dividends would be 478%. Inclusive of dividends and assuming no dividend reinvestment the return is closer to 512%.

Let us assume that the probability of a favorable outcome is only 20% and that the probability of the unfavorable outcome posited above were to be 80%. The expected return would be:

$$0.20 (512) + 0.80 (-50) = 62.4\% \text{ or } 17.5\% \text{ on a compound annual basis}$$

In order to make the comparison with the Nasdaq 100 more interesting as well as more comparable, it is not proposed to study the Nasdaq 100 in its entirety. The Nasdaq 100 is more interesting if the most profitable and therefore least risk-prone assets are excluded. Thus, firms such as Microsoft and Intel that have well-developed business franchises and strong balance sheets are excluded. However, there are many firms within the Nasdaq 100 that are currently unprofitable and do not have well-developed business franchises as yet. The balance sheets are far less well endowed than those of Microsoft and Intel. The purchase of the shares of these firms must entail more risk. Therefore, the comparison will

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be limited to these firms. It is these firms that should be the source of a disproportionate amount of the return within the Nasdaq 100 if modern portfolio theory has validity.

One might suppose that the compilation of a list of unprofitable firms is a relatively simple matter. This was once true. Unfortunately, this is no longer the case. One must choose between pro-forma earnings, GAAP earnings, operating earnings, EBITDA, non-recurring items that continually recur and other more pedestrian albeit less obvious adjustments. In the example to be presented, only GAAP earnings are used. The companies included are those that have reported GAAP losses for the past 12 months. Thus, the list includes firms such as Cisco and Comcast that most observers believe are profitable when appropriate adjustments are made to financial statements. The resulting list is therefore a very representative sample of that which is included in the Nasdaq 100.

Interestingly, 51 companies of the Nasdaq would qualify for inclusion on the list of unprofitable companies for the past 12 months using GAAP-basis earnings. This is obviously a numerically representative sample. The average market capitalization of this sample is approximately \$8.5 billion. The total market capitalization of these firms is \$433 billion. Let us assume that the market is efficient and that this aggregate valuation adequately or even more than adequately reflects the future success of these firms. Obviously, the aggregate market value must reflect anticipated success given its \$433 billion magnitude.

In order to simulate success, let us presume that earnings will grow at a 25% compound annual rate over the course of the next three years. At the conclusion of the three years these 51 firms will sell at 30X earnings. If the current valuation properly discounts future reality, it is only reasonable to conclude that the aggregate valuation will grow at the rate of 25% per annum between the current time and the next three years. Therefore, ignoring the imponderable of share issuance, the aggregate valuation would be \$845.7 billion in 2005. If the p/e multiple were 30X, this would imply the realization of \$28.2 billion of net profit by 2005. Given a 25% growth rate of profit and working backwards it would imply that the combined profit for this group of firms is anticipated to be \$14.4 billion in 2002. This is one version of a success scenario and let us arbitrarily assign a probability of 80% to its realization.

Although failure is not likely, a reasonable observer must admit that it is nonetheless possible. If it were not possible, then this collection of equities would be a riskless investment and this would conjure all manner of philosophical dilemmas for those conversant with modern portfolio theory. If the probability of success is 80%, then the probability of failure must be 20%.

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An interesting manner of simulating the failure scenario is by the use of the average price to book value ratio. Ordinarily, in the business world, failure is almost synonymous with unprofitability. However, despite unprofitability, the equity market does not regard this group of 51 firms as having achieved failure. The average price to book value ratio of these firms is 4.19X. Let us presume that an approximation of failure would be if these sold at book value. It is to be noted that unprofitability is by definition a state of affairs that erodes book value. Let us therefore endow these 51 firms with a hidden advantage insofar as failure is based upon trading at the current book value as opposed to the book value that might exist if unprofitability continued and consequently book value were lower. If these firms traded on average at book value, there would be a 76.1% loss in market value over the course of the next three years. This is to be compared with a 95.3% positive return if earnings grow at 25% per annum.

Thus, the expected return for the 51 firms within the Nasdaq 100 is:

$$0.80 (95.3) + 0.20 (-76.1) = 61.0\% \text{ or } 17.2\% \text{ on a compound annual basis}$$

Interestingly, this projected return, although most alluring, is still below the 17.5% return expected from an investment in a Lebanese bank. The matter of choice presents no difficulty for modern portfolio theory, since it is presumed that the slight excess return potentially offered by the Lebanese bank is not worth the much higher probability of loss. The more interesting question never adequately addressed by modern portfolio theory is why the expected return of 51 currently unprofitable firms is so high. Perhaps more properly stated, why is the probability that 51 currently unprofitable firms will consistently grow at 25% so high?

A cursory study of the NYSE or Value Line would lead one to the following inescapable conclusions. First, the probability that any firm will grow profits for three consecutive years at 25% per annum is far less than 80%. Second, the probability of this occurrence is much lower for those firms that experience periods of unprofitability. Third, if those firms can achieve this despite a period of unprofitability, it is not likely that these will trade at 30X earnings. An exercise best left to the reader is to peruse the Value Line Investment Survey from pages 100 to 2246 (the Survey commences with page 100) and see if 80% of roughly 2000 firms listed exhibit these characteristics.

As a practical matter it is very difficult to assign a probability to 25% per annum compound annual growth. The assignment of probability is a necessarily subjective undertaking. However, the question can be posed in the following manner. How high a probability of the realization of a 25% per annum growth scenario is required to compensate for the possibility that a firm could trade at book value?

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The following two tables are merely extensions of the expected return calculations for the Nasdaq Unprofitable 51 and the BLOM given the return premises posited some paragraphs ago. For instance, it will be recalled that the positive Nasdaq return scenario for the next three years is 95.3%. The negative return scenario is minus 76.1% for the same three year period of time. Thus, if success has a 60% probability and failure (trading at book value) a 40% probability then the expected return is as follows:

$$0.60 (95.3) + 0.40 (-76.1) = 26.7\% \text{ or } 8.2\% \text{ on a compound annual basis}$$

This return appears on the extreme right of the row reading 60%.

Similarly it will be recalled that in the positive instance the BLOM should produce a return of 512% over the course of the next three years. The negative case is that a return of minus 50% will be realized. As in the case of the Nasdaq Unprofitable 51, a 60% probability of a positive outcome and a 40% probability of a negative outcome produces that following expected return.

$$0.60 (512) + 0.40 (-50) = 287\% \text{ or } 57.0\% \text{ on a compound annual basis}$$

This return appears on the extreme right of the row that reads 60%.

<b>Unprofitable Nasdaq 100 Firms—Expected Returns</b>		
<i>Probability of 25% per Annum Growth for 3 Years</i>	<i>Probability of Trading at Book Value</i>	<i>Compound Annual Expected Return</i>
90%	10%	21.2%
80%	20%	17.2%
70%	30%	12.9%
60%	40%	8.2%
50%	50%	3.1%
40%	60%	-2.6%
30%	70%	-9.0%
20%	80%	-16.5%
10%	90%	-25.7%

<b>Banque du Libon et d'Outre-Mer—Expected Returns</b>		
<i>Probability of 15% per Annum Growth for 3 Years</i>	<i>Probability of Trading at Book Value</i>	<i>Compound Annual Expected Return</i>
90%	10%	77.1%
80%	20%	71.0%
70%	30%	64.3%
60%	40%	57.0%
50%	50%	49.0%
40%	60%	40.1%
30%	70%	29.8%
20%	80%	17.5%
10%	90%	2.0%

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The expected returns are uniformly positive based upon the assigned probabilities and scenarios. A reasonable expectation of success of only 20% is required to justify an investment in BLOM.

Of course, the number of calculable scenarios is actually infinite. Nonetheless, modest success is required in order that BLOM shares might be an outstanding investment. Conversely, outstanding success is required in a business sense for the Nasdaq unprofitable 51 in order that these firms collectively become a modestly remunerative investment.

## Summary Results

Banque du Libon et d'Outre-Mer cannot be recommended as a conventional investment due to its obvious lack of margin of safety. It can only be recommended as an Ultra-Contrarian investment (in this case, an Ultimate Ultra Contrarian), the investing ground rules for which were discussed in a primer in December 1999. It is in this context alone that the BLOM is recommended for purchase. It is therefore intriguing that, despite this deficiency, it seems to possess a far more substantial margin of safety than the Nasdaq Unprofitable 51. The former has a market capitalization of some \$300 million. The latter has an aggregate market capitalization of \$433 billion. Insofar as the former is concerned, there are many examples of nations having emerged from civil war and political turmoil to stable democracy and economic success. One need only cite in this regard the Germany of Hitler, the Italy of Mussolini, the Spain of Franco, the Taiwan of Chiang-Kai Shek, the China of Mao or the Japan of nearly six decades ago. One might also remark that the US emerged from a bloody Civil War and within a matter of decades became the dominant industrial power.

Insofar as the latter is concerned, Value Line provides substantial history but no real precedent for enduring success and high valuations for unprofitable firms. If there is evidence to support the notion that the Nasdaq Unprofitable 51 will become dominant growth firms, that evidence is not readily available. Consequently, it would seem that the Nasdaq Unprofitable 51 has less margin of safety than an investment in Banque du Libon et d'Outre-Mer. Most persons would regard a BLOM investment as imprudent. Such an investment is a gamble on long odds. If one believes that equity markets have become casinos, then such terminological inexactitude is appropriate.

The BLOM gamble at long odds is a fair bet albeit perhaps a bad bet. However, some do indeed win at long odds. There is no parallel that 51 large capitalization unprofitable firms in the same industry with evidently cyclical businesses will become 51 consistently growing firms with no evidence of cyclicity. Indeed, there is no other industry with 51 successful and large participants. The bet on the Nasdaq Unprofitable 51 might therefore be said to be a more dangerous investment than an investment in Lebanon. If reward is a function of risk level assumed, then perhaps one might also say that risk level assumed is truly a function of reward level presumed.

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## Appendix: The Nasdaq Unprofitable 51

(\$ mill.)

<u>Company Name</u>	<u>Ticker</u>	<u>Market Capitalization</u>	<u>Price/ Book Value</u>
Abgenix, Inc	ABGX	\$ 1,164	3.69
ADC Telecommunications, Inc	ADCT	2,819	1.90
Adelphia Communications Corp	ADLAE	541	1.89
Altera Corp	ALTR	7,357	7.34
Amazon.com, Inc	AMZN	7,303	NM
Applied Micro Circuits Corp.	AMCC	1,914	1.09
Atmel Corporation	ATML	4,058	2.31
BEA Systems, Inc.	BEAS	4,478	10.86
Bed Bath & Beyond Inc.	BBBY	10,198	9.36
Biogen, Inc.	BGEN	7,346	6.32
Broadcom Corp.	BRCM	6,317	3.37
Brocade Communications Systems, Inc	BRCD	4,563	10.49
Cephalon, Inc.	CEPH	3,048	10.43
Charter Communications, Inc.	CHTR	2,440	1.72
CIENA Corp.	CIEN	1,998	2.51
Cisco Systems, Inc.	CSCO	120,961	5.19
Comcast Corp.	CMCSK	27,170	2.35
Compuware Corp.	CPWR	2,629	1.70
Conexant Systems, Inc.	CNXT	2,068	1.19
EchoStar Communications Corp.	DISH	11,921	NM
Flextronics International Ltd.	FLEX	7,470	2.10
Gemstar-TV Guide Intl., Inc.	GMST	4,141	1.52
Genzyme General	GENZ	7,093	4.38
Human Genome Sciences, Inc.	HGSI	2,183	3.32
i2 Technologies, Inc.	ITWO	1,372	3.76
ICOS Corp.	ICOS	1,403	7.56
ImClone Systems Inc.	IMCL	781	NM
Integrated Device Technology, Inc.	IDTI	2,814	2.62
Invitrogen Corp.	IVGN	1,865	1.96
JDS Uniphase Corp.	JDSU	5,474	1.57
Juniper Networks, Inc.	JNPR	3,337	6.25
LM Ericsson Telephone Co.	ERICY	19,278	6.44
MedImmune, Inc.	MEDI	7,948	9.52
Milennium Pharmaceuticals, Inc.	MLNM	4,688	3.51
Nextel Communications, Inc.	NXTL	4,246	2.04
PMC-Sierra, Inc.	PMCS	2,448	12.96
Protein Design Labs, Inc.	PDLI	1,070	5.20

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		<b><u>Market Capitalization</u></b>	<b><u>Price/ Book Value</u></b>
QUALCOMM Inc.	QCOM	23,868	7.42
Rational Software Corp.	RATL	2,243	3.50
RF Micro Devices, Inc.	RFMD	2,953	5.08
Sanmina-SCI Corp	SANM	6,714	2.38
Sepracor Inc.	SEPR	1,066	NM
Sun Microsystems, Inc.	SUNW	21,952	4.82
Symantec Corp.	SYMC	4,786	3.74
Tellabs, Inc.	TLAB	3,949	2.51
USA Interactive	USAI	22,217	5.11
VeriSign, Inc.	VRSN	2,379	1.37
VERITAS Software Corp.	VRTS	9,637	6.66
Vitesse Semiconductor Corp.	VTSS	1,151	1.15
Xilinx, Inc.	XLNX	12,444	6.39
Yahoo! Inc.	YHOO	<u>10,170</u>	<u>5.19</u>
<b>Total</b>		<b>433,432</b>	
<b>Average</b>		<b>8,499</b>	<b>4.19</b>