investment intelligence

As seen in December 2010

Twin Cities BUSINESS

on the WEB
tcbmag.com

Scott Link

Shareholders, Check Your Bags

Our experience with Select Comfort shows why you need to open those big packages stuffing your mailbox.

If you or a family member own individual shares of common stock, this is the time of the year when your mailbox might start filling up with blue plastic bags. Those bags contain proxy materials, a company's annual Form 10-K regulatory filing, and (usually) an annual report.

Most people toss the documents without looking at them. That's not a good idea. If you own stock in a company, why wouldn't you take the time to look at the information they provide to their shareholders? It's like buying a car and ignoring the reminders from the dealer about regularly scheduled maintenance.

With the latest round of regulatory reform taking effect, publicly traded companies are subject to new rules that, among other things, liberalize the ability of dissident shareholders to stand for election to the board of directors, and require companies to give shareholders a greater voice in the pay that executives and board members receive. Perhaps most importantly, the company executives work for you. They deserve your close attention. And if they've earned your trust, they also deserve your vote.

My firm, Disciplined Growth Investors, can speak from experience about how important shareholder attention can be. We had a ringside seat at one of the closest shareholder votes in recent memory. And it happened just last year.

At the time, we held nearly 3.2 million shares of stock from Plymouth-based mattress maker Select Comfort (Nasdaq: SCSS). Our decision—and that of the shareholders we sided with, of course—swung the vote against a proposal to sell control of the company to a private equity firm. Under the conditions at the time, that deal would have given the buyers an instant paper profit of $100 million and allowed them to buy 50 million shares of new stock at a 75 percent discount to the level at which the stock was trading at the time.

> **0.1**
>
> Call this a *wake-up number* for shareholders: It's the percentage difference between Select Comfort investors voting against a 2009 purchase offer and those voting for it.

We made our initial investment in Select Comfort in the spring of 2002 at $4 a share. Later that year, we purchased more shares at $6. We added to the position when SCSS was trading at $16 a share, and again in early 2004 at $12 a share, after the stock took a major hit in the wake of some negative press. SCSS then proceeded to trade as high as $28 a share in late 2005. But after one last run-up in mid-2006, it began a long, slow slide—well, a crash, actually—that extended into the depths of the 2008–09 recession. Sales cratered, stores closed, and the company flirted with bankruptcy.

Throughout the period, we visited the company to see how things were going. (We took a particular interest in things when the stock traded down to about 20 cents per share.) During one visit, management pointed out to us that it had cut capital expenditures down to a maintenance level. In the next six months, this would generate enough cash flow to meet the company's debt obligations.

That was enough for us: We doubled our position, buying roughly 1.5 million shares of the stock at prices ranging from 21 cents to 27 cents.

Select Comfort received a buyout offer from Baltimore- and Chicago-based Sterling Partners in May 2009, after the company's stock had "recovered" to about 75 cents a share. The stock continued to climb throughout the summer; it was trading at $2.77 a share at the time of a special shareholder meeting in August 2009 to consider the Sterling Partners offer. As SCSS climbed, we heard repeatedly from Sterling, soliciting our support for its proposal.

At first, we voted in favor of the deal. Really. But as the stock continued to increase in price, it became clear that the offer would be highly dilutive to existing shareholders. We changed our vote. Sterling pressed on, offering us the chance to participate in the deal. That was tempting. But then we learned that we would have to pay the 20 percent "carry" charge—namely, a 20 percent share of the profits—that Sterling would have made on the transaction.

In the end, we voted against the proposal. The final vote: 16,163,360 against; 16,128,114 for. A difference of just 35,246 shares, or one-tenth of 1 percent of the total vote.

So the next time that blue plastic bag arrives in the mail, open it. Read what's inside. Learn all about what you own.

By the way, we still own Select Comfort stock. SCSS's price as of this writing: $7 a share. Undiluted! **TCB**

Archives

For more "Investment Intelligence," go to "Ideas and Opinions" at **tcbmag.com**. There you'll also find the archives of other *Twin Cities Business* columns, including "Capital Beat" and "Portfolio Positions."

11/2010
PLANNING FOR TAX "REFORM"
Assuming the "Bush tax cuts" are repealed, you'll be paying more to the government. That will require recalibrating your investment strategy.

Scott Link is a portfolio manager at Disciplined Growth Investors, a Minneapolis-based independent investment management firm founded in 1997.

scottl@dginv.com