

UST Inc. -- Smokeless Tobacco Products Leader

Greetings from LFS

Dear Clients and Friends:



Here is my quarterly newsletter, **Invest**. The goal of **Invest** is to keep you abreast of what is happening in the financial market, inform you about new investments and keep you informed about your current investments.

I welcome any questions, comments or suggestions.

Sincerely,

Doug Ruth

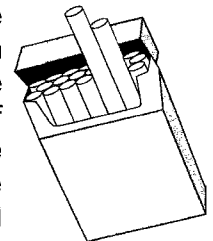
UST Inc. is the leading U.S. producer and marketer of smokeless tobacco products with approximately a 75% share of the moist smokeless segment.

The company's major brands include Copenhagen and Skoal. Copenhagen was introduced to the public in 1822 by its inventor George Weymann. In 1934, the company introduced Skoal, a wintergreen flavored smokeless tobacco.

Personally, I think chewing tobacco is a dirty, nasty habit. It is, however, legal. Additionally, UST is a very profitable and a very easy company to understand.

Currently, chewing tobacco is used primarily in the U.S., Canada and Sweden while other parts of the world use the product on a very small scale. The company is optimistic about changing this in the future. In 1998, 27% of the people in the U.S. who used chewing tobacco smoked; in 1999, this number had increased to 33%.

At present, 250 million people reside in the U.S. About 20% use cigarettes and 2% (5 million people) chew tobacco. The company feels that there is a lot of growth potential in the U.S. The company believes that some of the cigarette consumers could become customers if they were looking for an alternative to smoking.



A can of Skoal is made of the following:

- A small amount of processed tobacco which has been carefully aged over a 2-4 year period.
- A small amount of added flavoring such as wintergreen.

Invest

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- A container made up of a combination of paper, plastic and tin. The container is actually a work of art. (While you may find this whole description disgusting, you would probably agree that the product comes in a nice-looking container!)

That's it – except for the shipping boxes.

The cost to make a container of chewing tobacco is 45 cents. The company sells it to wholesalers for \$2.37 who mark it up another 15% (about 36 cents) and sell it to their customers, the retailers. The retailers mark it up another 15% (about 41 cents) and sell it to the public for about \$4.00. The retail price includes the state excise tax of 70 cents. The company sold 634 million cans in 1999.



Would a rational business person buy shares in UST Inc? In 1999, there were 166,807,086 shares of UST. As of September 4, 2000, the stock price was \$20.50. If the rational business person had unlimited financial resources, he or she could buy the entire company for \$3.42 billion:

$166,807,086 \text{ shares} \times \$20.50 = \$3.42 \text{ billion}$
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In 1999, the free cash flow generated by the company was \$403 million. This means that if our business person bought all the stock for \$3.4 billion he or she would earn a respectable return of 11.9%.

$\$403 \text{ million} \div \$3.4 \text{ billion} = 11.9\%$

When compared to alternative investments, it is difficult to find one that offers a yield as high as 11.9%. Alternative investments offer the following yields:

30 day treasury bill	6.09%
10 year treasury bond	5.675%

Why would UST offer such a high yield? There are two possible reasons: litigation fears and charges of Sherman Anti-Trust Act violations.

Litigation Fears – Are the fears justified? Could smokeless tobacco be treated the same as cigarettes? No, the litigation profiles are different: As you know,



the litigation against the cigarette manufacturers has been intense. Smokeless tobacco and cigarettes are different products with different litigation profiles.

Since 1954, there have been approximately 2,000 cases filed against cigarette companies. Currently, approximately 800 cases are pending. There have been five adverse verdicts, three of which have been reversed while the other two are on appeal.

However, since 1954, only 20 cases have been filed against the smokeless tobacco manufacturers, eight of which are currently pending.

UST believes Wall Street is treating the company the same as the cigarette manufacturers and that they should be treated differently. I agree.

Antitrust Litigation: Is UST guilty of violating the Sherman Anti-Trust Act? The marketing of smokeless tobacco is competitive. Effective marketing is challenging in any business. UST advertises in magazines as do the other companies. The most effective marketing method, however, is the in-store display. The correct product placement often is *the* factor in securing sales. Placing the product so it can be seen by the most potential customers is critical and often dictates success or failure.

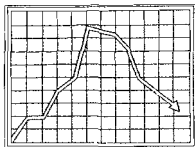
In April 1998, Conwood, the second largest industry producer, accused UST of trying to run it out of business. In an article from *Forbes* magazine written by Brandon Copple, one of UST's sales representatives was accused of taking down a Conwood display, tossing it in a dumpster, and putting UST advertising on a Conwood product display.



In May 2000, a Paducah, KY, jury found UST guilty of antitrust violations under the Sherman Anti-Trust Act. The court tripled the judgement to \$1.05 billion. The company has filed motions to have the verdict set aside. If this doesn't work, the company will appeal the verdict.

UST believes that two major defenses show that the company is not guilty of antitrust violations.

- Industry participants routinely move and/or damage each other's display racks – acts that have been documented over a period of time.
- UST market share has declined, a fact that is probably stronger than the first defense.



In 1990, UST had 87% of the smokeless industry business while in 2000, the market share has fallen to 75%. In fact, all the other industry participants gained market share at UST's expense.

It seems to me that it would be difficult to prove that UST has a monopoly or is guilty of antitrust when the company has lost market share.

Calculating the fair value of UST: It could be suggested that the fair value of UST on December 31, 1999, was \$37.35.

The fair value is calculated by dividing the cash flow per share by the interest rate on the 30 year Treasury Bond.

Cash flow	\$403 million	= \$2.42
Shares outstanding	166.8 million	

	\$2.42	= \$37.35
Interest rate on 30 yr Treasury bond	6.48%	

Investors who have owned tobacco stocks for the last several years find themselves with the investment problem known as a *value trap*. The stock is worth substantially more than the current market price, but for some reason – in this case, litigation – the security is not reaching its true value.

It is my opinion that investors in the tobacco

section are going to receive some relief from this problem.

In 1999, the food business and tobacco business were separated by RJR. Earlier this year, Philip Morris bought Nabisco, the food business that was separated from RJR. This transaction is scheduled to be completed by the end of the year.

The separation and sale of the food business has rewarded RJR stockholders. It appears that the ground work is being laid to separate Philip Morris' food business from its tobacco business.

What catalyst would move UST from \$20.50 to \$37.35? The tobacco business continues to consolidate and UST, which is currently trading at a nine year low, is vulnerable to being taken over by a larger company. In fact, Martin Feldman, a leading tobacco analyst from Solomon Smith Barney, has documented the possibility.

Mr. Feldman has suggested that RJR may buy UST for \$28.50 a share.



How did he calculate the \$28.50 price? In my opinion, he used the \$37.35 fair value and subtracted the \$1.05 billion Conwood verdict:

\$37.35 x 166,807,086 shares =	\$6.230 billion
Conwood verdict	(\$1.05) billion
	<hr/>
	\$5.180 billion

\$5.180 billion ÷ 166,807,086 shares =	\$31.06
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The discrepancy between \$28.50 and \$31.06 can be attributed to a "Fudge Factor."

Will RJR buy UST? It is difficult to say. However, UST, which pays a fat dividend of 8.6%, is attractive to investors. It is also possible that another company may emerge and purchase UST.

Sears, Roebuck and Company, the Nation's Second Largest Retailer

Overview: Sears, Roebuck and Company (Sears) is the nation's second largest retailer. Sears is involved in five different businesses, four of which are described in this newsletter:

1. Retail
2. Services
3. Credit
4. Corporate
5. International

1. Retail: The company operates 858 full-line Sears stores averaging 88,000 square feet of selling space and located primarily in the best malls in the nation. The stores offer a complete line of merchandise including apparel and other soft goods, home and automotive products, and hard goods which consist of hardware, home improvements, appliances and electronics.

The company's major brands include Kenmore (appliances), Craftsman (tools), Weather Beater (paint), and Die Hard (batteries).

The company also operates more than 2,100 specialty stores located primarily in free-standing, off-the-mall locations or high-traffic neighborhood shopping centers. These stores are divided into five distinct categories which are described below :



- **Hardware Stores:** The company operates 267 neighborhood stores under the Sears Hardware and Orchard Supply Hardware names.

- **Dealer Stores:** This category is made up of 758 independently-owned stores which are located in smaller communities. Customers can purchase Craftsman tools, Weather Beater and Easy Living paints, Kenmore appliances and Die Hard batteries.

- **Contract Sales:** Consisting of appliances and home improvement products, these showrooms serve commercial customers.

- **The Great Indoors:** The company built two prototype stores for home decorating and remodeling. The stores are dedicated to the four main rooms of the house; kitchen, bedroom, bath and great room. The stores are designed to be a woman shopper's single destination for home decorating and remodeling projects and were designed by women.

- **Automotive Stores:** The company operates 798 Sears Auto Centers and 310 NTB (National Tire and Battery) stores. The Sears Auto Centers are located "on the mall" while NTB stores are located off the mall.



Sears is the top tire retailer in the country, selling over 18 million tires at a cost of over \$1 billion annually.

2. Services: The company provides product repair services as well as parts for all major brands of home products, no matter who made them or sold them, through a network of 14,000 installation service technicians.

Also, the company offers service contracts, which provide annual maintenance checks as well as repair and replacement coverage; and home improvement services including residential heating and cooling systems, siding, roofing, replacement windows, pest control and carpet cleaning.

In 1998, the Services division, called Sears Home Central, made more than 15 million product repair services calls, sold service contracts on more than 13 million items and initiated more than 1 million home improvement products in households all across the United States.

- 3. **Credit:** Sears has more than 38 million active credit card accounts. The portfolio is the largest in the nation among retailers; it is even larger than the combined total of its 10 biggest competitors. It is the sixth largest portfolio overall when compared to bank card issuers.
- 4. **Corporate:** Not described in this newsletter.
- 5. **International:** The company operates stores in Canada (Sears Canada). This includes 109 full-line and 125 specialty stores offering retail services and credit products similar to those offered in Sears domestic operation. The company also owns 15.5% of the Sears stores in Mexico (Sears Mexico).

Understanding Retail: Understanding both the retail sector and Sears can be somewhat challenging. Using common sense and thinking like

a prudent business person, however, allows an investor to see the value in buying Sears stock at the current low, depressed stock price.

Retail is essentially divided into three tiers:

Tier		Retailers such as...
1	Self-Service	Wal-Mart, K-Mart and Target.
2	Mid-Service	J.C. Penney and Sears
3	Full Service	Marshall Field's and Nordstrom

As you can see, Sears and J.C. Penney are located in the middle between Self-Service and Full Service.

What is Sears? Sears is a combination of both a retailer and a credit card company. The company actually makes more money from the credit card operations than from the retail stores (see chart below).

<i>Retail Stores:</i>	1996	1997	1998	1999
Total Retail Revenues	\$27.862 billion	\$30.086 billion	\$30.429 billion	\$29.775 billion
Operating Income	\$841 million	\$928 million	\$734 million	\$886 million
Gross Margin	3.02%	3.08%	2.41%	3.0%
<i>Credit Card Operations:</i>				
Domestic Credit Revenues	\$3.995 billion	\$4.649 billion	\$4.369 billion	\$4.085 billion
Domestic Operating Income	\$1.164 billion	\$752 million ¹	\$1.144 billion	\$1.347 billion
Margin	29.14%	16.17% ¹	26.18%	32.97%

1. There was a one-time charge of \$475 million in 1997.



Who is the Sears' Customer? Sears believes that its core customer is a middle-income female, age 25 to 54, and head of her household. The stores are designed with this customer in mind. Two of every three square feet of selling

space is dedicated to apparel, accessories and home fashions.

Of course, when a customer makes a Sears

purchase, she can pay with cash or another company's charge card but the ideal customer is one who buys Sears products, has them installed by Sears technicians, and pays for them with a Sears charge card.

The company is disappointed with the amount of business the core customer is providing. Sears believes it should be higher.

The company has disclosed the percentage of sales using the Sears charge, the average balance each customer owes and the total amount owed (see chart below).

Sears Charge Statistics				
	1996	1997	1998	1999
Sears Card as a Percent of Sales	56.6%	55.1%	51.6%	47.9%
Average Account Balance	\$977	\$1,058	\$1,076	\$1,121
Average Managed Credit Card Receivables	\$24.631 billion	\$27.150 billion	\$ 27.922 billion	\$26.593 billion

Addition Through Subtraction: When you look at Sears results from 1997 through 2000, it appears that the sales are not growing:

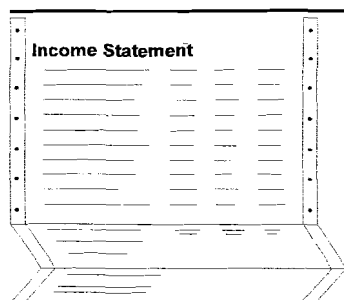
The company's net profit margin has improved from 3.2% in 1997 to a projected 3.9% in 2000.

Sales Results 1997 through 2000				
	1997	1998	1999	2000
Sales in billions	\$41.296	\$41.322	\$41.07 ₁	\$41.4*
Number of stores	3,530	3,028	3,011	3,060*

*Projected.

Net Profit Margin				
	1997	1998	1999	2000
Net Profit Margin	3.2%	3.1%	3.6%	3.9%*
Net Profits (in billions)	\$1.303	\$1.300	\$1.482	\$1.600*

* Projected.



The company sold four businesses that were non-core operations:

The company has also bought back a lot of the stock. The number of shares outstanding has decreased a projected 13% since 1997.

4 Non-Core Operations Sold		
	Year Sold	Annual Sales
Homelife	1998	\$600 million
Western Auto	1998	\$ 1 billion
Advantis	1997	Insignificant
Portion of Sears Mexico	1997	\$600 million

Shares Outstanding				
	1997	1998	1999	2000
Number of Shares Outstanding in millions	390.89	383.51	369.13	340*

* Projected.

When you think about the state of retail in this country you quickly realize how many choices (stores) there are. It is fair to suggest that there are probably too many.

The preceding analysis, however, shows how financially strong Sears is. Even though sales are not increasing, this is partially explained by asset sales. The profits are substantially higher in the year 2000 than in 1997.



Would a Prudent Business Person Buy Sears Stock?

If a person had unlimited financial resources, he or she could have purchased the entire company for \$11.2 billion on December 21, 1999. As of December 31, 1999, Sears had 369,100,000 shares

outstanding and on this date the stock was trading at \$30.38 per share.

$$369,100,000 \text{ shares} \times \$30.38 = \$11.2 \text{ billion}$$

After making the standard analyst's adjustments, the business person would have earned \$1.725 billion or 15.38% on his or her investment.

$$\$1,725 \text{ billion} \div 11,211,412,500 \text{ shares} = 15.38\%$$

This is impressive when compared to alternative investments. A prudent business person would be glad to take this investment opportunity, especially when other investments have a lesser return:

30 day treasury bill	6.09%
10 year treasury bond	5.675%

The Catalyst: One of the mistakes I have made as a broker is finding stocks that are cheap based on traditional valuation methods. The problem is that the stocks remain cheap.

The best example is to think about investing in a Florida swamp. If you buy the swamp land cheaply in 2000 and then tried to sell it 10 years later, it would still be swamp land and not worth very much.

Sears stock is cheap. Is there a catalyst that will make it increase in value? The answer is "Yes." Several factors that will cause the value to increase are described below:

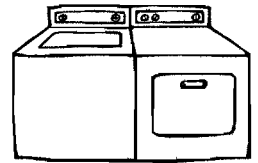
- The single most important indicator of a retail store's success or failure is same store sales in the current period versus the same period last year; i.e., August 2000 versus August 1999. During the second quarter of 2000, Sears' domestic same store sales were up 2.7%.

Sears same store sales are increasing. This

means that customers are happy and returning there to shop again. Also, they are telling their friends and families, who are also shopping at Sears.

- Sears is the number one seller of appliances in the country. Even though Wal-Mart will start selling General Electric appliances, Sears will remain as the only retailer to offer all six major brands: Amana, Frigidaire, General Electric, Maytag, Whirlpool and Kenmore.

In July, Circuit City announced that it will stop selling large home appliances. Sears believes it can gain some market share by selling appliances to the former customers of Circuit City. This offsets Wal-Mart's expansion of the appliance lines offered in its stores.



- Sears named Alan J. Lacy as the new president and chief executive officer. Mr. Lacy has done an excellent job improving the Sears Credit operation. The naming of a new president often encourages the investment community to take a new look at the company.
- The results of the Great Indoors stores have been intriguing. The initial stores have been generating annual sales of \$50 million each. The company is committing to 30 new sites by the end of the year.

Analyzing the First Half of 2000: During the first two quarters of 2000, Sears earned \$985 million. If we assume that the second half of 2000 will be the same as the first half, we can project that the company will earn \$1.970 billion in the year 2000. This is an extremely conservative estimate. Because the fourth quarter includes Christmas, this is usually Sears' best.

As investors we want Sears to do the right thing with the \$985 million earned in the first half of this year. Sears can do three things with this cash. The company can:

1. Invest it back into the business with the idea of generating more profits.
2. Raise the dividend, which in turn would mean that the investors will receive some additional cash. This is very acceptable and would make the investors happy.
3. Buy back stock. When you or I have extra money, it is usually more fun to spend it instead of saving it. It always feels good to buy something. It takes discipline to save, and for the company it takes the same type of discipline. It is fair to say the Sears showed a lot of discipline.

The company bought back \$901 million of stock. This allowed the company to retire 37.3 million shares or 9.8% of all the out-

standing stock. Sears is buying back stock because it feels that the stock is undervalued.

The Fair Value of Sears: It is fair to suggest that Sears could be worth approximately \$72 a share.

The fair value is calculated by dividing the cash flow per share by the interest on the 30 year treasury bond:

1999 Cash Flow	\$1.725 billion	= \$4.67
Shares Outstanding	369 million	per share

$\$4.67 \div 6.48\% = \72.00

With Sears currently trading at approximately \$35 per share, it appears there is a tremendous investment opportunity.

Illinois College Bonds Available in October 2000

The State of Illinois college bonds will be available from October 2nd through October 4th. They will be sold on a first-come, first-serve basis. The bonds are an excellent way to save for a child's education.

The bonds will have a minimum maturity of 3 years and a maximum of 22 years. The chart below shows the approximate yields, cost per bond, and bonus paid if the bonds are used for a child's education in the State of Illinois.

The interest from the bonds is free from Federal and State taxes, and a bonus is paid when the bonds are used for a child's education in the State of Illinois.

You can purchase these bonds through Lenox Financial. If you are interested, please return the enclosed card and I will forward the information to you when it becomes available.

Maturity Date	Cost Per Bond ¹	Interest Rate ¹	Bonus Per Bond	Maturity Value
August 1, 2003	\$4,430	4.40%	\$60	\$5,000
August 1, 2004	\$4,233	4.45%	\$80	\$5,000
August 1, 2005	\$4,041	4.50%	\$100	\$5,000
August 1, 2006	\$3,855	4.55%	\$120	\$5,000
August 1, 2007	\$3,673	4.60%	\$140	\$5,000
August 1, 2008	\$3,496	4.65%	\$160	\$5,000
August 1, 2009	\$3,325	4.70%	\$180	\$5,000
August 1, 2010	\$3,144	4.80%	\$200	\$5,000
August 1, 2011	\$2,967	4.90%	\$220	\$5,000
August 1, 2012	\$2,794	5.00%	\$240	\$5,000
August 1, 2013	\$2,627	5.10%	\$260	\$5,000
August 1, 2014	\$2,464	5.20%	\$280	\$5,000
August 1, 2015	\$2,324	5.25%	\$300	\$5,000
August 1, 2016	\$2,190	5.30%	\$320	\$5,000
August 1, 2017	\$2,061	5.35%	\$340	\$5,000
August 1, 2018	\$1,938	5.40%	\$360	\$5,000
August 1, 2019	\$1,821	5.45%	\$380	\$5,000
August 1, 2020	\$1,709	5.50%	\$400	\$5,000
August 1, 2021	\$1,619	5.50%	\$420	\$5,000
August 1, 2022	\$1,517	5.55%	\$440	\$5,000

1. Approximate values; actual values available on October 2nd, 2000.