

# What does China mean?

**E**ver since we wrote about steel we have been thinking about China. After 25 years of bright hopes and false dawns, it is now indisputable that China is happening. For confirmation we no longer have to look to internal statistics on abstractions like GDP growth, denounced even by the Chinese government as the dubious output of apple-polishing provincial bureaucrats. The real changes in China have nothing to do with futile attempts to track the minute economic behavior of 1.25 billion people, 900 million or so of whom remain irrelevant to the global economy. It is what the other 300 million are doing that counts, and that we can see in much more reliable data, especially trade statistics. We know how much steel China buys, how much it sells, and roughly how much it makes. We know how much oil China bought in 1995, 3 million barrels a day, and we know how much oil it bought in 2004, 6 million barrels a day. Growing demand for steel and oil, and the flood of foreign investment and the mass migration of manufacturing jobs, all of which can be verified externally, imply not only growth but a certain type of development. They imply capital goods, which imply middle class or soon-to-be middle class workers; they imply consumer goods of a sort that imply middle class consumers. Foreign-linked firms manufacturing for domestic consumption are no longer making just bicycles, watches, and cheap radios. They are making computers, color TVs, cars, and capital goods

The emergence of a Chinese middle class is confirmed by the most trustworthy Chinese economic data, trustworthy because it is an “admission against interest” and because it is confirmed by numerous academic and marketing studies by Westerners with

due skepticism for official data. The admission against interest is the rampant growth of income inequality, an almost obsessive subject of discussion among Chinese intellectuals and politicians. This obsession might even be a reason for concern about China’s future if it implied a strong sentiment to go back to Communism. So far at least the prevailing answer seems to be just the opposite: spread economic

## INSIDE

CHINA, SUTURA, OIL & SHORTS  
**PLUS: Steel, Apartment  
REITs, and Big Pharma**



liberalization, originally concentrated in zones of freedom near the coast, throughout the country and build rural infrastructure so that manufacturing firms can draw on rural labor.

The growth of income inequality is the best news that could possibly come out of China. The middle class is still small, so small that the term “middle” is a bit of a misnomer. It includes perhaps 30-150 million people, the first number being roughly the number of people who

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live in households that own automobiles, the second being the number who live in households that own a personal computer. Compared to the typical Chinese, who is still an impoverished and underemployed farmer or rural worker, these people must seem wealthy. To each other they probably look “middle class” because they all live together in a handful of rapidly developing urban areas. But neither upper nor middle class accurately describes them. These 30 to 150 million people are the citizens of the new and growing China. Trailing right behind them are maybe another 100 to 150 million

lower-paid urbanites knocking at the gates. The rest of the population lives in the old shrinking impoverished China. Chinese people become middle class not by gradually increasing their income from utterly impoverished to a little above that but by leaving the old China and joining the new.

Twenty years ago the most popular wrong way to look at China was as (then) 800 million poor people who, if they each bought just a little from the West, would make us rich. This was the “imagine if every Chinese bought just one Coca-Cola a week” model of the importance of China. But people who can buy only one Coke a week are not likely to buy even one. You can’t really sell Coke to subsistence farmers living outside the cash economy.

### THE POOR DON'T MATTER

Today the most popular wrong way to look at China is not as a nation of improbably poor consumers but as a nation of improbably poor producers. The constant lament, “How can the West ever compete with 1.25 billion workers in a country whose average annual per capita income (about \$940 in 2002) is less than what American auto workers make in a week?” springs from this view. But of course it is nonsense, even



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on the numbers. That average income figure includes 800 million or so people who are still living in the old rural China. In 1985 urban Chinese households had an average income only 50 percent higher than rural households. By 2001 urban households brought in more than three times as much as the rural households that still made up more than 60 percent of the population. Moreover this broad urban-rural distinction, dramatic as it is, actually understates the change occurring in the urban coastal areas of the country that are joining the world economy. Urbanites in places like Beijing, Shanghai, and Guangdong enjoy an average per capita income seven to ten times as high as rural Chinese in the interior, and the spread is growing.

Average Chinese urban employees earned about \$1,700 a year in 2003. But within that group are millions, perhaps tens of millions of workers earning more than \$4,000 a year on the factory floor of foreign-linked firms. Mid-level executives in such enterprises are making more than \$35,000 a year. Senior executives are making double that.

As we have learned again and again in the past 50 years, once industrialization begins in earnest—real industrialization, not souvenirs and penny goods, but bicycles and textiles, then cars and capital goods—wages rise with astonishing speed. Roughly speaking, most people can buy what they make. This is true in the strict economic sense that wages ultimately track productivity. But it is also more loosely true that within a few years of the first bicycle factory coming to town, most people who work there will be able to buy a bicycle. Within a generation of the first automobile factory coming to town, most people who work there will be able to buy a car.

It is nonsense to think that China as a whole will become rich *because* the Chinese individually are poor. The ugly truth is that poor people don't matter. They don't matter as consumers because they don't have any money; they don't matter as producers because once they start producing they do not stay poor for long. Show me a persistently poor factory worker and I will show you a rotten factory, no threat to the U.S. or anyone else. China has had those rotten factories for a long time, state-run enterprises profligate of labor but paying each worker a pittance, and still notoriously unprofitable. The Chinese economy started moving only when more efficient independent and private firms raised both pay and productivity.

Professor Thomas Rawski, a labor economist renowned for his work on China, cites data showing that private sector factories of various sorts, including foreign firms operating in China, were paying their workers almost 50 percent more than comparable state factories. Yet the private sector firms had 30 percent less labor cost per unit of production and were three times as profitable per unit of labor cost. In certain sectors the difference was far more dramatic. In food processing private-sector workers were paid twice as much and produced 10 times as much profit per unit of labor cost. In electronics and telecom, private sector workers made twice as much and produced 16 times as much profit per unit of labor cost. These are figures from the late 1990s. Some studies suggest that the efficiency of state firms has increased in response to competition, but that's a sideshow. The important development is that the state firms are dying out and employees are moving en masse to the private sector and higher salaries.

The public agonizing in the U.S. about shipping jobs abroad ignores the obvious lesson of history. When jobs move because of wage differentials, the wage differentials close with remarkable speed. The evidence for this abounds, but all one really needs to see this is a decent memory and common sense.

Remember Japan? Not Japan the economic powerhouse of the 1980s. Nor even Japan the financial basket case (but still industrial powerhouse) of the late 1990s through today. We mean Japan of the 1950s, 1960s, and early 1970s. In those days, just a few decades ago, the Japanese competitive edge was not that they did everything better than everyone else. It was that they worked cheaper than anyone else, or at least than anyone else with any industrial infrastructure at all. In those days "Made in Japan" was still a byword for junk.

Wage differentials helped Japan grab global manufacturing market share. But that advantage very soon ran its course. By the late 1980s no one was expanding production in Japan to save on wages. Japanese factory workers still earned less than U.S. workers as they do

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today. But not only had the gap between U.S. and Japanese wages closed dramatically, in both countries manufacturers responded to high wages by increased automation, pulling expensive man-hours out of the job. So the wage differential was not only smaller in itself, it applied to a smaller percentage of total manufacturing costs. Wage differentials moved rapidly from being the prime consideration in U.S.-Japan competition to being a footnote. Today, to the extent that Japan is still a manufacturing leader, it owes that leadership not to profligate

**For all practical purposes China is the last industrial frontier.**

use of cheap labor but to frugal use of ever more expensive and productive workers.

When Japan stopped being cheap, new Asian Tigers emerged, like South Korea and Taiwan. In the late 1970s and early 1980s, the wage spread between factory workers in the U.S. and the Tigers

was on the order of 20:1. By 2001 U.S. factory labor was only 2.5 times as costly as in Korea. By 2003, according to a survey by Oxford Economic Forecasting, the spread had narrowed to 2.2 times. Practically speaking, and depending on the productivity of the industry and the potential for automation, in many industries a 2X advantage might as well be zero. Few screams are heard about U.S. job loss to Korea or Taiwan today. In five years few will be none.

These things happen very quickly. Just 25 years after they became the bargain hunters' destination of choice, both Korea and Taiwan now have to compete on quality and productivity, not wages to maintain their positions against China. The same thing is happening even in China itself. Already there are scattered reports of coastal China shipping jobs to the interior as manufacturers fed up with the soaring demands of workers on the coast look for the next cheapest place.

In 2001, according to the same Oxford survey, factory labor cost 40 times as much in the U.S. as in China. Just two years later, that gap was only 36 times. Chinese labor costs jumped 20 percent in 2 years, while U.S. labor costs rose only 8.5 percent. In India the same thing is happening. In 2001 the cost spread between U.S. and Indian factory labor was 25:1. Two years later it was 22:1.

## A SMALL, RICH COUNTRY

The right way to think about China, from the point of view of its impact on U.S. business and investments, is not as a huge, poor country slowly getting less poor, but as a small, already prosperous country rapidly getting larger and more prosperous. Take the smallest possible definition of this new country, the 30 to 40 million households with cars. Even studies using modest estimates of future income growth show that in 15 to 25 years that country, the nation of Chinese car-owning households, will be larger than the U.S. Expand the definition just a little bit to capture reasonably prosperous urbanites who don't own cars, and the new China will be easily double the size of the U.S. by then.

When we argue that steel prices or for that matter oil prices are not likely to retreat wholesale over the next few years, this is the China we are thinking of. This China fits neither the fantasy of peasant consumerists buying the cheapest the West has to offer, nor the nightmare of infinitely patient proletarians putting the West out of work by contentedly showing up on the assembly line for pennies an hour, forever. This China is a nation of increasingly prosperous producers and consumers, buyers and sellers. Within 25 years, probably less, the wage differential between the new China and the rest of the industrial world will no longer be sufficient in itself to induce mass migration of industrial jobs.

## THE FINAL FRONTIER

So what will be the next place? Well that's the interesting point, isn't it? There isn't a next place, really. For all practical purposes China is the last industrial frontier. There is India, of course, but India is moving rapidly as well; Indian wages are higher than Chinese. There is the rest of undeveloped Asia, including Indonesia and parts of the former Soviet Union, but those countries are also moving and in any event their total population is small by comparison. When China and India, an additional 2 billion people, can be counted among the more or less industrialized/developed nations, the developed world will have become most of the world, by far. All that would remain, really, is Africa. Africa, alas, shows no signs of becoming a manufacturing center. And even if it did, a few

hundred million Africans are not going to do any considerable portion of the manufacturing for the rest of the world, at least not without becoming rich themselves, pretty darn quick.

What will this mean? What happens when industrial migration, the leitmotif of the global economy since the end of World War II, stops? What happens when there is no suitable place left on earth where large numbers of credible workers earn enough less than workers in the rest of the world, including the U.S., to justify the costs of shifting manufacturing abroad?

What? You want a good answer as well as a good question in the same issue? Twenty-five years may be a short time in the history of nations, but it is a longish stretch over which to make a wager in the market. So we are not suggesting wholesale investment in the U.S. industrial renaissance to come. For now, mostly we are suggesting contemplation. That said, contemplating the speed at which the new China is likely to progress does make us even happier that we own steel and more confident that we are going to be even happier owning it five years from now than two years from now.

The same goes for oil. As we noted a couple issues back, our “radical conservative asset allocation” should include at least 5 percent of assets in energy stocks, more specifically oil and natural gas. Typically energy portfolios comprise a somewhat broader spectrum of stuff, including power generation and even coal. But the argument for coal is really a derivative of the argument for oil and gas. There is plenty of coal; oil and gas supplies are tight and getting tighter; coal will swap for oil in some applications, so buy coal. OK, but why not buy oil and gas, the things that there is actually a shortage of, and keep life simple? The same argument applies in spades, we think, to power generation. If the bet we want to make is on energy resources, why gum it up with all sorts of operational, regulatory, and (yuck!) political complications? Keep the bet clean.

## THE OIL BET

**T**he bet is simple. Oil has not yet begun to rise. As with steel, the oil complex is operating near 100 percent capacity today not only in production but in refining, transport, and storage as well. As with steel, global demand is growing, very rapidly, large-

ly driven by China and India. But oil supplies obviously are less predictable and elastic than steel. Practically speaking, the world can have as much steel as it chooses to make, at a price. But we have only as much oil as we can find and profitably extract. And though we count ourselves among the optimists who assume there is a whole lot more out there still to be discovered, it remains true that the decision to “find oil” can never be as sure of execution as the decision to “build a steel mill.” Moreover while the increase in supply has generally tracked the increase in demand, that statistic is somewhat misleading. Supply has continued to increase largely because oil producers are going after harder to reach and more expensive deposits, using more expensive technology to wring the last drop out of tired wells. By definition oil supply and demand will track until the last drop is pumped; only the price will change. The direction will not be down.

We have spent a good deal of time delving through oil market research in the past couple of months. Happily for you, we are going to spare you the details. As with any valuation debate it is quite possible to make a good argument either way about the share prices of oil companies today. Since oil is essentially a price-taking industry, those debates must revolve around the price of oil over the next 24 months. The consensus is that the majors are currently priced for oil at about \$30 bbl, and that is a reasonable guess at the “equilibrium” price for oil right now, i.e., the price people would really be paying if they weren’t nervous as cats about supply interruptions and price volatility and the dollar. We have no basis for arguing with that reasoning. That being the case, why bother? Why buy a bunch of companies that may be fairly priced already?

Because there is an upside possibility and we can buy into it at very low risk.

The major integrated oil companies are for the most part conspicuously well managed, with strong balance sheets, long histories of positive earnings, and good

**The best environment in which to make money is a bumpy market with an upward trend.**



if not perfect records of earnings improvements. Exxon Mobil (XOM) is more than a century old and has increased its dividend every year for more than 20 years. The balance sheet glows in the dark, with negative net debt and plenty of cash. Return on equity, as with most of the majors, is high and generally trending upward. One of the reasons the oil complex is so pressed for capacity these days is that most of the majors have shown very tight investment discipline over the past decade, thus high ROE. Also there are about 7 percent fewer XOM shares outstanding today than five years ago right after the merger. This is the ultimate quality company. It is not amazingly cheap at the moment, but it also has decent near-term growth prospects: several West African offshore projects ramping up over the next few years promise to boost production and sales volume. XOM is the class of the group, but the rest of the class follows the pattern.

So, to start with, we're looking at your basic "why not" stocks. The likelihood that anyone will ever really, deeply regret owning one of the major integrated oils five

years after buying it is very low.

**Oil is a virtually risk-free bet on what the world will look like when three-quarters of the Third World ceases to be third.**

The next argument for the oil stocks is volatility. What? Didn't we just get finished saying these were nice boring stable stocks we'd never have to worry about? Right. Mid to long term they are. But when an industry is operating at near

100 percent capacity, a condition the oil industry is not likely to be able to change for some time, it prices funny. Small changes in supply and demand can push prices much further off equilibrium than in an industry with lots of excess capacity. That stands to reason. If the world's steel mills are running at 75 percent capacity, and demand jumps to 80 percent, prices will probably rise in a more or less linear fashion. But if plants are running at 97 percent and demand pops to 102, prices may not behave so sensibly.

We have seen this in recent weeks with oil. In November \$50 bbl was the new permanent reality. Just a

few weeks later prices plummeted on the discovery that inventories were a little richer than anticipated. Both moves were probably overreactions.

## MR. MARKET IN MANIC MODE

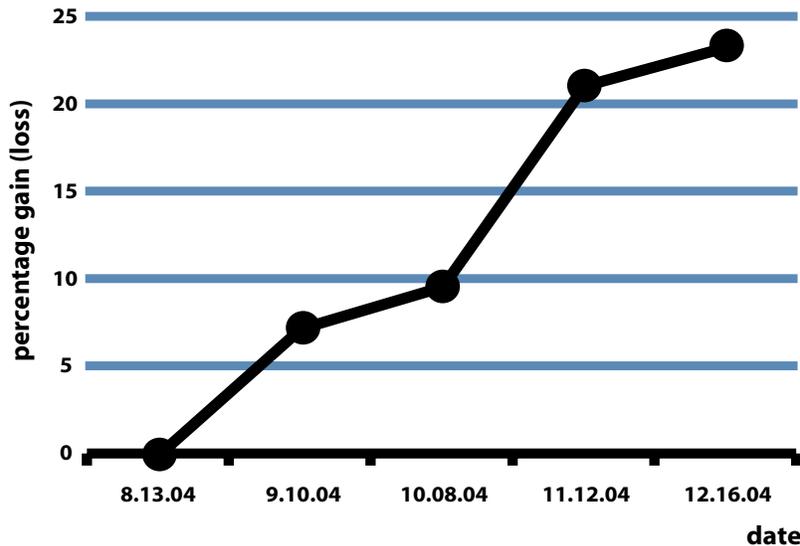
The best environment in which to make money is a bumpy market with an upward trend. That way you get not only the eminently deserved long-term rewards for your excellent and sober investment decisions, but crazy Mr. Market will fairly frequently offer to wildly overpay for your shares. Yes, he will go into depressive mode sometimes, but unless you have pressing liquidity concerns you can ignore him then. Expect lots of silly highs in oil stocks over the next few years.

Two more points, before we get to the real bet. Obviously oil is an inflation play, which we think is better than the reverse. Perhaps more importantly, oil stocks have been out of fashion for several decades, after having been on everyone's front burner for a while back in the seventies and eighties when they accounted for as much as 30 percent of the S&P market cap. Then tech pushed everything earthy off center stage. But with tech now almost an afterthought, American eyes focused on the Middle East as they have not been for decades, and with the new explosion of demand from Asia, it seems almost inevitable that market players will be following the oils much more diligently, which has to help multiples.

That's what we might call the background argument for oils; very low risk of loss and a strong argument for at least modest growth and renewed market interest. Then there is the upside, the real bet, which is that the demand for oil rises much more and more rapidly than current valuations imply. In short, as far as we can tell, no prominent analyst is taking China or India seriously enough. Projections for the next year or two essentially extrapolate current growth rates, but as yet we see no consciousness of the mid-to-long-term implications of Asia growth, where oil prices will stand when Chinese consumption is not a fraction of U.S. consumption (it's less than a third today), but a multiple thereof, or how rapidly that date might approach.

As we noted above, from Q1 1995 through Q4 2003 Chinese demand for oil essentially doubled from 3 million barrels a day to 6 million barrels. And yet after all

## WMO Apartment REIT Index



that growth, guess how many cars there are in China? No, wait. First, guess how many cars there are in the United States, per one thousand population? Answer: 798. In China there are currently 10 automobiles for every thousand people.

In 1980 Taiwan and South Korea both had about as many cars per person as China has now. Today, Korea has 240 cars per thousand; Taiwan has 258. When China reaches the same level of car ownership as those nations, it will have more cars than there are in the U.S. today.

But will the Chinese buy cars or gasoline, with oil at \$50 or \$100 bbl? Well remember this: while oil may be getting more expensive for us, for the Chinese the price is coming down rather dramatically. Ultimately the price that matters in terms of personal consumption decisions is percentage of personal income. On that basis, 20 years from now, even at \$100 bbl, oil would cost the average Chinese a small fraction of what it costs today.

Oil is a low-risk bet on what the world will look like when three-quarters of the Third World ceases to be third.

How to place the bet? Really, we could just buy a basket of the majors and leave it at that. But as usual we vote for having some fun. We will eventually build a basket of six stocks, just as we have with our other sectors. Today we start with three. First, Exxon Mobil, for the reasons given above. Murphy (MUR) looks overpriced on a

PE basis, but of the majors it is the purest bet on just owning oil. Technically an integrated company because it does some refining, Murphy's revenues are overwhelmingly driven by exploration and production. Ramp up on projects in Malaysia and elsewhere should raise volume throughout the decade.

We also like Oneok (OKE), whose main business is natural gas: drilling, producing, transport, and storage, though they also produce and trade oil. They are the largest gas distributor in Kansas and Oklahoma and the fifth largest in Texas. Natural gas is partly fungible with oil. And with the U.S. gas market increasingly looking to liquefied natural gas imports to satisfy demand, this once domestically priced commodity is increasingly exposed to global price pressures, including echoes from global oil markets. We like OKE especially as a play on storage, which is very tight at the moment. We probably want something in oil field services and maybe some smaller exploration and production companies as well, but we haven't found the right ones yet.

**A cardiologist usually measures his success on whether he can keep you from ever meeting a cardiac surgeon.**



## CLOSING WITH SUTURA

With any luck, you have never been to a cardiologist. And if you have never been to a cardiologist you may not have a very clear idea of what they do. We certainly didn't until we met Anthony Nobles, founder and CEO of Sutura. The crucial thing to remember, he explained the first time we ever talked, is that a cardiologist is not a cardiac surgeon. In fact a cardiologist usually measures his success on whether he can keep you from ever meeting a cardiac surgeon. And that's the first thing you need to understand to grasp the promise of Sutura, our latest medical device enthusiasm, once again brought our way by our colleague Gary Kohler, who brought IFLO into the fold.

Cardiologists are medical guys, not surgeons. Functioning in diagnostic mode, your cardiologist may be the guy who tells you "triple bypass today, not tomorrow" and send you to the surgeon. But "interventional cardiology" tries to resolve the problem without surgery. Drugs, diet, exercise. Plus some "procedures." Balloon angioplasty, for instance, which involves sticking a little balloon in your arteries, inflating it, and then using it to scrape the gunk off the sides so the blood can flow. Or inserting a "stent,"

**Prominent cardiologists with whom we have spoken confirmed that Superstitch is far easier to use than Perclose.**

a little device that stays inside an artery that has shown an inclination to get blocked, so as to help the blood keep moving.

Hmmm. Sounds like surgery, right? Wrong, wrong, wrong! Do not say surgery. Bad word! Bad! Must never admit that these procedures are surgery or else they could not

be done by cardiologists. Define them as surgery or do them in a way that requires surgery or has to be done in an OR, and then the nasty cardiac surgeons come in with their buzz saws and start ripping open patients' chests and even worse stealing the cardiologists fees.

No, these procedures are done in "cath labs," places that specialize in inserting catheters in various parts of the circulatory system or other bodily plumbing systems. Placing a catheter in an artery isn't surgery, exactly. Think of it as somewhere between surgery and inserting an IV.

The cutting device looks more like a needle than a scalpel. It makes a nice round hole about half the diameter of a pencil, running from the skin surface into the target artery, into which is inserted a sheath, a sort of plastic tunnel through which the cardiologist will work. In the case of most cardiology procedures, the point of entry is the femoral artery, near the groin. The femoral is a nice big one and relatively easy to get to as big arteries go. Once the sheath is placed inside, the cardiologist can snake whatever device he is using back toward the coronary arteries.

The problem is closure. Small as it is, the hole the procedure makes in the wall of the femoral artery is big enough for the patient to bleed to death in a matter of minutes unattended. Typically the opening is small enough to be closed with a single stitch, perhaps two. But how do you close a wound several inches beneath the skin, without slitting the patient open to suture it, which would require a surgeon, an OR and team, and all the attendant expense and risk?

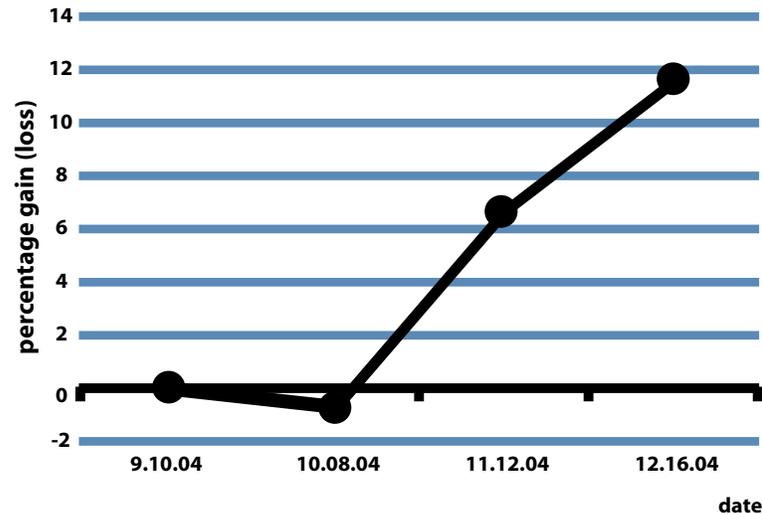
Just a few years ago, the only answer was to apply pressure, lots of pressure for a long time, as in having a nurse press on the wound for hours, or duct taping sandbags to the inside of the patient's thigh, not to mention the judicious employment of wood clamps. Only recently have more sophisticated solutions become common. The two most common are Perclose, made by Abbott Labs and the collagen plug, offered by several manufacturers, the most important and successful being St. Jude.

Perclose, like the device Sutura is bringing to market, is a stitching device. It actually allows doctors to stitch closed the entry hole in the artery several inches below the skin. Perclose was a great advance in its time, but it is difficult to use and has been losing market share to the collagen plug. The plug, as its name implies, simply stuffs the hole with an inorganic material. Many doctors consider plugs (and glues) easier to use than Perclose, but they can be dangerous. Stuff the plug in too deep and the artery can be blocked; not deep enough and the patient can bleed out internally.

Despite the shortcomings of these devices, their advent made possible a huge increase in interventional cardiac procedures so that the vessel-closure market, which essentially did not exist 10 years ago, is now a half a billion dollars annually and growing more than 25 percent a year.

More than 10 years ago, Anthony Nobles, Sutura's founder and CEO, set out to build a closure device that

## WMO Steel Index



would be easy to use, highly reliable, minimize the chance of infection, and crucially would never produce a false impression of success. If the puncture were not successfully closed, he wanted the doctor or technician to have visible and immediate evidence that the patient was still bleeding.

He seems to have done it. The resultant device, called “Superstitch,” is extremely easy to use. In fact both Andy and Gary Kohler learned to use it and actually closed an artery in the Sutura lab. (From a dead animal not a live human!) The original version took a little bit of training. The current version is essentially idiot proof: the procedure involves inserting the Superstitch through the sheath until you get resistance from the arterial wall and then pressing three buttons, conveniently labeled 1, 2, and 3, in the proper order, and then tying off the stitch, which because of the nature of the suture material slides down the sheath and into place. Prominent cardiologists with whom we have spoken confirmed that Superstitch is far easier to use than Perclose. Stitching is an inherently safer and more reliable method of closure than plugs or glues. Doctors like sutures; the shift from Perclose to plugs is testimony to how difficult Perclose is to use and how much doctors dislike it. Nobles argues that if doctors are offered a suture device that is simple and reliable they will very likely switch back.

As per Nobles’s original plan, with Superstitch, if the stitch does not take (which can happen because of the condition of the arteries) the doctor or technician knows immediately—blood spurts out of the wound through the sheath. With a plug, by contrast, the patient

may continue to bleed internally even when from the surface the wound appears to be closed. When the stitch does not take, the docs go back to the old-fashioned method—applying lots of pressure for several hours. It is not convenient or pleasant for the patient, but it’s worlds better than going home believing the artery has been closed and then bleeding to death internally. The mechanics of the Superstitch also substantially reduce the risk of infection.

Because the device is so simple, there is not a great deal more to say about how it works or its advantages over the competition. Nobles’s argument is a simple one: doctors like sutures and are rightly suspicious of the reliability and safety of plugs and glues. Give them a simple, reliable stitching device and they will use it. The simplicity we can attest to. The excellent reliability and safety record is based on about 10,000 procedures performed in Europe with results strong enough that the FDA allowed the company to fast-track approval in the U.S.

Nevertheless as laymen we were naturally skeptical: there is no way really for us to confirm the value of this sort of device on our own. So we enlisted the help of a very prominent cardiologist from the Minneapolis area. When Gary first described the device to him, the doc was mildly interested. But after using Superstitch and going

**The mechanics of the Superstitch substantially reduce the risk of infection.**



out with us to visit Sutura, he became an apostle. His verdict: just as Nobles says, docs hate Perclose but they love sutures; Superstitch is the answer. We got other opinions. Not every doc expressed the same level of enthusiasm for Superstitch or hatred for Perclose, but everyone we talked to agreed on the basics: the current methods are problematic; Superstitch is better.

**When the law is crazy there is no point trying to explain it.**

We have done lots of work on this company. With seven patents granted or pending, the intellectual property portfolio seems strong as does management. Nobles can come across a bit more like a street hustler than a medical device guy; some readers who saw him at our conference in October told us they found him “too slick” and his presentation “too good to be true.” We also sometimes find ourselves wishing Tony would dial it back just a bit. Nevertheless his track record is strong. He has been in the industry for nearly 20 years, done several startups with the same partners he is working with in Sutura, and has been involved in the development of dozens of devices. He has never before run a public company, and nothing he has done previously comes close to the potential of Superstitch.

At this writing Sutura is not yet a public company. Eschewing the long and expensive road to an IPO, the company announced several months ago that it was going public via a reverse merger with a public shell known as Millennium Holding Group (MNHG). We did not love the deal; we thought Sutura was effectively paying too much for the shell. But the Millennium deal fell apart. The current plan is to do a reverse merger with Technology Visions Group (TVGR), a high-tech startup that may or may not have a viable product; we’ll assume not. Under the new terms TVGR stockholders would get 5 percent of the surviving company, which would be known as Sutura. At a current market cap of \$5.5 million, buying TVGR’s stock today effectively values Sutura at \$110 million.

Is that a good deal? If Sutura works it will certainly be worth much more than \$100 million. The current total vessel-closure market is about \$500 million, but it has been growing by more than 25 percent a year since the late 1990s. If Superstitch works it should help keep the market growing. With 25 percent of that market and a valuation of 4X sales (which the implied growth rate would justify),

Sutura would be worth at least \$500 million. In reality if the device proves popular, Sutura will never get to 25 percent market share, or even 5 percent market share, as an independent company. It will be bought by one of the major device companies.

Having seen the device work and spoken to the docs in the field eager to have it, and based on the success in Europe, we think Sutura itself is a good asymmetric risk-reward proposition. Translation: its chances of being worth \$500 million are at least one-fifth as good as its chances of being worth zero. Gary and Andy and some partners have invested about \$6 million in the company, albeit at an earlier stage and under somewhat more favorable terms than the likely post-merger market cap implies.

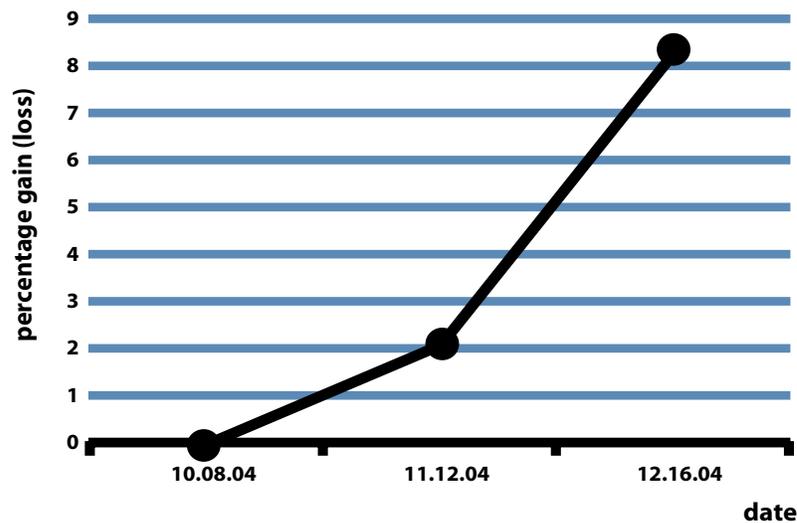
But what about TVGR? Will the merger go through? Should investors buy TVGR today on the assumption the deal is done or should they wait until it really is done?

Buying TVGR certainly adds risk to the deal. If the merger falls through, most of TVGR’s value disappears instantly. On the other hand, after the merger closes Sutura is likely to have a market cap substantially over \$100 million. Everyone involved wants the deal to get done; there are no regulatory issues of any consequence. Millennium, the former prospective merger partner was unhappy enough about Sutura killing the deal that it had its lawyers write letters to all and sundry threatening grave consequences, but the consensus of legal folks we have talked to is that they have no case. No litigation has been filed.

Richard who did not participate in the earlier deal is going to buy some TVGR stock. But anyone who does so should contemplate long and hard the possibility of slips twixt cup and lip.

So are we adding TVGR to our model portfolio? Nope, but mostly because as of January 1 we are going to revert to our pre-February 2004 format and no longer display the model in its current form. Why? Simple: lawyers. Unlike most newsletter authors we are SEC-regulated (it has to do with our day jobs). Our lawyers have been screaming for months that maintaining a formal model portfolio carries too many potential conflicts of interest as well as potential violations of SEC solicitation rules. We won’t go into detail for the simple reason that when the law is crazy there is no point trying to explain it. The lawyers wanted us to do this months ago; we compromised on waiting till the end of the year so as to salvage our pride. We didn’t want to change things until it was clear the returns were heading into the

## WMO Big Pharma Index



black, otherwise it might seem like we were backing away from our mistakes. In any event we're at the end of the year and that's the deadline we agreed to.

Will this make the WMO less useful? Should you cancel your subscription? We don't think so. The model portfolio is only 10 months old; most of you liked the WMO just fine before we started it up; some of you liked it better. We will still cover and update the same companies just as thoroughly as before. We will still update our asset allocations and run those indexes. Plus in February we are going to two issues a month, so you will be getting double the value. But rather than try to convince you now, we have a special offer for the skeptical. Stick with us through February. Then in March if you still want to cancel and you have a refundable subscription, we will refund your money for January and February as well as any remaining balance.

### THE SHORTS, TOX, AND ACP

**W**e do have a few last adjustments to our model portfolio. First of all we are covering all our shorts. What is the point of this, just as we are closing the thing out? Well even after we stop actually displaying the model portfolio in its current form, the stocks therein will remain a notional list of companies you can expect us to cover and update. We haven't done a very good job updating the shorts in part because our readers haven't been that interested—we never get questions—

and in part because we haven't been that interested. We are more engaged by scenarios for success than for failure. So we are covering now so you know not to expect updates on those companies in the future.

TOX is up nearly 50 percent since February 17 when we launched the portfolio. ACP is up a nice 40 percent over four months. We still like both, especially ACP for its casino exposure. But money in the bank is good too. We may carefully lighten our positions in the coming weeks, gradually easing back down to our original investment.

### TOWER

**N**ot much in the way of other updates in this the last month of the quarter, but we should note that Tower has not completed that AR securitization it was working on. And when the company deferred payment of the dividend on its preferred (which we applaud and which it has the legal right to do for five years), TWR management noted that TWR's first proposal on the AR agreement was rejected by a majority of the creditors whose consent the company needs to do the deal. The company is about to submit a new plan. In short, TWR is not home free yet and there is still a real chance of bankruptcy or, more likely in our view, a dilutive reorganization outside bankruptcy.

—Andrew J. Redleaf and Richard Vigilante

December 17, 2004



# WMO Model Portfolio

DECEMBER 17, 2004

## LONG BOOK

COMPANY	SYMBOL	ACTION	DATE	PRICE *	SHARES	INVESTMENT	MARKET ON 12.16.2004	% GAIN (LOSS)
BROADWING	BWNG	BUY	2.17.04	20.8**	360.58	7,500.06	3,082.96	(58.9%)
I-FLOW	IFLO	BUY	2.17.04	15.97	469.6	7,499.51	8,659.42	15.47%
MEDTOX SCIENTIFIC	TOX	BUY	2.17.04	5.75**	1,305	7,500.26	11,092.50	47.9%
PLUM CREEK	PCL	BUY	2.17.04	30.15	248.7	7,498.30	9,647.07	28.7%
SPAN-AMERICA	SPAN	BUY	2.17.04	13.9	539.6	7,500.44	6,739.60	(10.14%)
TOWER	TWR	BUY	2.17.04	6.7	1,119.40	7,499.98	2,160.44	(71.2%)
PENN TREATY AMERICA	PTA	BUY	3.15.04	1.9	3,947.40	7,500.06	7,736.90	3.16%
TALK AMERICA	TALK	BUY	4.12.04	9.5	789.47	7,499.97	5,305.24	(29.2%)
BROADWING	BWNG	BUY	5.17.04	14.7	510.20	7,499.94	4,362.21	(41.8%)
TOWER	TWR	BUY	5.17.04	3.44	2,180.23	7,499.99	4,207.84	(43.9%)
SMART & FINAL	SMF	BUY	6.21.04	13.921	538.75	7,499.94	7,407.81	(1.23)%
BASSETT FURNITURE	BSET	BUY	7.12.04	20.79	360.75	7,499.99	6,901.15	(7.9%)
DURA	DRRA	BUY	7.12.04	8.79	853.24	7,499.98	9,018.75	20.25%
I-FLOW	IFLO	BUY	7.12.04	10.39	360.92	3,749.96	6,655.37	77.48%
AMERICAN RE PARTNERS	ACP	BUY	8.16.04	20.11	372.95	7,500.02	10,442.60	39.23%
ALDILA	ALDA	BUY	10.11.04	12.47	601.44	7,499.96	8,432.19	12.4%
<b>TOTAL LONG</b>						116,248.36	111,852.05	(3.8%)

## SHORT BOOK

AMAZON	AMZN	SELL SHORT	2.17.04	45.47	82.5	3,751.27	3,304.12	11.9%
AMERICAN CAPITAL	ACAS	SELL SHORT	2.17.04	34.39	109	3,748.51	3,515.25	6.2%
JUNIPER	JNPR	SELL SHORT	2.17.04	26.67	140.6	3,749.80	3,773.70	(.64%)
<b>TOTAL SHORT</b>						11,249.58	10,593.07	5.8%
<b>CASH***</b>							37,219.64	
<b>LONG PLUS SHORT P&amp;L TO DATE</b>						(3,739.80)		
<b>PERCENT RETURN ON ORIGINAL INVESTMENT (\$150,000 TO DATE)</b>								(2.4%)

## PORTFOLIO CHANGES

							GAIN/LOSS	
AMAZON	AMZN	COVER	12.20.04	45.47	82.5	3,751.27	~447.14	~11.9%
AMERICAN CAPITAL	ACAS	COVER	12.20.04	34.39	109	3,748.51	~233.26	~6.2%
JUNIPER	JNPR	COVER	12.20.04	26.67	140.6	3,749.80	~(23.90)	~(.64%)
<b>NET CASH CHANGE</b>						~656.50		
<b>STARTING CASH</b>						37,219.64		
<b>ENDING CASH</b>						~36,563.14		

\* VOLUME WEIGHTED AVERAGE PRICE FOR FIRST TRADING DAY AFTER PUBLICATION OF OUR INTENT TO TRADE

\*\* REFLECTS 10:1 REVERSE SPLIT FOR BWNG; 3:2 STOCK SPLIT FOR TOX

\*\*\* INCLUDES \$5,531.17 FROM SALE OF SNCI ON 10.01.04 &amp; \$14,717.58 FROM SALE OF ABXA.OB ON 11.12.04

NOTE: FINAL PRICES &amp; SHARE AMOUNT WILL BE ENTERED AT THE VOLUME WEIGHTED AVERAGE PRICE FOR MONDAY, DECEMBER 20, 2004.

PLEASE READ BEFORE YOU MAKE ANY DECISION BASED ON THE DATA ON THIS PAGE: Recommendations for this model portfolio refer only to the model. Changes we make are unlikely to be perfectly appropriate to any given reader's own portfolio. Use the model as a source of ideas and a way of assessing the model's performance over time, but make your own investment decisions based on your own present holdings and goals. Depending on the contents of your portfolio and other considerations, what we call a "buy" on this page, may be a "sell" for you, or even for us in another context, if, e.g., you or we are already overexposed to a given position. **In case you have forgotten, the authors, their colleagues, clients, families and friends, kissing cousins and poor relations, barbers, bartenders, bookies, and taxi drivers not only may have active positions in these companies, they probably do, and those positions, long and short, may be frequently adjusted without reference to the publication date or contents of this newsletter.**