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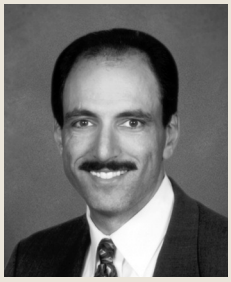
Templeton Analysts Uncover Unique Opportunities in Challenging Sectors

In an effort to dive deeper into how Templeton Global Equity team members apply our fundamental investment philosophy based on value, patience and bottom-up research to different sectors, we have invited four of our global analysts to illustrate what excites them about the sectors they cover and why.

PHARMACEUTICALS

Finding Opportunities Beyond the Patent Cliff



PETER A. NORI
Executive Vice President
Portfolio Manager/Research Analyst
Templeton Global Equity Group

Peter A. Nori is the information technology sector team leader and has research responsibility for the global semiconductor and global pharmaceutical industries. In addition, he manages several institutional portfolios.

Q: If you were speaking to someone who doesn't know anything about the pharmaceuticals sector, how would you explain what a pharmaceutical company is, and from an analytical point of view, what matters?

A: When you think about what a traditional pharmaceutical company is, it is first a research organization. Their job is to identify different categories and ailments, figure out what causes those particular ailments, and turn the scientists loose on figuring out what mechanisms are needed to either cure, or in the case of vaccines, prevent those ailments from happening. It's a high-risk, high-return model, meaning that it's very difficult and very expensive, with a low probability at the starting point that anything worked on today will make its way to the market. It's also very time-consuming, taking up to ten years, from start to finish, to get through the different phases of research.

Q: If the sell side is also looking on a pretty long horizon, five to ten years to get over the patent cliffs and expiries, where does Templeton seek to add value? Where is the potential to make money from these stocks?

A: There is still a big focus on near-term P/E multiples. We think there is a view that with the patent cliffs coming up, people say: let's avoid the sector, let's not deal with it, let's see how the companies handle it. On the flip side, when we look at the models (and unless we're completely wrong on the impact of patent expirations), for a lot of these companies we are looking at a different business model in five years. We think that the traditional pharmaceutical business likely will be a smaller percentage of revenues than what you're seeing today, and some of the longer duration assets likely will be a larger percentage. What's interesting is that when we look at some companies which have a fairly significant presence in consumer health, and we look at the multiple placed on that stock and the multiples placed on the large, global, diversified consumer companies or even some of the stand-alone generic companies, it just doesn't make sense. We think, and this is part of what we're assuming, the market is so focused on the problems and the risks in the traditional pharmaceutical business that it's not properly valuing the other parts of the business. So, by doing nothing (let's just say that nothing happens in the pipeline and there are failures with everything out there), it then becomes, by default, a smaller part of the business. What we're left with is a higher percentage of revenues and profits coming from vaccines, animal health, consumer health, eye care, diagnostics, etc; those are currently the stand-alone companies that have been trading at higher multiples on the market. We think it's just a question of the time horizon.

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Ten years ago, investors were willing to give management teams the benefit of the doubt on their pipelines. If you just looked at the valuations placed on the stocks in terms of the split between currently marketed products versus pipeline products, we believe a fair amount of expectations were built-in from the prior long run of success. Perhaps investors were looking at pipelines and not properly risk-adjusting those numbers. And, it looks as if they were giving companies credit for the free cash they were generating under the assumption that they would use it in a wise way. Yet here we are in 2011, and it appears that when you do the DCFs and the NPVs on these companies, there isn't a lot of value being placed in these pipelines. It's almost as if investors have said: the last ten years have been so bad we just don't think these companies have the ability to generate much of anything any longer.

If you go back and consider that if you buy stocks at the right valuation, where our expectations are low or negative, then simply getting back to a point that is better than that may generate quite a good return.

Q: What could lead to a re-rating? Is this re-rating going to be rapid or more of a slow burn?

A: To the question of what could lead to a re-rating, we believe time will tell as the market begins to appreciate what the businesses actually look like, whether for a typical large pharmaceutical company in five years, or for a consumer health business that's growing in the high single digits. We also believe management teams will begin to explicitly lay out what their capital allocation policies will be, what return on capital targets they're setting and the rationale behind how they're allocating their capital. Then, if they deliver on it and carry out what they say they will do over a year, two years, three years, the market will have more faith in the cash flow they generate and accruing to investors, then the stock should re-rate.

Instant gratification on these stocks would occur if something were to come out of the pipeline. However, we think it's a slower burn in that you're going to have a slower transition with the business model changing, and that's not going to happen right away.

Q: Do you think the reason the Templeton Global Equity Group sees this sector differently than many other investors is due to its long-term focus? If there was a shorter-term focus would you have the same view on this sector that you have today?

A: If we had a twelve-month focus I think we would probably say "you know what, let's just sit out 2011 and see how these companies deal with these patent expirations." To be fair, some of the stocks that we don't own have cliffs that are so large we don't know how they're going to deal with them without significantly impairing earnings or making an acquisition that's not helpful, so we don't own everything. We've decided that we can't properly analyze some of the larger patent cliffs or how those companies will eventually deal with them. As analysts, it's our job to be selective.

Q: What would be the parting comment you would want to leave to ensure that somebody understood the key message regarding the pharmaceuticals sector?

A: This is a sector with very low expectations that are certainly understandable. The sector has had a ten-year stretch of poor capital allocation and poor R & D productivity. Almost every company out there has turned over or replaced their management teams and it appears there's a different view on capital allocation, so hopefully we'll see more constructive use of cash in the future. However, the valuations placed on these stocks suggest that the market believes it won't happen, that the pipelines won't pan out and that capital will be destroyed. It's our view that management teams have learned something in terms of capital allocation and they'll be a little smarter at it than they have in the past. For a number of these companies, the cash flows they have been generating would appear to indicate value not reflected in recent stock prices.

MEDIA

Media Industry Evolving in a Digital World

MATTHEW R. NAGLE
Vice President
Portfolio Manager/Research Analyst
Templeton Global Equity Group

Matthew R. Nagle has global research responsibilities for the cable and satellite sector and electronic manufacturing services companies. He also serves as a portfolio manager for some of Templeton's largest mutual funds.

Q: Can you elaborate on the various drivers of media companies?

A: Two things influence media companies. The first is the biggest, the structural debate. The demise of media has generally been a hot topic. We have seen what has happened to the music and newspaper industries. Technological changes and their implications for the media sector are a big structural question. During the 1999–2000 Technology-Media-Telecommunications (TMT) era, the Internet was perceived as a big positive for media companies since it opened up many new avenues to sell their content and it reduced the costs associated with doing so by essentially taking out the chunks of the value chain, such as the distribution companies themselves, that added less value. And, it has taken ten years for the sector to lose its valuation premium. These companies sold at a fairly significant discount at the depths of the recession. The second is the consensus view that media companies are losers as a result of this technological shift. This is due, in large part, to the thinking conditioned by what has happened to certain parts of the industry already, namely music and newspapers.

Q: With regards to where we are in the cycle, if everybody was deleveraging, are they still doing so? Where will the spending come from and how does it impact media companies?

A: It is fair to say that everyone is still deleveraging except the corporations themselves. They have very strong balance sheets and peak profitability levels which are benefiting them so that many are releveraging. Consumers and governments arguably still have too much debt. The question is: Where will the spending that drives media companies come from? We believe the reality is that the spending will come from areas other than cyclical advertising, which represents 15–30% of revenues in the U.S. companies we are exposed to. During the recession, consumers cut many other things before coming close to thinking about doing anything to their media consumption. On the TV and movie side, it wasn't really seen as a discretionary item but something they perceived as necessary as a form of escapism from the economic woes surrounding them.

Q: It doesn't seem to be as doom and gloom within the sector overall. How have you been able to differentiate amongst companies and where would you expect the winners and losers to be at the company level?

A: I believe this is where we take a slightly different view to the market overall in two ways. The first is our point on advertising. The relationship is low which leads us to believe that normalization of that relationship would support much higher numbers than the consensus for the next two or three years. We are saying that earnings estimates should continue to rise for these companies. The second way involves our view on technology and the assumption that everything will be going the way of music and newspapers, turning out to be a real negative for the sector. We spend a significant amount of time looking at media usage and how it changes over time. In reality, overall media usage continues to grow reasonably quickly. There is a general misconception that everything in media is ex-growth or a declining business. This does mean that you have to pick your stocks or businesses you need to get exposure to, but there is still potential growth there.

Q: It sounds like these companies can be highly cash generative since they retain pricing power. Do you believe that they spend that cash wisely?

A: The first thing I would say is that we can't argue the past; the track record of the industry is the track record of the industry. Our default assumption is not to give them the benefit of the doubt in terms of that cash generation and how they're using it, so you have to build in an adequate margin of safety into the evaluation of the business. This sector has suffered for ten years, up until the last couple of years, and there have been many management changes, so you can see why behavior is starting to change. In the cable sector, for example, we have seen a material return of capital to shareholders through dividends and buybacks during the past two–three years. Given the free cash flow that the cable companies are now generating, we believe capital returns can accelerate from here.

Q: Many media companies have done reasonably well lately. Looking forward, what should we expect from the sector?

A: There is still a lot of skepticism around digital media and how that will play out. We are slightly more focused on the reality that demand is not shrinking, it's increasing. The fate of many of these companies, at least in the digital arena, is still in their own hands. Many of them were criticized for not moving quickly enough. When we see what happened to music and newspapers, it has given them time to see where these industries went wrong and to make sure it won't be detrimental to their own business. As it relates to where do we go from here, I agree that the sector has done pretty well. Having said that, we think relative valuations are still reasonable and expectations are reasonable. We are now around a market multiple for these businesses. Despite concerns over growth, we believe there will be companies growing earnings by double-digits over the next two to three years with regard to my previous comments about advertising that have significant potential upside. Moreover, the free-cash-flow yield and capital returns are currently well above the market averages.

ENERGY

Identifying Value in a Complex Sector

MAARTEN H. BLOEMEN
Executive Vice President
Portfolio Manager/Research Analyst
Templeton Global Equity Group

Maarten H. Bloemen has global research responsibilities for the integrated energy industry and energy E&P. In addition, he also manages several institutional separate account portfolios.

Q: Looking at exploration and production energy companies as well as the diversified companies—where is the story better?

A: I think that the street is generally focusing on the pure exploration and production (E&P) companies, the ones that don't have the drag of the refining business. The pure E&P companies are 8–10% production growth companies and are more levered to oil price in the short term, hence that's where the market runs to when the price of oil moves higher. There is a lot of evidence showing that a higher oil price does impact integrated energy companies, which follow a higher priced commodity with a lag, but you get a lot of support on the dividend yield as well. So, you've got a business that is more robust than a highly volatile, more cyclical E&P business. We've come to the table looking at trying to catch both by focusing on the more highly oil-levered of the integrated oil companies, so that's how we're capturing the E&P side. We enjoy the dividend on top of it and we don't have to pay the valuations that the pure E&P companies have. We look to position ourselves with the bulk of funds in the cheaper valuation segment of diversified, integrated energy companies—specifically those that have higher production growth profiles, are located in the right basins, have steady cash flow, strong balance sheets and high dividend yields, then we bolt on several pure E&P and oil service names which have been left behind for a variety of reasons.

Q: When you describe focusing on the integrateds that are more highly levered to oil such that they don't act completely like an E&P, what do you mean by "highly levered" and how do you define that within your research?

A: Those would be the higher production growth integrated companies, the ones that aren't really growing at the 2% average, which most of the groups' production has been at, but rather at 3–5%.

Q: Within your analysis, you're attempting to normalize the price of a commodity that swings by huge amounts, sometimes quite violently and suddenly. How would you counter the argument that making money in these stocks is not just about predicting the oil price movement?

A: In my view, there's evidence that the integrated energy companies do follow the oil price well, but with a lag effect. In our business view, the E&P and the driller companies, in a broad sense, have already captured that higher oil price in the stock price so that the valuations are richer. So, with integrateds you've got the production growth that can come along, but not as high as the E&P companies, and multiples reflecting a worse case than the E&Ps and oil service companies, which capture that higher price. Hence, we believe that a package of all those companies, weighted by the cheapest of the group, the integrateds from a longer-term perspective, makes the most sense.

Q: Your growth estimates are higher than the consensus for the integrateds. Is the market missing that the integrateds do have this E&P aspect to them and that they can grow faster than what is being expected?

A: Well, actually we believe our numbers on both oil prices and production in general are lower than the street's estimates. But, we still have to be selective, focusing as best as we can on the integrateds which are all devalued and de-rated as compared to the higher growth E&P segment of that business. So, we think the short-term/long-term differentiation we employ works, and if you add to that a whole diversified portfolio approach, that enables us to sit and wait with some of these which are structurally longer-term stories.

Q: Why do you view them as being attractive over the longer term and what's different about how you're looking at them versus the consensus point of view?

A: The feedback we have received regarding how our competitors are positioned shows that investors have been underweight integrated, but better received than in the past. That means investors have been chasing the higher oil price momentum and forgetting values in the midstream and downstream business. As per the late Sir John Templeton's principle, we look for opportunities where maximum pessimism persists, and we think integrated fits best with that principle as you are not ignoring the value play in the refining sector, yet you are still playing the higher oil price correlation without paying the premium multiple that an E&P company enjoys. So, in part it comes down to the term or the investment horizon that we are investing in. We are looking out from a longer-term perspective than most of the street, which is looking very short term, and even though we may agree with the street regarding the quality of those assets, the street doesn't believe that returns will materialize within their investment horizon, whereas we believe the return potential exists within ours.

Q: From your previous comments, it seems you don't agree with "peak oil." What risk does this pose?

A: We believe in a diversified approach and that's what clients understand. I started the conversation with the complexity of this whole business and the idea that if you run a diversified portfolio with the bulk of it in the large, diversified, high dividend yield, production growth-orientated names and then add on the higher-for-longer, leveraged areas of the oil service companies, particularly in the global oil service and E&P companies, you have the potential to capture the upside. If we are wrong and oil collapses again, then the diversifieds' nature should help on the downside since investors will likely go to the large, liquid, high dividend yield names. So, we believe we are protective on the downside and that we have the potential to participate on the upside. Regarding "peak oil" specifically, we lean toward the view that pricing will get more expensive as it becomes more difficult to extract oil. However, technology continues to advance in oil sand, oil shales and recovery methods, and to suggest that "peak oil" may be reached in the near term is, in my view, doubtful. So, there are different reasons why price is likely to go higher.

Q: What would be the most compelling aspect that you could discuss with someone who knows nothing about the oil industry?

A: I recently spent ten days in the Middle East. I went to Saudi Arabia and I spent some time in Kurdistan, in the northern part of Iraq. The message I came away with is that I have many more arguments against "peak oil" in the medium term, and traveling there confirmed my belief that technology is moving along at a staggering pace. Though the extraction might cost more as we move further to other frontier areas such as the Arctic, the advancement in extracting more oil from existing wells, as well as new drilling and completion techniques, has the potential to allow the industry to extract more oil. A theme that should be highlighted, and which is present in our portfolio, is natural gas. All the integrateds are involved in LNG, liquefied natural gas, and I believe we are well-positioned for that theme.

TELECOMMUNICATIONS

Focusing on Cash Flow

TINA SADLER
Senior Vice President
Portfolio Manager/Research Analyst
Templeton Global Equity Group

Tina Sadler is the telecom services sector team leader and has research responsibilities for global wireless telecommunication services, small cap telecommunications, and global building and construction materials.

Q: With telecommunications stocks, what do you think the market is ignoring or misunderstanding about these stocks?

A: Let's start with valuation and where the stocks are priced. Many of the stocks are single digit P/Es, and the sector, as a whole, has been around a 7% dividend yield. Some of these stocks, especially in Europe, have been trading at higher dividend yields than that. Essentially what you're seeing built into expectations is ex-growth industry, a situation where free cash flows are declining over time. So, identifying potential opportunities comes back to examining free cash flow generation, and I feel the growth opportunity is definitely there.

We're seeing growth from emerging markets, growth from data and cost-cutting opportunities feeding into some earnings growth. But, we're looking at a total return situation, so we believe we have a very good starting point with high yields and free cash flow, which we argue can be sustained through earnings and controlled capital expenditures. There is fear of a capital expenditures bubble for the industry as was the case two years ago and up through part of this year. It seems that every year the market is worried about capital expenditures spiking, but so far the companies have done a good job of controlling it. So, with the starting point of extremely low valuations and low expectations, the total return potential looks very positive.

Q: Do you think the networks to handle that mobile data can be developed without an increase in capital expenditures?

A: There currently is ample capacity in many markets, such that the operators could go a year or two without needing to spend significantly more on capital expenditures. If there is continued usage and if it's priced right, we think the market would be happy to see capital expenditures go up if it means higher revenue. The market is concerned about the potential for declining revenues and increasing capital expenditures, which could be the worst of both worlds. If we see more of a positive relationship between capital expenditures and revenues, this would be viewed positively.

Q: In the past year or so, emerging markets have generally outpaced developed markets. However, you still seem to find more opportunities in emerging markets wireless companies than in developed markets. Can you explain this?

A: Everything we do here is based on valuation. If we are finding companies with good fundamentals and interesting growth combined with low valuations, then those are appropriate for the Bargain List. We've found a number of opportunities in countries such as Thailand, China, Russia and Turkey where that's the case, and these stocks have often underperformed their local markets, making them value situations. There is better growth in the developing markets in terms of top-line, but good dividend yields and valuations are driving the bargains.

Q: Pricing power issues seems to be a large overhang for the industry in general. Is it pervasive throughout the industry? Or, is it more company specific in the sense that certain companies you follow have, in your opinion, more of a handle on pricing power than others? Or, is it more attributable to the industry itself?

A: It has certainly been an industry-wide issue. As it relates to the wireless companies, voice is a commodity, so we've seen continued pressures on prices over the years, but we believe the opportunity comes from mobile data. This is a product customers are willing to pay for, and more importantly, the companies seem to understand that this is the real opportunity if they price it correctly. In some U.S. companies, we saw all-you-can-eat type plans, then they moved to more usage-based packages with caps—use more, pay more. We're seeing those types of pricing plans in Europe as well. Emerging markets are a little lower in terms of data penetration, but they've

learned from the developed markets, so they really haven't had the all-you-can-eat type packages as seen in the developed markets. The opportunity here is for these companies to continue to price this correctly. Interestingly, certain European markets, Spain for example, have started pricing data in terms of the speed and quality of service. If we see that continue, it could hopefully provide that inflection in terms of revenues that no one believes right now. Of course, not all companies will experience this equally and as with everything, it will come down to the competitive intensity and regulatory practice of the individual markets in which the company operates. At Templeton, it is my job as the analyst to search for what I believe are the most attractive opportunities.

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