

“INVESTING AS THE FOUNDATION SHIFTS”

15th Annual Ira Sohn Investment Conference

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Perella Weinberg Partners

May 26, 2010



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[1]

XERION

Definition:

Reputed to be hard as stone and malleable as wax, *xerion* is a legendary alchemical tool, capable of turning base metals into gold—which we’ve seen can be a metaphor for ‘enlightenment’. It was also sometimes believed to be an elixir of life, useful for rejuvenation and possibly for achieving immortality—all of which fit in nicely with alchemy processes in general being metaphors for ‘enlightenment’. (Encyc. Brit., 15th ed., 1976)

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- [2] It’s an extra special privilege for me to be here today. I happen to be the grateful parent of a cancer survivor. My 15-year old son Matthew was a hero through seven years of leukemia therapy. He’s been fine for six years and is here today [*stand up Matt*]. We’re here to tell you that your support of this conference helps our family, and others like us in this community. Kids’ cancer is fought on many levels beside the obvious. This conference supports important medical research. It also creates hospital treatment environments in which families can enjoy some light, and even fun, as they deal with life-threatening medical situations. Our family thanks the Sohn Family, Doug Hirsch, Dan Nir, and each of you from the bottom of our hearts.

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Source: Vanityfair.com

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- [3] My message today is this: The very foundation of the global economy and monetary system is shifting under our feet. People are internalizing that the spectacular rebound in risk assets has been *synthetic*—fabricated by governments who can't afford it. Sovereigns are the new flavor of credit stress, but even fiscal imbalances are only a *symptom*. The underlying *diagnosis* is an un-sustainable model of global growth that marries the West's insatiable appetite for consuming cheap Eastern product on credit, with the

East's continued over-dependence on selling and lending to the West. The debt crisis will persist until the habits driving it are changed. *The world economy must transition to a more balanced model of global consumption and leverage, with more consumption in the East and less borrowing in the West.* This is much bigger than the '08 financial crisis; it implicates the entire postwar global economic model. There's no quick fix here, no more big government-spend-us-back-to-status-quo band-aids. Unprecedented policy accomplishment and dramatic changes in consumer behavior are going to be required globally. Markets may still not yet be connecting all the dots, but the clouds overhead anticipate peoples' *anxieties* of the enormity of the situation, and outright *fear* that we and our politicians may not be up to the task.

- *Expect the course to be wrenching and unpredictable.* The implication for all of us is that the days of investing in stocks and bonds against a placid macro-economic backdrop are over. Picking securities within a narrow investment strategy that's blissfully indifferent to the top-down picture, won't work any more. Episodes of indiscriminate selling across asset classes and geographies that we've been experiencing since '07, will be more frequent. These macro squalls can lay waste in a flash to a well-selected, but un-protected, portfolio of corporate investments. Investing success now demands that we be positioned on the right side of global themes, and hedged against their dark side. We need

to be flexible in our use of corporate capital structure. And, for hedging, we must be proficient with a wide array of asset classes beyond debt and equity, including currencies, commodities and rates.

- Here are some big investment themes that we at Xerion like in the transitional framework: *[CLICK]* We like *Shaking Hands With China*, meaning positioning to benefit from China's government investment program, and buying what rising EM consumers need. *[CLICK]* We want to *Sell What Emerging Markets Make Better*, as in short overleveraged Western producers. And, we must protect against the unfolding sovereign train wreck, by shorting the weakest currencies and government bonds, *[CLICK]* and *Hedging Monetary Debasement* with exposure to precious metals and miners.

ARE WE FROGS IN BOILING WATER?



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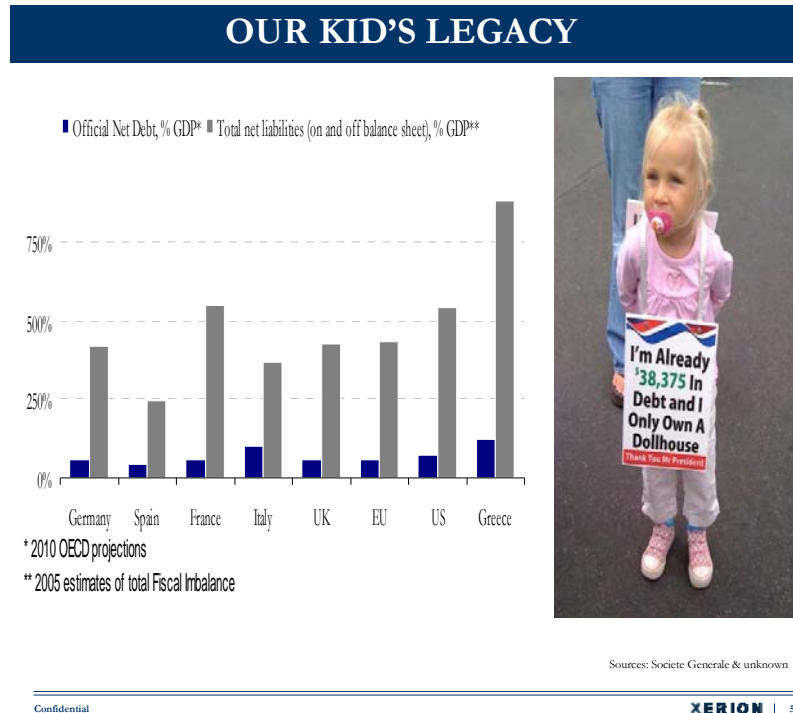
Source: www.small-house-building.com

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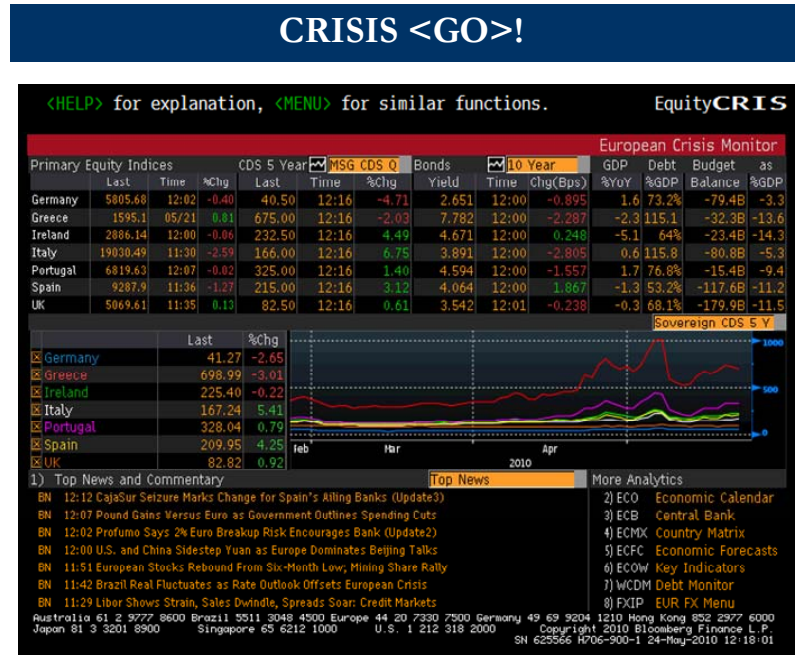
[4] *Here's How Today's Model Looks:* China works, saves and builds. The West borrows, buys and consumes. *They* drive 5-year urbanization and employment targets, generating low wages, long hours, high education standards and 24/7 productivity. *We* have high-paid unions working 35-hour weeks; over-leveraged consumers defaulting on \$10 billion a month in mortgage payments and paying off credit cards to buy new iPads; and a messy democracy beholden to special interests, and apparently incapable of making complex policy choices until forced by crisis. Chinese consumption is 35% of GDP, and they save half of their disposable income and have no real government benefits. We consume twice as much, save a fraction, and rely on entitlements that add up to a multiple of our GDP. Our nation owes China

almost \$1.5 Trillion; and we, and many of our G-7 sovereign friends are *sporting* seriously distressed balance sheets.



[5] *Now the Hangover.* The Western debt balloon has migrated from homeowners to their banks, and now across governments, in an epic process of *balance sheet contamination* [El Erian term]. Yet, while moving debt around or paying it off with more debt helps short term liquidity, it does nothing good for *solvency*. The brand new European circuit breaker is already melting. It doesn't really matter whether Eurozone politics converge on a set of conditions that will be either hard enough for the Germans, or easy enough for the peripherals--because every scenario looks bad for the Euro. Strong conditions probably intensify civil unrest and an early demise of the EMU, while weaker

ones would lead down a more painful, drawn out path to the same place. *We're bearish on the Euro and Euro sovereign debt. U.S. Treasuries and risk assets look like a good short term safe haven, but it's really just swinging from vine to vine.*



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Source: Bloomberg, "Crisis" <Go>

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Welcome to the End Game of the Debt Supercycle—[6] Just type “Crisis Go” on your Bloomberg for a live update. Rising risk premia and declining currencies are just the beginning. Investors fleeing the Euro for the Yen or Dollar may find little sanctuary, because the debt problems of the front G-7 countries are, by key metrics, the worst of all. As confidence in fiat paper erodes, expect to see a real acceleration in demand for the world’s original medium of exchange:

GOLD ON THE RUN



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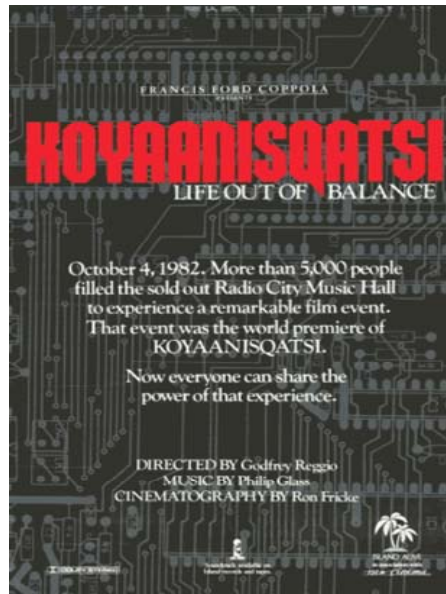
Source: www.yahoo.com

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[7] *We like Gold and Other Precious Metals.* In case you didn't notice, while much of the commodity complex has been hammered this month, Gold is still *up*. Notwithstanding this *ridiculous* gold ATM idea from--*of course*-- Dubai, there's obviously *something* going on here, and I doubt it's a top. It's not that we're interested in gold as a hedge against traditional metrics of inflation: all this excess labor in the West, and capacity in the East, points to a *deflationary* framework. Gold isn't necessarily going up; it's the value of the paper we use to buy it that's headed *down*. Prepare for a new strain of *stag-asset inflation* as we experience monetary debasement and economic deflation at the same time.

TIME TO REBALANCE



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Source: http://en.wikipedia.org/wiki/File:Koyaanisqatsi_poster.png

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[8] *The Prescription*. The next chapter in the global narrative may be called *Re-Balancing Consumption, Entitlement and Leverage, From West to East*. Watch as the protagonists change places in the next 20 years: Eastern consumers will be ascending, while we need to buy less, eat less and study more to stay in the game. And it will be *Western* societies that will be subject to more government, especially to the as-yet un-proven ability of our public institutions to address excessive structural debt and entitlements. Think about the irony here: Post-Maoist China has no social entitlements and needs to implement some to draw out domestic consumption, while the United States is on a path toward more intervention in markets and inevitably curtailing entitlements. It should be interesting to see where the matrix of leverage,

consumption, regulation and entitlement ultimately stabilizes in the East and West. Will the penitence for our generation's borrowing and spending be our kids' taxes and frugality?

GOVERNMENT COMES TO A MARKET NEAR YOU



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Source: www.americanelephant.com

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[9] What ever the outcome, it's time for us investors to gear up for a protracted period of markets taking a back seat to politics as the main influence in our lives. Political risk is everywhere, and sound investment positioning is no match for the heavy, unpredictable hand of government. The *future* is America's re-shuffling of car creditor priorities; Australia's confiscatory 40% mining tax; Germany's criminalization of short selling; and countless interventions to come. If you're a rich person or industry, *government wants you*. At least it's still legal to own gold.

SHAKE HANDS WITH CHINA



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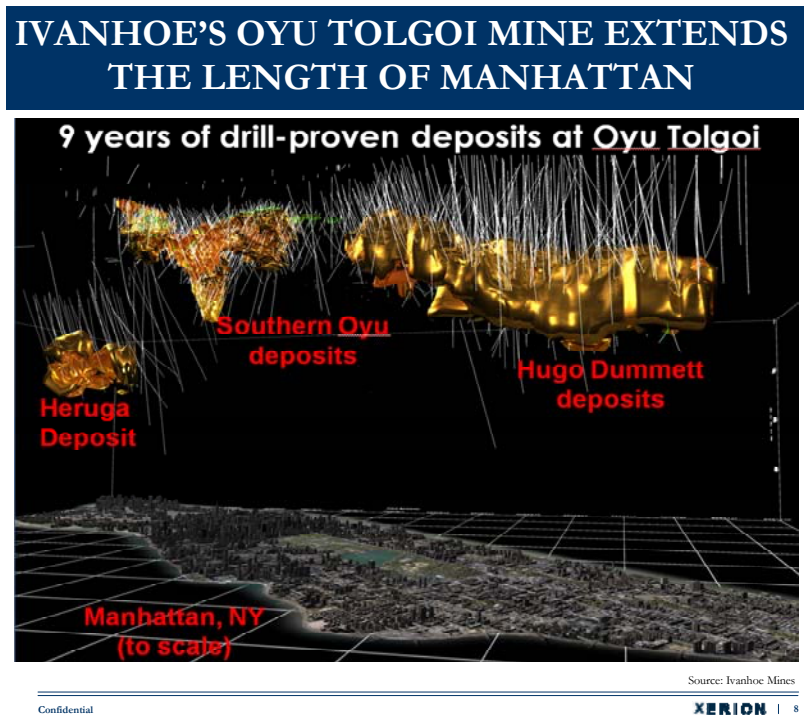
Source: <http://www.nicholsoncartoons.com.au>

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- *Fighting Global City Hall is a Tough Living*—Probably best to play themes that follow the money. [10] *Shake Hands With China*. Developing economies will be spending about \$2.25 Trillion annually for the next several years to meet their infrastructure needs. They have the money and the political control to make it happen, regardless of what’s going on in our part of the world. China alone will increase its urbanization rate from 46% to 58%, adding 210 million urban residents in 70 million households. They need a lot of *stuff* to urbanize 20 million people a year, and we want to be long the guys who will be selling it to them.

- We like commodities and the commodity nations in the G-20 and even Africa, both fundamentally and as a currency debasement hedge. But the challenge is how to create the exposure to withstand short term volatility. Do this with *junior mining companies* that own big assets close to their customers. These will often start out trading at discounts as much as 90% to their cash flow potential, and often show less downside beta than large caps. Buy them and play the financing and execution events that unlock their value. We've owned names like Fortesque Metals Group, Riversdale, Legend and OGX over the years, giving us exposure to huge iron ore, met coal, fertilizer and oil assets, early in their life cycle to markets.



[11] One of our favorites continues to be *Ivanhoe Mines*, which we've owned for five years (NYSE: IVN, \$15/share \$6 billion MCAP). IVN owns the world's largest undeveloped copper and gold mine, on the border of China's industrial heartland. It also owns met coal assets, recently IPOed with a lead order from China Investment Corporation, which should deliver \$600 million of annual EBITDA by 2013. The met coal and other non-core assets alone are worth over half the current market cap.

DAN & MATTHEW CONDUCT DUE DILIGENCE A MILE UNDERGROUND



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[12] [Homework: Matt & Me a mile under the Gobi desert].

MILESTONE DRIVEN PERFORMANCE



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Source: Bloomberg

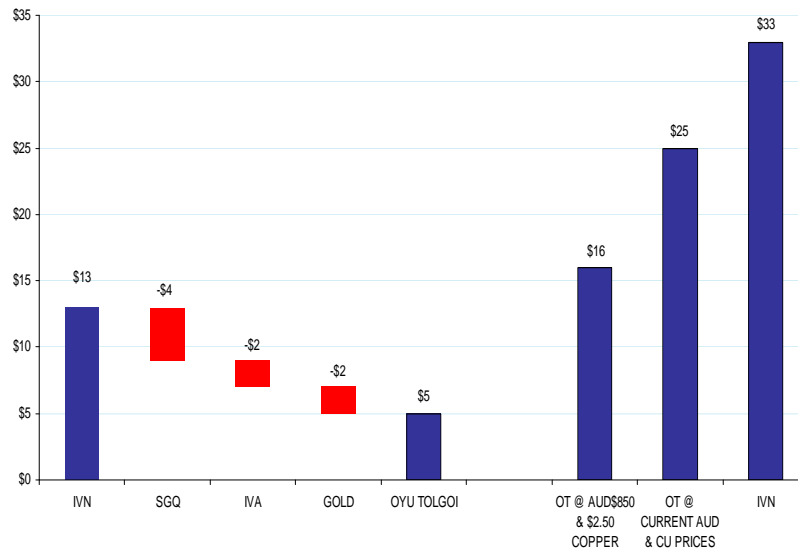
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[13] Rio Tinto invested as a strategic partner in 2006, and will have bought over 46% of the Company, first paying \$10 a share, and most recently up to \$16. Rio's financing and operating role substantially de-risks this story. And once they finish building the mine, I have no doubt Rio will want to consolidate their ownership, so there's an endgame here too.

Excluding the drop in late '08 (which presented an epic buying opportunity), the chart is a *junior mining stock's dream*: gapping up to new levels closer to cash flow potential as the company achieves each successive financing and project development catalyst.

SUM-OF-PARTS CREATES CHEAP OPTION



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Source: Bloomberg, IDP-10 Independent Report, Xerion

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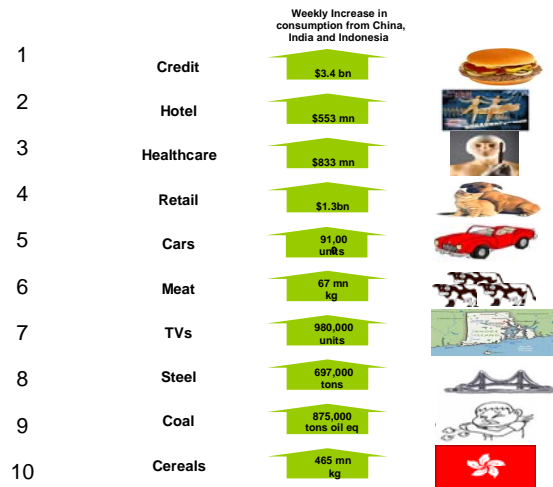
[14] Backing out the coal business and other peripheral assets, the stock at its current price under \$15 creates the copper mine at less than \$2.5 billion, which is less than half of what it's worth on an NPV basis, and a tiny fraction of in-ground metal value, assuming \$2.50 long term copper and \$1000 gold.

MIDSTREAM OPPORTUNITIES



- [15] Another play on the theme is to look for good downstream businesses trading at attractive discounts to comps and growing aggressively in EM. We like *Solutia* and *Celanese*. These are solid twenties margin chemical companies with dominant market shares in their core products, both trading at 30% multiple discounts to their domestic peers. Both are enjoying aggressive Asian growth which is way under-reflected in valuation.

ASIAN EM CONSUMERS: COILED SPRING



- [16] Then, look for opportunities to be migrating even further downstream over time, closer to the EM consumer. For a glimpse of the future, check out *Yum Brands'* most recent 10Q: YUM's operating profits in the United States fell by 9%, but China saved the quarter with a blistering 37% growth rate. China contributed 23% more profit than the United States in 1Q. YUM has 3500 restaurants there and is growing internally by 1400 a year, even while it closes 150 stores a year in the United States.

SELL WHAT EMs MAKE BETTER



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Source: http://vasylpuzanov.blogspot.com/2009_08_01_archive.html

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- [17] *Don't Forget to Sell What Emerging Markets Make Better.* About 70% of all products now sold by Walmart are made in China. China has crushed U.S. manufacturing margins, by bidding up raw materials and selling finished products at everyday low *China Prices*. We're conceptually short labor-intensive, downstream Western producers, especially of the leveraged variety. We'll eventually be long the debt capital structures of the few that can survive, giving us the *next generation equity* after inevitable balance sheet restructuring. Many of the best junk franchises were overleveraged to begin with. Now the triple whammy of falling margins, declining revenues and credit-constrained multiples has dropped valuations by half or more. There will be some great

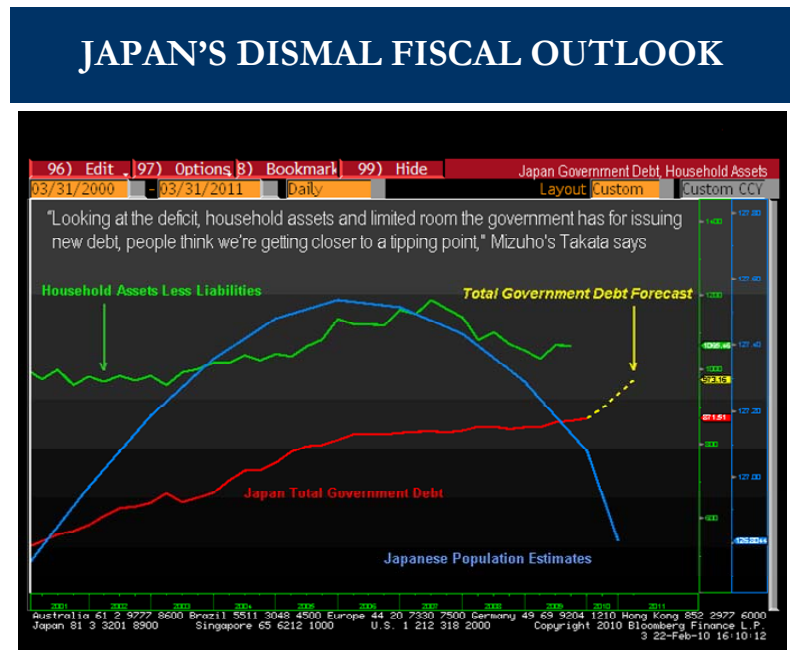
distressed debt opportunities, as the next \$1 Trillion of junk credit matures over the next five years.



- [18] To those who suffer from *China Bubble Anxiety*, I would say the following: China's successes of the past 30 years are the real thing. The country's economic reforms have brought about huge productivity benefits, and these have translated into a formidable competitive manufacturing advantage. China's global creditor status and massive internal savings endow it with more than sufficient resources to fund its urbanization-led employment growth. While it's true their recent investment-heavy growth path has been funded with enormous stimulus through the domestic banking system, in the context of an annual urbanization rate of 20 million people, we're not concerned that

industrial and infrastructure capacity will remain idle for long. Anyway, China has the \$2 Trillion balance sheet and policy discipline to reconsolidate its banking system NPLs any time it wants to. This is not to suggest that there aren't risks to China's growth path—there are plenty—but China's fiscal situation puts it in a much better position than ours to deal with excesses.

- [19] Here's one last idea, a short leverage / long resources macro trade we'd use for portfolio accent: *Short the Yen against the Canadian Dollar*.



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Source: Bloomberg

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Japan is shrinking while its debt is growing, exactly the opposite of the urbanizing emerging markets. Its total government debt is approaching 200% of GDP and forecast to *exceed the entire net asset base of the country's households*. Its debt

service burden is growing faster than total GDP. And the government is facing hopelessly conflicting policy options. It needs to keep its bonds attractive to a dwindling demographic base of local buyers, which implies a stronger yen and higher rates. But is also has to offset the damage inflicted on its economy by falling exports, and that suggests a weaker yen and lower rates.

CAD vs JPY



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Source: Unknown

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[20] Canada, by contrast, has arguably the soundest economy in the G-7. No coincidence, they really don't like leverage up there. And the country is rich in *Shake Hands With China* resources. Australia and Brazil enjoy many of the same riches, but Canada's got the added edge on oil, and its trade ties with the U.S. give it more insulation from a potential EM slowdown.

Just watch those correlated *risk off* days in the market though, because for some inexplicable reason, investors still flock back to the Yen as a safe-haven currency during risk reversions. The trade has downside to the low \$80s, but it's ultimately headed to parity.

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Source: Vanityfair.com

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[21] Let's wrap up with the following recently circulated paraphrase from a well known statesman and political theorist:

The Budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance of foreign lands should be curtailed lest [the

Republic] become bankrupt. People must again learn to work, instead of living on public assistance.

This was supposedly said by Marcus Cicero in 55 BC. As they say in Canada, “*Plus ca Change, Plus C’est la Meme.*” The More Things Change, the More The Stay the Same...

IMPORTANT DISCLOSURES

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