

NUCOR CORPORATION

It's probably not surprising that this steel company started as part of a carmaker, but Nucor's evolution into America's top steel producer has been an unusual one. The company's history can be traced to the REO Car Company, founded in 1905 by Robert E. Olds. REO made several popular but unprofitable vehicles and was forced into bankruptcy in 1938. The reorganized firm continued to perform poorly, and most of the company's assets were sold in 1955. Seeing value in what was left, a small group of REO shareholders bought the remaining assets and formed a nuclear services company, Nuclear Corporation of America. As was the strategy of many public companies during the 1950's and 60's, Nuclear soon became a conglomerate, collecting a wide range of businesses. Nuclear, however, was no more successful than its predecessor and filed for bankruptcy in 1966. This time around, the company was reorganized around its only profitable business, steel joist production. Unhappy with the prices charged by steel suppliers, Nuclear began to produce its own steel, building its first mill in 1968. Following several steel-related acquisitions, the company changed its name to Nucor in 1972. Since then, Nucor's ongoing efforts to control inputs, create new production technologies and continuously focus on costs and employee welfare have been very successful, resulting in record profits from the 21 million tons of steel produced last year.

There are many reasons for the company's success, but perhaps the most critical strategic decision occurred when the first mill was built: choosing to make steel from scrap, using an electric arc furnace "mini-mill" rather than the more widely employed traditional blast furnace. Today, it's easy to see how mini-mills have changed the steel industry, but in 1968, huge, integrated blast furnaces were the only proven model. In the early days of mini-mills, a very limited number of steel types could be produced, and using scrap metal inputs on a large scale was unheard of. Over time, however, mini-mills have proven to be cheaper and more efficient in a number of ways. First of all, being smaller than traditional steel mills, they are much less expensive to construct. And because re-making steel from scrap is done at lower temperatures than in integrated mills, electric arc furnaces are more energy efficient. Additionally, scrap inputs are cheaper than the coke and iron ore used in making steel from scratch. And compared to larger mills, Nucor's smaller facilities provide more production flexibility, which is critical in such a cyclical industry. More recently, an additional benefit has emerged in the context of a potential national "cap and trade" system. Because traditional integrated mills make steel from scratch, using iron ore and coke (which is made of carbon), their carbon emissions are much higher than steel made from scrap. All in all, these factors help keep costs down.

None of these advantages was anticipated decades ago, but now it's clear that moving away from the traditional business model has served Nucor well. Although operating in a commodity-like, highly-cyclical industry often characterized by uneven results, the company has performed very consistently. Returns on capital have averaged in the high double-digits over the last decade – a significant accomplishment in such a capital-intensive business. Not only have operations become more efficient, but revenue has averaged over 13% annual growth since 1993, while earnings-per-share averaged more than 22% growth over the same period. We wouldn't have much interest in Nucor if it were just another commodity steel producer, but clearly these results suggest the company has established compelling advantages over its competitors.

Today, it's popular for companies to talk about their commitment to the environment, but Nucor has led the way for decades. No company in the U.S. recycles more metal than Nucor. In 2007, it recycled more than 22 million tons of metal; that's equivalent to one SUV every four seconds. In an effort to maintain control over access to scrap metal, the company has acquired several scrap brokers over the years. The company is also a leader in new steel-making technologies, some of which are licensed to other producers. Nucor has recently established several joint ventures that could dramatically change the way steel is produced. In Australia and Brazil, the company is helping to develop new, low-cost sources of iron for use in steel making. Also, its Crawfordsville, Indiana plant produces steel without the need for huge, expensive, energy-consuming rollers in a process known as Castrip. If it can build on these initial efforts, a new generation of smaller, even more efficient "micro-mills," costing about 1/10th the price of an integrated mill, is possible.

Another important area where Nucor departs from traditional steel makers is its culture. You'd be hard pressed to find a company more focused on its employees. In every quarterly earnings call, CEO Dan DiMicco can be counted on to offer a "special thanks to every single member of the Nucor family." Were he given the time, he'd probably acknowledge every employee by name. Instead, he prints the names of all employees in each year's annual report. The company also boasts that it has never made a layoff for lack of work – a record that's clearly being tested in the current environment. If you think all this is just a token gesture or mere lip service, think again. No Nucor mill has ever faced a successful union certification election. Certainly, the company's incentive-laden compensation structure for line employees helps -- some workers can earn 150% of their base pay. In any case, Nucor's employees are intensely loyal. We think it would be nearly impossible for another steel producer to replicate this powerful advantage.

CEO DiMicco has also been good to shareholders; late last year, the company declared its 139th consecutive quarterly cash dividend. In particularly good years,

Nucor has also declared a special dividend. We especially like it when management makes it a priority to pay shareholders. Management compensation is also shareholder friendly. Nucor deliberately caps management's incentive compensation at 90% of its peers, so that even when it outperforms its competitors, executives won't be paid even as much as their competitors. The company's commitment to eliminating unnecessary costs is also reflected in the management structure -- there isn't a lot of fat at Nucor. Instead, DiMicco and his senior management team are just two layers from the shop floor. Further, the company's headquarters is staffed with just 80 employees – incredibly lean for the nation's largest steel producer. In short, we wish more companies would adopt Nucor's approach to stewardship.

One major risk for Nucor is the cyclical nature of steel demand. During periods of strong economic growth, when demand for durables, and subsequently steel, is high, industry metrics appear stellar. That's when mills running at or above 75% capacity generate high double-digit profit margins, low incremental costs and lots of cash. That's also when shares of steel makers become very popular. But because the economy ebbs and flows, it's probably better for investors to watch steel companies when demand is slack and industrial capacity is low. Good companies survive these rough periods, and great companies use their competitive advantages to become even stronger by exploiting the weaknesses of their struggling peers. We believe Nucor's low cost structure, technological leadership, unique culture of shared sacrifice and reward, and conservatively financed assets make it a great company. It's the sort of company we love to own, especially when the market's fixation on short-term fluctuations in the economy provides the opportunity to acquire shares at an attractive price.

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