

"MAGIC FORMULA" TUTORIAL:

**Joel Greenblatt's
Winning Investment Approach
— Why It Works**



**Top 10 "Magic Formula"
Stocks for 2009**

Our research team analyzed 100 "magic formula" stocks to bring you the ten best investments for 2009.

Stocks considered include Accenture, Acme Packet, Aladdin Knowledge, Allegheny, Ambassadors Group, American Eagle Outfitters, AmerisourceBergen, Bare Escentuals, Barrett Business Services, Biovail, Boeing, Broadridge Financial, BSQUARE, Cadence Design, CF Industries, Coach, CTC Media, Darling, Dell, Deluxe, DepoMed, Diamond Mgmt & Technology, DISH Network, Double-Take Software, Dynacq Healthcare, EarthLink, eBay, EMCOR, Emulex, First Advantage, Forest Labs, Foster Wheeler, Gannett, Garmin, Hansen Natural, Heidrick & Struggles, Herbalife, Herman Miller, Hurco, iBasis, ICF International, Iconix, infoGROUP, Jackson Hewitt, KBR, Kenexa, KHD Humboldt Wedag, King Pharma, Korn/Ferry, Lam Research, LCA-Vision, Lear, Lincare, Lorillard, Manitowoc, McGraw-Hill, Medicis Pharma, MEMC Electronic Materials, Meredith, Mesabi Trust, Microsoft, Monster, Mosaic, Net 1 Ueps, New Frontier Media, NutriSystem, NVIDIA, Pacer, Perini, Pre-Paid Legal, Precision Castparts, Premier Exhibitions, PRIMEDIA, Questcor Pharma, R.G. Barry, RadioShack, Robert Half, Rockwell Automation, Seagate, Sierra Wireless, Sigma Designs, Spark Networks, SPSS, Syneron Medical, Take-Two Interactive, Tempur-Pedic, TheStreet.com, Total System Services, Travelzoo, USA Mobility, VAALCO Energy, Value Line, ValueClick, Varian Semiconductor, Verigy, Versant, Viacom, ViroPharma, Western Digital, and more.

EDITOR'S COMMENTARY

Revealing Our Top 10 "Magic Formula" Stocks For 2009

Ideas are the lifeblood of investing. To be sure, many investors have failed despite good ideas, but few have succeeded without them. The goal of *The Manual of Ideas* is to put you in the best possible position by consistently delivering high-quality analysis and winning ideas.

It's a good time to be in the ideas business. The dislocations over the past few months have been truly extraordinary. The deleveraging wave sweeping markets and the blowup of specific pools of capital have left an unprecedented number of securities trading with little regard for intrinsic value.

We've uncovered some compelling opportunities among the 100 "magic formula" companies we analyzed.

Our Top 10 magic formula selections for 2009 are high-ROIC businesses misunderstood by investors and, therefore, mispriced. **American Eagle (AEO)**, the youth fashion brand, has been shunned despite one of the best business models in retail, featuring strong brand loyalty, efficient sourcing and excellent store economics.

Garmin (GRMN), the leading provider of personal navigation devices, has lost the momentum that had attracted speculators; yet, the company continues to enjoy a large market opportunity and trades at 6x 2009E EPS.

KHD Humboldt Wedag (KHD), a global cement plant engineering firm, is run by an unusually adept CEO and has massive under-appreciated non-core assets, including cash, preferred stock and an iron ore interest.

MEMC Electronic Materials (WFR), a wafer maker for semiconductor and solar applications, is valued as a commodity semi cap equipment firm, ignoring the company's leadership in the growing solar industry.

Microsoft (MSFT) has finally said "no" to Yahoo and embarked on a \$40 billion accretive stock buyback, yet it continues to trade at a major discount to the sum-of-the-parts value of its business units.

Net 1 (UEPS), a provider of payment cards to the unbanked in South Africa and elsewhere, continues to grow and has recently removed major uncertainty, yet it trades at 5x forward earnings.

Premier Exhibitions (PRXI), a developer of museum-quality exhibitions and the salvor-in-possession of the Titanic shipwreck site, has misstepped and is now valued not only at a low single digit multiple of normalized EPS but also below the appraised value of its

collection of Titanic artifacts. 16% shareholder Mark Sellers launched a push to fire the CEO earlier this month.

Syneron (ELOS), an aesthetic medical products company, has substantial earning power yet trades below net cash and investments. Baupost is a major shareholder.

Tempur-Pedic (TPX), the non-innerspring mattress leader, has been heavily shorted due to its discretionary, high-ticket product, input cost pressures and financial leverage. The short thesis grossly underestimates the company's highly variable cost structure and ability to service the debt, potentially setting up a short squeeze.

Travelzoo (TZOO), an online distributor of travel deals, has been dismissed as a casualty of weak consumer spending. However, the company's solid U.S. profitability is masked by startup losses related to global expansion. With large insider ownership and insider buying, the market appears to have hugely misjudged intrinsic value.

Barely missing our Top 10 selections are fellow magic formula stocks **Barrett (BBSI)**, **Dell (DELL)**, **New Frontier (NOOF)**, and **Versant (VSNT)**.

☪

Enjoy — and be sure to keep the good ideas coming by visiting www.manualofideas.com today. Do also let us know how we can make *MOI* more valuable to you. Email us at editor@manualofideas.com.

Sincerely,



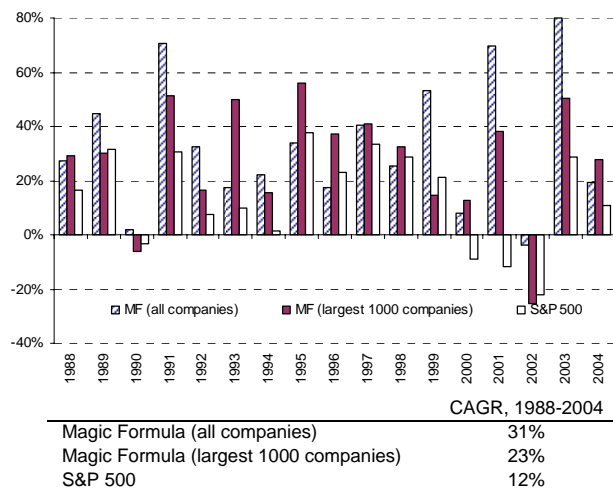
John Mihajevic, CFA,
Managing Editor

and *The Manual of Ideas* Editorial Team

Magic Formula 100
Greenblatt's Approach – Why It Works
Our Top 10 Magic Formula Selections
Profiles of Magic Formula 100

Magic Formula investing is based on a simple yet powerful way of searching for undervalued stocks. According to Joel Greenblatt's *The Little Book That Beats The Market*, portfolios of stocks selected quantitatively based on MFI criteria have handily outperformed the S&P 500 over the past couple of decades.

Magic Formula Performance vs. S&P 500, 1988-2004



Source: Joel Greenblatt, *The Little Book That Beats the Market*.

WHY WE LIKE MAGIC FORMULA INVESTING*

Advocated by “super investor” Joel Greenblatt.

Greenblatt invented MFI as a do-it-yourself version of the approach he has espoused while amassing one of the most impressive investment track records of all time. While reliable data on Greenblatt's complete track record is not available, some estimates put his annualized returns over the past couple of decades at well north of 20%. From 1985-1994, Greenblatt managed the Gotham Partners hedge fund, reporting annualized returns of 50% (after expenses, before performance fees). Gotham returned all outside capital in January 1995.

Simple. The MFI screen ranks companies based on only two variables: “cheapness” (pre-tax unlevered earnings yield) and “goodness” (return on capital

* (besides the fact that it makes money)

employed). The two rankings are given equal weight in the final compilation of the MFI Top 100. This simple process stands in stark contrast to most quantitative screening methods, which rely on multiple variables and are difficult to replicate.

Makes sense. Few investors would prefer a bad business to a good one, and few would purposely ignore the price they pay for a stock. MFI seeks out good companies that are available at good prices. The result is a list of businesses that offer both a high earnings yield and a relatively high probability that capital reinvested in the business will generate high returns. It makes intuitive sense that such stocks should outperform.

WHY MAGIC FORMULA WILL CONTINUE TO WORK

“Institutional imperative” makes adherence to MFI difficult. Institutional managers care not only about investment risk but, perhaps more acutely, about career risk. Many managers cannot afford to follow a winning strategy if it involves enduring long stretches of relative underperformance. It is much safer from a career standpoint to be “wrong” when everyone else is losing money than to be “wrong” when everyone is making money. During the 1988-2004 period studied by Greenblatt, MFI handily outperformed the S&P 500, yet the strategy experienced two non-overlapping three-year periods of underperformance. While most fund managers may be able to endure a quarter or a year of underperformance, they may be left with few investors after a two- or three-year period of subpar results. It is therefore extremely difficult to stick with MFI when the going gets tough.

Investors have a hard time turning off their emotional biases. Even a quick peek at the list of candidates generated by the MFI screen – available at www.magicformulainvesting.com – is likely to make an investor's stomach churn. Many companies on the list are either in out-of-favor industries or have major company-specific issues, such as regulatory scrutiny, accounting problems, executive turnover, or deteriorating operating momentum. While many investors may agree conceptually that buying good companies when they are out of favor is a path to long-term outperformance, a much smaller number would actually be willing to follow such a strategy. As a quantitative method, the MFI screen is perfectly sanguine about picking a headhunting firm during a recession or a laser eye surgery provider when the media is calling into question the safety of laser eye surgery. Professional investors legitimately want to use the MFI list as a starting point from which to do further research and ultimately make a subjective judgment

regarding an investment opportunity. Unfortunately, the subjective judgment is frequently tainted by emotional bias. As a result, the investor may dismiss the headhunting firm by thinking, "Of course it's cheap, we're in a recession!" Similarly, the investor may dismiss the laser eye surgery company by thinking, "Of course it's cheap, they might go out of business!"

MFI never runs out of investment candidates.

Several value investment strategies have become *de facto* obsolete over time. For example, whereas Ben Graham successfully searched for so-called "net nets" more than a half-century ago, such companies have become virtually extinct today. The few companies whose current assets exceed the sum of their equity market value and total liabilities are typically either depleting those current assets at a rapid pace or there are other reasons why theoretical liquidation values might not be realized. As a result, today's professional investors cannot build their businesses around "net nets." By contrast, MFI simply ranks public companies relative to each other. There is no absolute cheapness requirement, whether it be "net net" or that book value exceed market value. As a result, MFI will always provide investors with an investable list of *relatively* attractive public companies.

Investors tend to remain skeptical of winning strategies even after long periods of outperformance.

Investors have been taught – you might say "brainwashed" – that markets are efficient and there is no free lunch. As a result, they struggle with the notion that a simple quantitative strategy can systematically outperform the best efforts of large numbers of securities analysts and portfolio managers. For example, stocks that trade at a low multiple of price to book value have outperformed the broader market in a statistically significant way for a long period of time. Economists Eugene Fama and Kenneth French have studied this phenomenon extensively (latest data is available at www.kennethfrench.com). Ironically, even after having observed this contradiction of the efficient markets hypothesis (EMH) for many years, Fama, in true professorial fashion, tried to explain it away by invoking the EMH adherents' favorite axiom: If a strategy outperforms, it must be riskier! Unfortunately for Fama, the strategy of buying stocks with low price-to-book multiples also exhibited relatively low volatility. Volatility, of course, is the EMH adherents' favorite definition of risk. Undeterred, Fama concluded that low price-to-book stocks must be riskier in other ways... The continuing lack of disappearance of the low price-to-book "anomaly" suggests that investors may not flock to MFI even after many years of demonstrated outperformance.

OUR PROPRIETARY TOP 10 SELECTION PROCESS

The Manual of Ideas has developed a process that seeks to improve upon the already impressive performance of the magic formula screen. The MF 100 is an unranked list of the 100 most attractive companies based on earnings yield and return on capital employed. We highly recommend Joel Greenblatt's MFI website, www.magicformulainvesting.com.

MOI's methodology recognizes that not every equity investment should be approached with the same set of questions. Security analysis should be tailored to the type of opportunity examined. For example, an investor analyzing a company that trades at a large discount to net cash and tangible book value might inquire whether the company can be liquidated without major asset impairments, not whether the company's long-term competitive position is favorable. On the other hand, an investor analyzing a company that trades well above book value and at a high multiple of earnings must examine prospects for sustained rapid earnings growth.

The performance of the MFI screen can be improved if one asks questions that take into account the nature of magic formula selections. Of particular concern is the fact that MFI favors firms exhibiting high returns on capital employed. Such companies are generally not cheap based on the liquidation value of their assets. Instead, they might be cheap based on current and prospective earning power. As a result, a crucial determination when evaluating MF selections is whether they exhibit above-average returns on capital for transitory reasons or for reasons that have some permanence. Warren Buffett calls this moat; others may know it as sustainable competitive advantage. It is also crucial whether a business operates in a growing industry that allows the company to reinvest a portion of free cash flow at high rates of return.

The MOI seeks out companies whose earnings yield is likely to increase over time if the stock price remains unchanged. Such companies not only sustain high returns on capital, but also grow earnings by reinvesting cash in the business. As they generate high returns, such companies need to reinvest only a portion of FCF in order to achieve respectable growth. As a result, they generally have cash available for dividends and stock repurchases. Buybacks executed at "good" prices accelerate EPS growth and value creation.

In order to narrow down the list of 100 MF companies to the ten most promising investments, we use a scoring methodology to rank the companies. We then consider the scoring results and a number of increasingly subjective criteria to narrow down the list to

ten investments. In addition to “positive” criteria, such as sustainability of competitive advantage, management quality and industry growth, our selection methodology takes into account the following negative criteria, among others (as Charlie Munger might say, “Invert!”):

- *Pro forma adjustments:* We eliminate companies that would not be on the MF list if their financial statements were adjusted to reflect true operating performance (may include companies recently engaged in large M&A).
- *Capital reinvestment:* We avoid companies with virtually no opportunity for high-return reinvestment of capital (typically companies in industries in long-term decline).
- *Threats to key revenue source:* We avoid companies dependent on a specific customer or contract, if loss of latter has become a real possibility (circumstances may include acquisition of major customer, ongoing re-bid process for large contract, or loss of patent protection).
- *Cyclical:* We avoid capital-intensive businesses that generate high ROIC only during cyclical upswings in their respective industries.
- *Faddishness:* We avoid companies providing a product or service that has a reasonably high likelihood of being a fad.
- *Insider selling:* We avoid companies with heavy recent insider selling, particularly if such selling occurred at prices roughly equal to or below the current market price.
- *Alignment of interests:* We avoid companies with major CEO conflicts of interest or corporate governance abuses.
- *Value proposition:* We avoid companies that offer a questionable value proposition to their end customers.
- *M&A rollups:* We avoid companies that have meaningful integration risks due to major reliance on acquisition-driven growth.

MAGIC FORMULA TOP 10 — MOI SELECTIONS FOR 2009

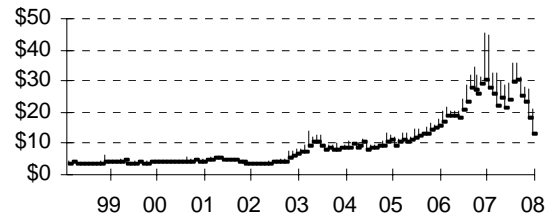
(in alphabetical order)

- American Eagle Outfitters (AEO)
- Garmin (GRMN)
- KHD Humboldt Wedag (KHD)
- MEMC Electronic Materials (WFR)
- Microsoft (MSFT)
- Net 1 UEPS (UEPS)
- Premier Exhibitions (PRXI)
- Syneron (ELOS)
- Tempur-Pedic International (TPX)
- Travelzoo (TZOO)

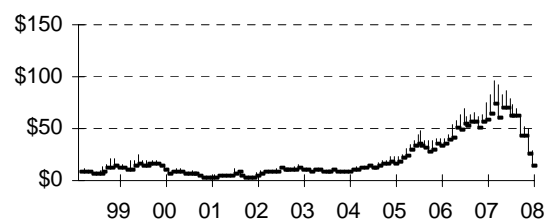
American Eagle Outfitters (NYSE: AEO)		Branded Apparel Retail (www.ae.com)					
Price: \$8.88 (\$8.44-\$23.84)	P/E FYE 2/2/08: 4.9x	<i>Year ended</i>	<u>1/28/06</u>	<u>2/3/07</u>	<u>2/2/08</u>	<u>8/2/08</u>	
Market value: \$1.8 billion	P/E FYE 1/31/09: 7.0x	Revenue:	2,322	2,794	3,055	3,069	
Enterprise value: \$1.5 billion	P/E FYE 1/31/10: 7.2x	GP:	1,078	1,340	1,423	1,361	
Shares out: 205.9 million	P/E FYE 1/31/11: 6.5x	EBIT:	459	587	599	514	
Institutional ownership: 80%	EV / LTM revenue: 0.5x	Net income:	294	387	400	344	
Insider ownership: 10%	EV / LTM EBIT: 3.0x	Diluted EPS:	1.26	1.70	1.82	1.61	
Insider buys/sales: 4/2	P / tangible book: 1.3x	Capex:	82	226	250	288	
<p>Business: American Eagle Outfitters sells its own brand of laidback, current clothing targeting 15-25 year-olds, providing quality merchandise at affordable prices. The collection includes standards like jeans and graphic Ts as well as accessories, outerwear, and footwear. AEO operates ~875 stores in the U.S. and ~75 in Canada. AEO also markets a girls' underwear collection, aerie, available in 81 standalone and AE stores. Martin + Osa targets 28-40 year-olds and offers Refined Casual clothing and accessories in 22 stores.</p> <p>Thesis: American Eagle is a well-managed specialty retailer with a strong, proprietary brand and good alignment of interests (insiders own 12%; chairman Schottenstein bought one million shares at \$23-24 last year). While investors are acutely aware of the macro headwinds facing the average AEO customer, the market is not giving AEO enough credit for continuing to deliver strong returns on capital invested in AE stores. At the recent trading price, AEO shares offer a rare opportunity to buy a great company with no net debt at a small premium to tangible book. We value AEO at \$17-27 per share, based on a range of 6x trailing EBIT to 8x estimated normalized EBIT (detailed analysis herein).</p>		FCF:	384	523	214	201	
		Net cash:	752	814	620	305	
		ST assets:	1,077	1,189	1,021	859	
		ST liabilities:	352	465	376	386	
		Intangibles:	10	10	12	11	
		Book value:	1,156	1,417	1,341	1,405	
		Total assets:	1,606	1,980	1,868	1,945	
		ROIC:	>100%	>100%	>100%	65%	

Garmin (Nasdaq: GRMN)		Personal and Specialty Navigation Devices (www.garmin.com)					
Price: \$19.04 (\$18.00-\$112.68)	P/E FYE 12/29/07: 4.9x	<i>Year ended</i>	<u>12/31/05</u>	<u>12/30/06</u>	<u>12/29/07</u>	<u>9/27/08</u>	
Market value: \$3.9 billion	P/E FYE 12/31/08: 5.1x	Revenue:	1,028	1,774	3,180	3,663	
Enterprise value: \$3.3 billion	P/E FYE 12/31/09: 5.7x	GP:	535	882	1,463	1,632	
Shares out: 202.5 million	P/E FYE 12/31/10: 5.8x	EBIT:	338	555	907	939	
Institutional ownership: 31%	EV / LTM revenue: 0.9x	Net income:	311	514	855	882	
Insider ownership: 46%	EV / LTM EBIT: 3.5x	Diluted EPS:	1.43	2.35	3.89	4.08	
Insider buys/sales: 6/0	P / tangible book: 2.0x	Capex:	27	93	157	143	
<p>Business: Garmin provides GPS-enabled navigation, communication and information devices and applications. Garmin's products serve automotive, mobile, wireless, outdoor recreation, marine, aviation, and OEM applications. Large dealers and distributors include Best Buy and Wal-Mart, but no customer accounts for 10% or more of revenue.</p> <p>Thesis: Garmin shares are unjustifiably cheap. The company is the worldwide leader in personal navigation devices, ahead of Dutch provider TomTom, which has a leveraged balance sheet and appears to be struggling to survive the current downturn. Garmin continues to grow revenue, and while unit growth has slowed, the market for personal navigation devices continues to benefit from increasing consumer adoption. Profits have stagnated due to rapid ASP erosion. However, price declines appear likely to moderate, enabling the company to continue reasonably strong operating performance even in a weak economic environment. The stock has been "orphaned" as momentum investors have exited. We value Garmin at \$35-65 per share, based on a range of 10x estimated 2009 earnings to 10x estimated normalized earnings (detailed analysis herein).</p>		FCF:	220	269	525	496	
		Net cash:	367	410	745	540	
		ST assets:	801	1,169	2,333	2,037	
		ST liabilities:	196	338	802	697	
		Intangibles:	36	68	196	214	
		Book value:	1,157	1,558	2,351	2,140	
		Total assets:	1,362	1,897	3,292	3,015	
		ROIC:	92%	>100%	99%	88%	

KHD Humboldt Wedag (NYSE: KHD)		Cement Plant Engineering (www.khdhumboldt.com)				
Price: \$9.10 (\$7.26-\$35.79)	P/E FYE 12/31/07: 6.4x	<i>Year ended</i>	<u>12/31/05</u>	<u>12/31/06</u>	<u>12/31/07</u>	<u>9/30/08</u>
Market value: \$278 million	P/E FYE 12/31/08: 4.3x	Revenue:	384	459	580	638
Enterprise value: -\$118 million	P/E FYE 12/31/09: 5.1x	GP:	52	72	86	116
Shares out: 30.5 million	P/E FYE 12/31/10: 7.7x	EBIT:	31	43	53	86
Institutional ownership: 44%	EV / LTM revenue: n/m	Net income:	25	30	34	70
Insider ownership: 22%	EV / LTM EBIT: n/m	Diluted EPS:	1.01	1.04	1.42	2.31
Insider buys/sales: 0/0	P / tangible book: 0.8x	Capex:	3	3	4	3
Business: KHD Humboldt Wedag operates in two segments: <i>Industrial plant engineering and equipment supply</i> provides technologies, equipment, and engineering services for cement, coal, and minerals processing. The segment also builds plants that produce clinker, cement, clean coal, and minerals. <i>The resource property segment</i> consists of a mining sublease on which the Wabush iron ore mine is situated that commenced in 1956 and expires in 2055.		FCF:	65	40	127	111
Thesis: KHD is a rare cyclical magic formula stock we find compelling. The business has existed for more than a century, and KHD has proven itself an innovator. Growth exploded in recent years, as cement plant engineering services and equipment experienced strong global demand. Chairman Michael Smith has a proven track record of efficient capital allocation at several public companies. The market is myopically focused on the outlook for cement engineering while completely ignoring KHD's excess assets. We value KHD at \$25-37 per share, based on a sum-of-the-parts valuation analysis that considers the company's \$481 million in net cash, investments and Mass Financial preferred shares; the Wabush iron ore interest; and the core cement engineering business (detailed analysis herein).		Net cash:	102	221	356	395
		ST assets:	462	513	634	709
		ST liabilities:	249	316	396	412
		Intangibles:	0	0	0	0
		Book value:	285	319	307	352
		Total assets:	610	748	789	848
		ROIC:	52%	>100%	n/m	n/m



MEMC Electronic Materials (NYSE: WFR)		Wafers for Semiconductor and Solar Applications (www.memc.com)				
Price: \$15.34 (\$13.79-\$96.08)	P/E FYE 12/31/07: 4.3x	<i>Year ended</i>	<u>12/31/05</u>	<u>12/31/06</u>	<u>12/31/07</u>	<u>9/30/08</u>
Market value: \$3.4 billion	P/E FYE 12/31/08: 4.3x	Revenue:	1,107	1,541	1,922	2,115
Enterprise value: \$2.4 billion	P/E FYE 12/31/09: 3.7x	GP:	367	689	1,001	1,105
Shares out: 224.5 million	P/E FYE 12/31/10: 3.3x	EBIT:	257	558	850	943
Institutional ownership: 89%	EV / LTM revenue: 1.1x	Net income:	249	369	826	694
Insider ownership: 1%	EV / LTM EBIT: 2.5x	Diluted EPS:	1.10	1.61	3.56	3.00
Insider buys/sales: 1/0	P / tangible book: 1.7x	Capex:	163	148	276	346
Business: MEMC provides silicon wafers for semiconductor and solar applications. It has global R&D and manufacturing facilities. Customers include semi device and solar cell makers. MEMC sells wafers from 100-300mm and intermediate products such as polysilicon and silane gas. The company has 200+ U.S. and 450+ foreign patents. Samsung and Yingli Green Energy each accounted for 10%+ of revenue in 2007.		FCF:	158	379	641	410
Thesis: MEMC is a technology company tapping into long-term semiconductor industry growth and global adoption of solar cells. Shares have declined as the outlook for semi cap equipment makers has deteriorated and management has slashed guidance (the CEO resigned in late October). We believe momentum-oriented investors have overreacted to the slowdown in growth. While semi cap equipment is highly cyclical, solar represents a major secular growth opportunity, which the market is currently ignoring. We value MEMC at \$30-36 per share, based on a range of 6x trailing EBIT to 10x estimated 2009 EPS (detailed analysis herein).		Net cash:	101	551	1,286	1,089
		ST assets:	436	900	1,590	1,429
		ST liabilities:	225	258	444	523
		Intangibles:	0	0	0	0
		Book value:	711	1,167	2,035	2,080
		Total assets:	1,148	1,766	2,887	2,985
		ROIC:	46%	90%	>100%	>100%



Microsoft (Nasdaq: MSFT)		Operating Systems, Business Software, Games & Online Services (www.microsoft.com)				
Price: \$20.06 (\$18.74-\$36.72)	P/E FYE 6/30/08: 10.7x	<i>Year ended</i>	<u>6/30/06</u>	<u>6/30/07</u>	<u>6/30/08</u>	<u>9/30/08</u>
Market value: \$178.4 billion	P/E FYE 6/30/09: 9.9x	Revenue:	44,282	51,122	60,420	61,719
Enterprise value: \$159.7 billion	P/E FYE 6/30/10: 8.8x	GP:	36,632	40,429	48,822	49,948
Shares out: 8,895.6 million	P/E FYE 6/30/11: 7.7x	EBIT:	16,064	18,499	22,180	22,204
Institutional ownership: 61%	EV / LTM revenue: 2.6x	Net income:	12,599	14,065	17,681	17,765
Insider ownership: 13%	EV / LTM EBIT: 7.2x	Diluted EPS:	1.20	1.42	1.87	1.90
Insider buys/sales: 1/28	P / tangible book: 9.2x	Capex:	1,578	2,264	3,182	3,450
Business: Microsoft, founded in 1975, is the world's largest software firm. It operates in five segments: <i>Client</i> (Windows OS), <i>Server and Tools</i> (Windows & SQL Server), <i>Online Services</i> (MSN), <i>Business</i> (Office, Project, Visio, Exchange, Live Meeting), and <i>Entertainment and Devices</i> (Xbox, Zune, Windows Mobile, Windows Embedded).		FCF:	12,826	15,532	18,430	15,654
Thesis: Microsoft is quite possibly the world's best business, as reflected by the company's global ubiquity, virtually unassailable market position in operating systems, strong management, and ability to generate enormous profits while employing no capital in the business. While Microsoft is cheap based on 10x estimated FY09 headline EPS, the undervaluation becomes even more apparent if one considers that the company's balance sheet remains deleveraged and that valuable businesses, such as MSN and Xbox, are not yet contributing to headline EPS. We value Microsoft at \$41-54 per share, based on the sum-of-the-parts valuation analysis presented herein. Our estimate ascribes no value to the company's recently announced \$40 billion stock repurchase plan, which should be highly accretive to EPS.		Net cash:	34,161	23,411	23,662	18,747
		ST assets:	49,010	40,168	43,242	37,202
		ST liabilities:	22,442	23,754	29,886	24,383
		Intangibles:	4,405	5,638	14,081	14,190
		Book value:	40,104	31,097	36,286	33,594
		Total assets:	69,597	63,171	72,793	65,117
		ROIC:	n/m	n/m	n/m	n/m

Net 1 Ueps Technologies (Nasdaq: UEPS)		Electronic Payment Processing (www.net1ueps.co.za)				
Price: \$10.97 (\$9.88-\$33.28)	P/E FYE 6/30/08: 7.3x	<i>Year ended</i>	<u>6/30/06</u>	<u>6/30/07</u>	<u>6/30/08</u>	<u>9/30/08</u>
Market value: \$641 million	P/E FYE 6/30/09: 5.8x	Revenue:	196	224	254	262
Enterprise value: \$509 million	P/E FYE 6/30/10: 5.1x	GP:	146	170	187	190
Shares out: 58.4 million	P/E FYE 6/30/11: 4.8x	EBIT:	90	97	110	112
Institutional ownership: 67%	EV / LTM revenue: 1.9x	Net income:	59	64	87	95
Insider ownership: 16%	EV / LTM EBIT: 4.6x	Diluted EPS:	1.03	1.11	1.50	1.65
Insider buys/sales: 0/2	P / tangible book: 4.2x	Capex:	2	4	4	6
Business: Net 1 provides a proprietary universal electronic payment system (UEPS) to the underbanked in developing economies. It operates in four segments, primarily in South Africa: <i>The transaction-based activities segment</i> earns fee income from a state welfare distribution service. <i>The smart card segment</i> derives revenue from the provision of smart card accounts. <i>The financial services segment</i> provides short-term loans on a principal basis and life insurance on an agency basis. <i>The hardware, software and technology segment</i> derives revenue from sales of hardware, SIM cards/licenses, and cryptography.		FCF:	74	62	115	39
Thesis: Net 1 has developed a workable electronic payment solution for the underbanked in developing countries. The company's system addresses the needs of four billion people, an enormous addressable market. While Net 1 faces the long-term risk of losing government-related revenue in South Africa (two-thirds of revenue), a competitive bidding process was terminated in early November, with Net 1 retaining all contracts on existing terms. Revenue and earnings continue to grow despite global macroeconomic weakness. We value the company at \$20-30 per share, based on a range of 10x trailing EBIT to 15x forward EPS (detailed analysis herein).		Net cash:	190	168	269	131
		ST assets:	241	248	346	370
		ST liabilities:	43	55	77	185
		Intangibles:	20	118	99	207
		Book value:	209	281	340	358
		Total assets:	270	376	454	588
		ROIC:	>100%	>100%	>100%	>100%

Premier Exhibitions (Nasdaq: PRXI)			Recreational Activities – Exhibitions (www.prxi.com)				
Price: \$0.78 (\$0.74-\$12.08)	P/E FYE 2/29/08: 2.1x		<i>Year ended</i>	<u>2/28/06</u>	<u>2/28/07</u>	<u>2/29/08</u>	<u>8/31/08</u>
Market value: \$23 million	P/E FYE 2/28/09: 19.5x		Revenue:	13	30	62	64
Enterprise value: \$14 million	P/E FYE 2/28/10: 4.3x		GP:	10	22	41	35
Shares out: 29.2 million	P/E FYE 2/28/11: n/a		EBIT:	3	12	18	5
Institutional ownership: 34%	EV / LTM revenue: 0.2x		Net income:	5	7	12	4
Insider ownership: 13%	EV / LTM EBIT: 3.0x		Diluted EPS:	0.19	0.24	0.37	0.10
Insider buys/sales: 4/0	P / tangible book: 0.7x		Capex:	2	2	5	11
			FCF:	0	9	12	(4)
			Net cash:	3	17	18	9
			ST assets:	10	25	28	24
			ST liabilities:	3	2	4	6
			Intangibles:	4	3	10	12
			Book value:	20	33	47	46
			Total assets:	22	35	51	53
			ROIC:	83%	>100%	>100%	29%

Business: Premier develops touring, museum-quality exhibitions. The exhibitions, including *Bodies* and *Titanic*, have attracted 20 million visitors. Since 1994, Premier subsidiary RMS Titanic has been salvor-in-possession of the wreck of the Titanic, as ordered by a federal district court. RMS has conducted multiple expeditions, recovering 5,500 artifacts. Revenue sources include exhibition ticket sales, merchandise sales, licensing activities, and sponsorship agreements.

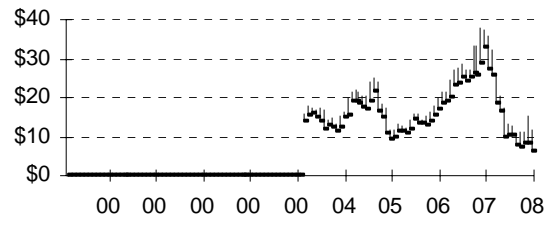
Thesis: Premier's revenue has exploded in recent years, primarily due to the success of the Bodies exhibitions. The company has misstepped recently, allowing the cost structure to get out of hand. However, with involvement by 16% shareholder Mark Sellers, Premier should be able to improve execution. While the company may not remain salvor-in-possession of the Titanic wreck site in the long term, it owns 2,000 recovered artifacts, appraised at \$46 million but on the books for only \$3 million. We value Premier at \$1.50-7.50 per share, reflecting high earnings uncertainty. At the low end, we ascribe zero value to the company's ongoing business, zero value to the net cash position of \$9 million, and \$46 million to the Titanic assets (detailed analysis herein).

Syneron Medical (Nasdaq: ELOS)			Aesthetic Medical Products (www.syneron.com)				
Price: \$7.74 (\$7.71-\$18.04)	P/E FYE 12/31/07: 6.9x		<i>Year ended</i>	<u>12/31/05</u>	<u>12/31/06</u>	<u>12/31/07</u>	<u>9/30/08</u>
Market value: \$215 million	P/E FYE 12/31/08: 8.7x		Revenue:	87	117	141	139
Enterprise value: \$95 million	P/E FYE 12/31/09: 10.8x		GP:	76	99	114	108
Shares out: 27.7 million	P/E FYE 12/31/10: 6.1x		EBIT:	39	35	25	24
Institutional ownership: 65%	EV / LTM revenue: 0.7x		Net income:	41	40	31	26
Insider ownership: 10%	EV / LTM EBIT: 3.9x		Diluted EPS:	1.48	1.44	1.12	0.94
Insider buys/sales: 0/0	P / tangible book: 0.9x		Capex:	1	1	2	2
			FCF:	30	36	46	41
			Net cash:	133	103	168	120
			ST assets:	166	153	222	179
			ST liabilities:	21	26	33	30
			Intangibles:	0	1	5	5
			Book value:	145	194	231	254
			Total assets:	170	225	269	290
			ROIC:	>100%	>100%	98%	70%

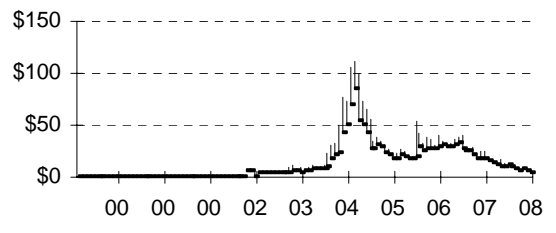
Business: Syneron provides aesthetic medical products based on proprietary Electro-Optical Synergy (Elos) technology, which uses electrical and optical energy to provide effective and safe aesthetic treatments. The products are primarily sold to physicians and target non-invasive procedures, including hair removal, wrinkle reduction, treatment of superficial vascular and pigmented lesions, and treatment of leg veins. The company has an installed base of 10,000 products.

Thesis: Syneron offers innovative products in the growing global market for aesthetic medical procedures. Investors appear to be ignoring the company's existing earning power and emerging growth prospects, including new recurring revenue opportunities related to the LipoLite Energy Access Program and a potentially meaningful partnership with P&G. We value Syneron at \$14-18 per share, based on a sum-of-the-parts analysis that considers the company's \$219 million in net cash and investments and values the aesthetic products business based on a range of 8x trailing EBIT to 8x estimated normalized EBIT (detailed analysis herein).

Tempur-Pedic International (NYSE: TPX)		Mattresses and Pillows (www.tempurpedic.com)				
Price: \$6.72 (\$6.04-\$33.08)	P/E FYE 12/31/07: 3.9x	<i>Year ended</i>	12/31/05	12/31/06	12/31/07	9/30/08
Market value: \$503 million	P/E FYE 12/31/08: 7.2x	Revenue:	837	945	1,107	1,028
Enterprise value: \$934 million	P/E FYE 12/31/09: 7.6x	GP:	424	461	535	461
Shares out: 74.8 million	P/E FYE 12/31/10: 6.5x	EBIT:	186	199	244	176
Institutional ownership: n/a	EV / LTM revenue: 0.9x	Net income:	99	112	142	98
Insider ownership: 9%	EV / LTM EBIT: 5.3x	Diluted EPS:	0.97	1.28	1.74	1.29
Insider buys/sales: 0/0	P / tangible book: n/m	Capex:	87	38	17	17
Business: Tempur-Pedic provides premium, branded, non-innerspring mattresses and pillows. The company operates in two segments: <i>Domestic</i> consists of two U.S. factories and a distribution subsidiary. <i>International</i> consists of a factory in Denmark and distribution subs.		FCF:	15	128	109	149
Thesis: Tempur-Pedic enjoys a wide competitive moat, fortified by strong brand equity, pricing power, industry-leading cost structure, high returns on capital, and favorable long-term growth prospects. We believe investors underestimate the variability of the company's cost structure and the company's ability to service debt in a difficult market environment. The discretionary nature of Tempur-Pedic's high-ticket products makes the stock an easily conceptualized short. The high short interest could, however, result in explosive stock price upside once the market refocuses on the company's significant normalized earnings power. We value Tempur-Pedic at \$11-18 per share, based on 7x trailing EBIT and 12x estimated normalized EPS.		Net cash:	(327)	(345)	(569)	(431)
		ST assets:	228	238	327	320
		ST liabilities:	121	132	127	146
		Intangibles:	274	269	267	267
		Book value:	226	213	48	84
		Total assets:	702	726	806	782
		ROIC:	68%	62%	70%	59%



Travelzoo Inc. (Nasdaq: TZOO)		Travel-related Internet Media (www.travelzoo.com)				
Price: \$4.48 (\$4.11-\$17.20)	P/E FYE 12/31/07: 7.9x	<i>Year ended</i>	12/31/05	12/31/06	12/31/07	9/30/08
Market value: \$64 million	P/E FYE 12/31/08: n/m	Revenue:	51	70	79	81
Enterprise value: \$48 million	P/E FYE 12/31/09: n/m	GP:	50	69	77	78
Shares out: 14.3 million	P/E FYE 12/31/10: n/a	EBIT:	15	30	21	5
Institutional ownership: 29%	EV / LTM revenue: 0.6x	Net income:	8	17	9	(4)
Insider ownership: 45%	EV / LTM EBIT: 9.4x	Diluted EPS:	0.45	1.01	0.57	(0.28)
Insider buys/sales: 129/0	P / tangible book: 2.9x	Capex:	0	0	1	3
Business: Travelzoo's free Internet media properties reach 12 million consumers in the U.S., Europe and Asia. The properties include the Travelzoo website, the Top 20 list of weekly deals, email alerts, and a travel search engine. Travelzoo publishes offers from 900 advertisers, with deal experts reviewing offers to find the best travel deals.		FCF:	8	17	9	(6)
Thesis: Travelzoo is a good business run by capable insiders who have loaded up on shares this year. The market values Travelzoo's international startup operations materially below zero even though the company has a proven model and management knows Europe well (founder Ralph Bartel was educated in Germany and Switzerland). The downside appears limited as the Bartel brothers are heavily incentivized to create shareholder value. If international operations do not achieve desired profitability, management could shut them down and sell the U.S. business to a competitor such as Priceline.com. We value Travelzoo at \$25-26 per share, based on a probability-weighted scenario analysis that includes estimated ranges of annualized EBIT for North America and the rest of the world (detailed analysis herein).		Net cash:	44	34	23	16
		ST assets:	55	43	36	30
		ST liabilities:	7	7	10	12
		Intangibles:	0	0	0	0
		Book value:	49	37	26	22
		Total assets:	56	44	37	35
		ROIC:	>100%	>100%	>100%	>100%



In-depth profiles of our Magic Formula Top 10 picks for 2009 are included on the following pages.

American Eagle Outfitters (NYSE: AEO)

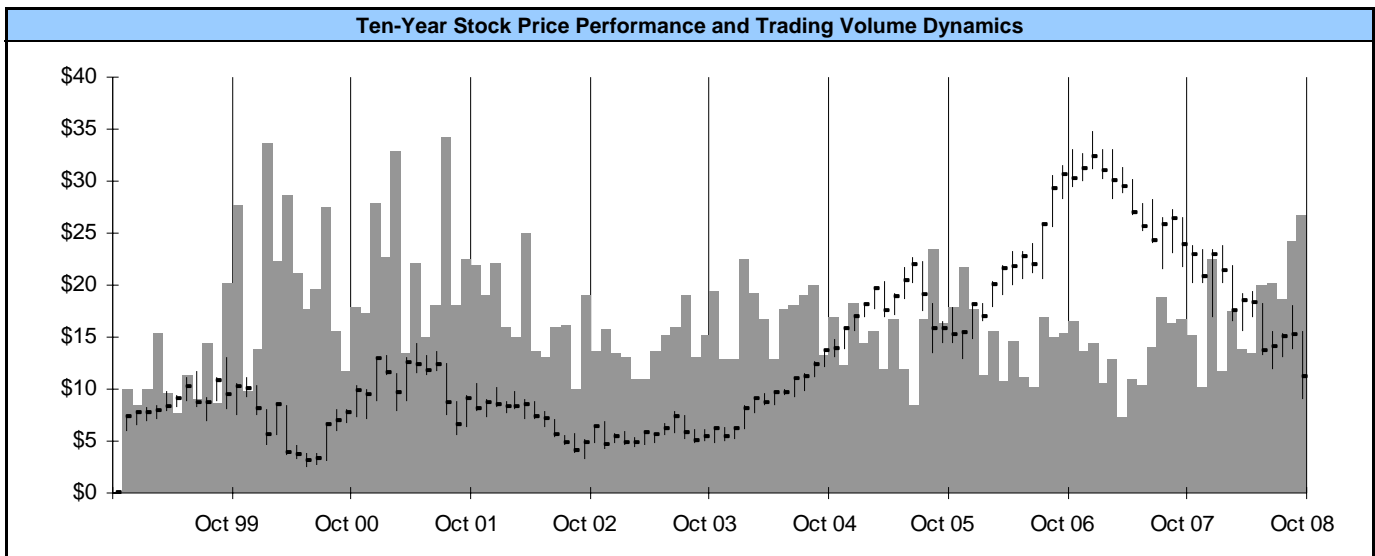
Services: Retail (Apparel), Member of S&P MidCap 400

Pittsburgh, PA, 412-432-3300

<http://www.ae.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$8.88 (as of 11/14/08)		Month	# of		P/E FYE 2/2/08	4.9x
52-week range: \$8.44 - \$23.84		<u>Latest</u>	<u>Ago</u>	<u>Ests</u>	P/E FYE 1/31/09	7.0x
Market value: \$1.8 billion	This quarter	\$0.30	\$0.32	28	P/E FYE 1/31/10	7.2x
Enterprise value: \$1.5 billion	Next quarter	0.47	0.53	25	P/E FYE 1/31/11	6.5x
Shares out: 205.9 million	FYE 1/31/09	1.27	1.36	28	EV / LTM revenue	0.5x
	FYE 1/31/10	1.23	1.42	29	EV / LTM EBITDA	2.4x
	FYE 1/31/11	1.37	1.47	6	EV / LTM EBIT	3.0x
Ownership Data	LT EPS growth	12.8%	13.0%	12	P / tangible book	1.3x
Insider ownership: 10%	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider buys (last six months): 4	<u>Date</u>	<u>Actual</u>	<u>Estimate</u>		LTM EBIT yield	34%
Insider sales (last six months): 2	8/26/08	\$0.29	\$0.28		LTM pre-tax ROC	65%
Institutional ownership: 80%						
# of institutional owners: 667						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	2/2/02	2/1/03	1/31/04	1/29/05	1/28/06	2/3/07	2/2/08	8/2/08	8/4/07	8/2/08
Revenue	1,372	1,383	1,435	1,881	2,322	2,794	3,055	3,069	703	689
Gross profit	547	541	550	878	1,078	1,340	1,423	1,361	317	289
EBIT	167	159	133	363	459	587	599	514	123	89
Net income	106	88	60	213	294	387	400	344	81	60
Diluted EPS	0.48	0.46	0.38	0.99	1.26	1.70	1.82	1.61	0.37	0.29
Cash from ops	175	122	204	378	466	749	464	489	92	90
Capex	119	79	78	97	82	226	250	288	55	84
Free cash flow	56	43	126	281	384	523	214	201	37	6
Cash & investments	226	242	338	590	752	814	620	380	617	380
Total current assets	377	427	531	865	1,077	1,189	1,021	859	1,074	859
Intangible assets	24	24	10	10	10	10	12	11	10	11
Total assets	674	741	932	1,329	1,606	1,980	1,868	1,945	1,837	1,945
Short-term debt	4	4	5	0	0	0	0	75	0	75
Total current liabilities	151	142	209	283	352	465	376	386	313	386
Long-term debt	19	16	14	0	0	0	0	0	0	0
Total liabilities	172	164	295	365	450	562	527	540	462	540
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	502	578	637	964	1,156	1,417	1,341	1,405	1,375	1,405
EBIT/capital employed	64%	55%	41%	>100%	>100%	>100%	>100%	65%	n/m	n/m



BUSINESS OVERVIEW

American Eagle Outfitters (AEO) sells its own brand of laidback clothing for 15-25 year-olds, providing quality merchandise at affordable prices. The collection includes jeans and graphic Ts as well as accessories, outerwear, and footwear. AEO operates 875 stores in the U.S. and 76 in Canada. AEO also markets a girls' underwear collection, *aerie*, available in 81 standalone and AE stores. *Martin + Osa*, a concept targeting 28-40 year-olds, offers Refined Casual clothing and accessories in 22 *Martin + Osa* stores.

SELECTED OPERATING DATA

FYE February 1	2006	2007	2008	1H09 ³
Same store sales growth	+16%	+12%	+1%	-7%
Stores (period end) ¹	869	911	987	1,054
Net sales per gross sq. ft.	\$471	\$524	\$517	n/a
Net sales per selling sq. ft.	\$577	\$642	\$638	n/a
Gross sq. ft. (period end) (mn)	4.8	5.2	5.7	6.1
Square footage growth	5%	8%	10%	14%
Internet sales ² (\$mn)	\$127	\$188	\$243	n/a
Internet sales growth	72%	48%	29%	n/a
% of sales by merchandise group:				
Men's	35%	35%	37%	n/a
Women's (incl. intimates)	60%	60%	59%	n/a
Footwear	5%	5%	4%	n/a
% of sales by geography:				
U.S.	92%	92%	91%	n/a
Foreign	8%	8%	9%	n/a

¹ Store breakdown as of August 2: 951 AE, 81 aerie, and 22 Martin + Osa.

² AEO Direct (includes ae.com, aerie.com, and martinandosa.com).

³ The company has released the following data for the first three quarters of FY09, i.e., through October 30, 2008: sales up 1%, SSS down 7%.

INVESTMENT HIGHLIGHTS

- **Ranked top two clothing brand by teenagers.** Top competitors include Abercrombie (higher price points), Aéropostale (lower price points) and Gap.
- **Strong new store economics.** Based on AEO data, a new AE store requires investment of \$630K and generates first-year four-wall profit of \$661K (27% of sales), a pre-tax ROI of 105%. New store size is 6,000 sq. ft., with \$410 sales per sq. ft. in year one.
- **Strong remodeling economics,** with payback period of 16 months. Data on 57 remodeled stores shows sales and profit increases of 30-40%.
- **Expects to grow square footage 12% in 2008.** Net new store targets: 40 AE, 76 aerie, 9 Martin + Osa.
- **Expects to have 115 aerie stores at yearend 2008,** up from 39 at yearend 2007. The concept has shown "strong initial productivity" and is profitable.
- **Website sales grew 29%** to \$243 million in 2007. The company is targeting \$500 million by 2010.
- **Launched children's brand at 77kids.com,** with stores planned for 2010. The new brand, *77kids*, offers on-trend, high-quality clothing for ages 2-10.

- **Strong management.** Chairman Jay Schottenstein (53; owns 7% of AEO) has been with AEO and predecessors since 1980. CEO James O'Donnell (67; owns 1.5% of AEO) joined the company in 2000. The team has grown the business profitably.
- **Repurchased no shares YTD,** \$438 million in FY08, \$154 million in FY07 and \$172 million in FY06. Chairman Schottenstein bought one million shares at \$23-24 last year.
- **Stock price implies 11% trailing FCF yield,** 6x trailing P/E and 7x forward P/E.

INVESTMENT RISKS & CONCERNS

- **Missed fashion cycle in women's jeans (~15% of sales),** causing women's comp store sales to decline 16% in 2Q09 while men's comps rose 2%. 3Q09 SSS declined 7% (vs. 3% drop in 3Q08), with EPS guidance revised from \$0.31-0.36 to \$0.30. Chief merchandising officer McGalla resigned in August.
- **Challenging retail environment.** The company targets 15-25 year-olds, a demographic whose discretionary spending may decrease significantly in the current downturn. AEO has a conservative inventory position and expense controls in place to mitigate the negative impact of lower spending.
- **aerie success uncertain; Martin + Osa may shut down.** Management may opt to close *Martin + Osa* in Q1 CY09 if sales per sq. ft. do not improve.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
ANF	1,548	1,350	.4x	0.9x	5x	6x
ARO	1,070	999	.6x	4.4x	7x	7x
GPS	8,217	6,725	.4x	1.9x	9x	8x
JCG	701	687	.5x	3.3x	8x	7x
PSUN	80	89	.1x	0.2x	41x	9x
AEO	1,828	1,523	.5x	1.3x	7x	7x

MAJOR HOLDERS

Chairman Schottenstein 7% | CEO O'Donnell 1% | Other insiders 5% | Wellington 6% | Lone Pine 6%

RATINGS

- VALUE** Intrinsic value materially higher than market value? ☆☆☆☆☆
- MANAGEMENT** Capable and properly incentivized? ☆☆☆☆☆
- FINANCIAL STRENGTH** Solid balance sheet? ☆☆☆☆☆
- MOAT** Able to sustain high returns on invested capital? ☆☆☆☆☆
- EARNINGS MOMENTUM** Fundamentals improving? ☆☆☆☆☆
- MACRO** Poised to benefit from economic and secular trends? ☆☆☆☆☆
- EXPLOSIVENESS** 5%+ probability of 5x upside in one year? ☆☆☆☆☆

THE BOTTOM LINE

American Eagle is a well-managed retailer with a strong brand and good alignment of interests (insiders own 12%; chairman Schottenstein bought one million shares at \$23-24 last year). While investors are acutely aware of the macro headwinds facing the average AEO customer, the market is not giving AEO credit for continuing to deliver strong returns on capital invested in AE stores. AEO shares offer a rare opportunity to buy a great company with no net debt at a small premium to tangible book. We value AEO at \$17-27 per share, based on a range of 6x trailing EBIT to 8x estimated normalized EBIT.

...additional insight into AEO:

WHAT ARE THE SHARES WORTH?

- **We value AEO at \$17-27 per share**, based on the valuation analysis summarized below. We note that the company has roughly \$400-500 million in excess marketable assets; however, the vast majority of value resides in the capitalized earnings of the core American Eagle retail business.

American Eagle — Valuation Summary

(\$ in millions, except per share data)

Value of excess marketable assets:¹

	Low Value	High Value
Cash and equivalents	\$353	\$353
Short-term investments	27	27
Long-term investments	309	309
Notes payable	(75)	(75)
Net cash and investments	\$614	\$614
Cash needed to run business ²	(200)	(100)
Total	\$414	\$514

Value of startup concepts:³

aerie, Martin + Osa, 77kids	\$0	\$206
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Value of AE core business:

Estimated LTM EBIT ex. startup concepts	500	
Fair value multiple of LTM EBIT	6x	
Estimated EBIT power in 2-3 years		600
Fair value multiple of EBIT power		8x
Total	\$3,000	\$4,800

Estimated fair value of AEO per share	\$3,414	\$5,520
	\$17	\$27

¹ Based on balance sheet values as of August 2, 2008.

² Represents *MOI* estimate.

³ Represents *MOI* estimate. On the low end, the concepts are conservatively worth zero. On the high end, we value 77kids at zero, while ascribing \$2 million of business value to each of aerie and Martin + Osa's 103 stores.

Source: Company filings, *The Manual of Ideas* estimates and analysis.

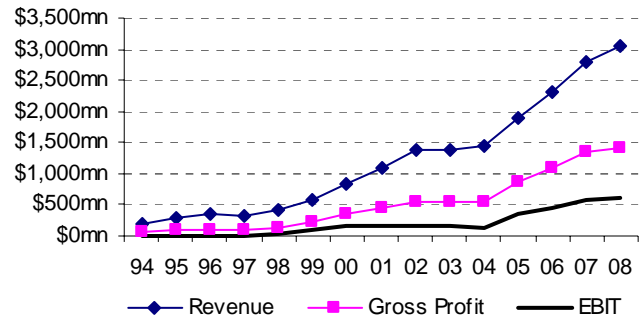
WHY THE SHARES MAY BE MISPRICED

- **Indiscriminate selling of retailers.** With consumer spending hurt by the real estate downturn, lower credit availability and rising unemployment, it is impossible to predict how weak consumer spending may get and when it may rebound. As a result, many investors prefer to stay on the sidelines or to sell short U.S. retailer stocks. However, American Eagle stands out due to its strong market position, strong management, excellent returns on capital, and a rock-solid financial position. While near-term results are likely to continue to be affected by macro weakness, we have little doubt that the company's earning power will be restored — and will grow — once consumer spending turns the corner.
- **Core AE store profitability modestly higher than suggested by overall EPS,** as new concepts are still losing money. As a result, the market is valuing core AE earnings at a slightly lower multiple than may be apparent.

REVENUE, PRODUCTIVITY AND PROFIT MARGINS

AEO – Revenue, Gross Profit and EBIT, FY 1994-2008

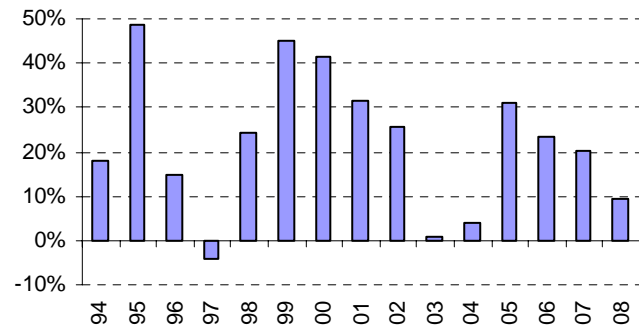
The company has moved from microcap to near-midcap status over the past fifteen years as the American Eagle brand has gained in popularity, with revenue growing nearly twenty-fold from \$169 million in FY93 to \$3 billion in FY08. Gross profit and operating income have increased even more dramatically during the same period.



Source: Company, *The Manual of Ideas*.

AEO – Y-Y Revenue Growth, FY 1994-YTD 2008

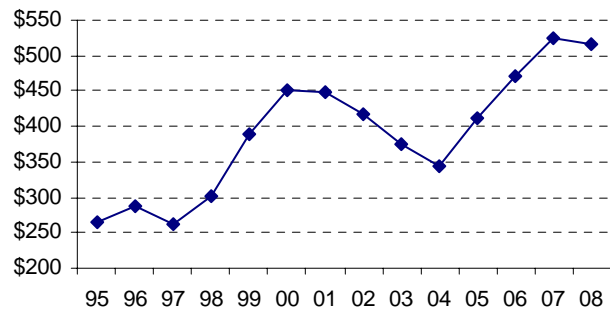
The company has posted remarkably strong growth for more than a decade, driven by an ability to reinvest capital at high rates of return. Even so, growth has not been smooth, with multi-year cycles of relatively stagnant results, followed by years of rapid growth.



Source: Company, *The Manual of Ideas*.

AEO – Sales per Average Gross Square Foot, FY 2000-08

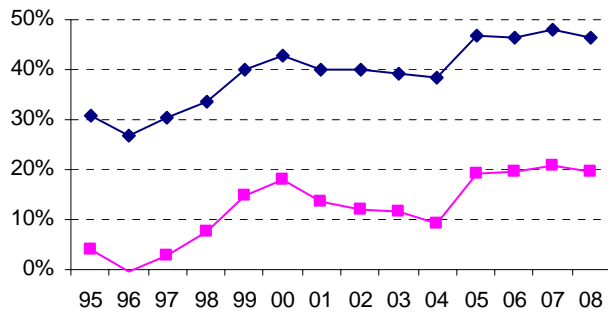
Sales productivity has roughly doubled since 1995, albeit along an uneven path. Sales per square foot declined in the early part of this decade, only to rebound strongly since 2005. Perhaps the most significant risk to the bullish thesis on AEO is the possibility of sales productivity falling sharply once again in coming years.



Source: Company, *The Manual of Ideas*.

AEO – Gross and Operating Margins, FY 1995-2008

The company has achieved record margins in recent years, reflecting the operating leverage inherent in same-store sales growth. Profit margins remained quite strong even in years, such as 2003-04, in which revenue growth ground to a halt.



Source: Company, *The Manual of Ideas*.

AEO CORE STORE METRICS

A new American Eagle store generates a “four-wall” return on invested capital of 91% in year one, based on our calculations and data provided by the company. Company data is based on 40 stores opened since early 2006. We note that four-wall returns for new stores opened in the current economic environment are likely significantly lower than the return shown here. Nonetheless, we believe the company can sustain reasonable returns on capital in a difficult economy, with returns like to rebound substantially when consumer spending trends improve.

New American Eagle Stores – First-Year Economics

New AE store size	6,000 square feet
Investment to open new store ¹	\$730,000
Sales per square foot	\$410
Sales	\$2,460,000
Four-wall profit margin	27%
Four-wall profit	\$664,200
Pre-tax return on investment	91%

¹ Includes opening inventory of ~\$100K but excludes tenant allowances.
Source: *The Manual of Ideas*, American Eagle.

MANAGEMENT’S VIEW OF BUSINESS

CEO O’Donnell and CFO Hilson provided the following commentary on the 2Q09 earnings call on August 26:

- **Operating environment:** “store traffic and consumer demand have been down compared to prior years;” “traffic... has been relatively choppy”
- **Promotional front:** “we do expect... third quarter markdowns to be higher than last year”
- **Management focus:** “managing the business conservatively, with tight inventories, and we continue to pursue expense opportunities”
- **AE brand:** “strong, well positioned, and top of mind with our 15 to 25-year-old customers”

- **Women’s business:** “has been very challenging;” “denim business has been the one category that has hurt us;” “changes that we’ve made in fashion have definitely started to resonate with the customer;” “we have not held our position of strength... in denim, and the whole denim assortment is not a catastrophe. We just have a few styles, and they did not resonate very well with the customer and there were a couple of misses, to be honest with you. We have addressed those, and we expect to be in a very strong denim position, trend-wise for holiday this year;” “very encouraged by spring ’09;” “not... writing off holiday ‘08”
- **Men’s business:** “has been good”
- **Accessories business:** “have struggled with accessories for some time now, and although we’ve had periodic improvements, ...the category is not where we want it to be”
- **Direct business (aео.com, etc.):** “continues to demonstrate strength;” “increase in conversion as well as an increase in unique site visits;” “direct to consumer processing costs per unit declined by over 25% [in FQ3];” “ship to 62 countries;” “continuing to see the global appetite for our brand grow” **aerie:** “performing well;” “stores are ramping up ahead of our plan;” “really been turning on over the last quarter... very pleased with the performance;” “undies have taken off... strong bra performance;” “AUR is somewhat lower than the AE brand”
- **Martin + Osa:** “continue to see an improvement;” “our targets for the brand to reach an annual run rate of \$375 per square foot, and a four wall break even in the fourth quarter of this year, are the parameters for keeping the business ongoing”
- **New stores:** “profitable in their very first year;” “running out of new store locations, so I expect over the next handful of years, two to three years, to see our new store opening cadence probably get somewhere around 15 to 20 stores, and we’re going to cap out at approximately 1,100 [AE] stores”
- **Relief from landlords?** “very definitely;” “between 35 and 45 stores [come up for lease renewal] a year”
- **Share repurchases:** “...as auction rates loosen up, we will continue to evaluate share repurchase. We still have our authorization out there. So it’s really dependent on the auction rate market.”
- **Chief merchandising officer replacement:** “very pleased at the caliber of individuals we’re speaking with;” “I would think that we would have someone identified, and hopefully announced by year’s end”

RECOMMENDED READING

- Value Investors Club write-ups dated November 2, 2007 and July 7, 2008.

Garmin Ltd. (Nasdaq: GRMN)

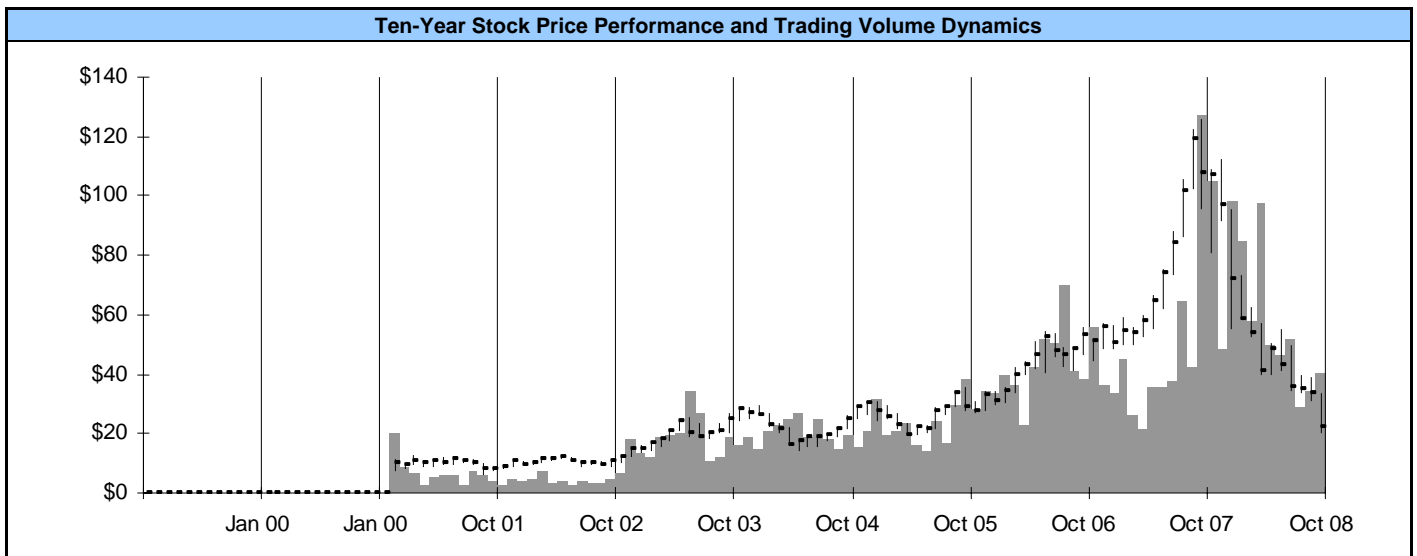
Technology: Scientific & Technical Instruments

Camana Bay, Cayman Islands, 345-640-9050

<http://www.garmin.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$19.04 (as of 11/14/08)		Month	# of		P/E FYE 12/29/07	4.9x
52-week range: \$18.00 - \$112.68					P/E FYE 12/31/08	5.1x
Market value: \$3.9 billion					P/E FYE 12/31/09	5.7x
Enterprise value: \$3.3 billion					P/E FYE 12/31/10	5.8x
Shares out: 202.5 million					EV / LTM revenue	0.9x
					EV / LTM EBITDA	n/a
					EV / LTM EBIT	3.5x
					P / tangible book	2.0x
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 46%					LTM EBIT yield	28%
Insider buys (last six months): 6					LTM pre-tax ROC	88%
Insider sales (last six months): 0						
Institutional ownership: 31%						
# of institutional owners: 479						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	12/29/01	12/28/02	12/27/03	12/25/04	12/31/05	12/30/06	12/29/07	9/27/08	9/29/07	9/27/08
Revenue	369	465	573	763	1,028	1,774	3,180	3,663	729	870
Gross profit	198	255	331	411	535	882	1,463	1,632	342	386
EBIT	131	177	227	271	338	555	907	939	214	214
Net income	113	143	179	206	311	514	855	882	194	171
Diluted EPS	0.52	0.66	0.82	0.94	1.43	2.35	3.89	4.08	0.88	0.82
Cash from ops	130	162	174	209	247	362	682	639	134	233
Capex	27	12	33	78	27	93	157	143	18	34
Free cash flow	103	150	141	131	220	269	525	496	116	199
Cash & investments	234	330	327	314	367	410	745	540	762	540
Total current assets	360	473	540	637	801	1,169	2,333	2,037	1,858	2,037
Intangible assets	17	25	42	50	36	68	196	214	164	214
Total assets	539	706	857	1,117	1,362	1,897	3,292	3,015	2,646	3,015
Short-term debt	4	0	0	0	0	0	0	0	0	0
Total current liabilities	56	81	104	176	196	338	802	697	568	697
Long-term debt	28	20	0	0	0	0	0	0	1	0
Total liabilities	85	103	107	182	205	339	941	876	660	876
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	454	603	750	936	1,157	1,558	2,351	2,140	1,985	2,140
EBIT/capital employed	91%	>100%	>100%	>100%	92%	>100%	99%	88%	n/m	n/m



BUSINESS OVERVIEW

Garmin provides navigation devices and applications enabled by GPS technology. Products serve auto, mobile, wireless, outdoor recreation, marine, aviation, and OEM applications. No customer accounts for 10% or more of revenue.

SELECTED OPERATING DATA

FYE December 31	2005	2006	2007	YTD 9/30/08
<i>Revenue by segment:</i>				
Auto / mobile	39%	61%	74%	70%
Outdoor / fitness	23%	16%	11%	13%
Aviation	22%	13%	9%	10%
Marine	15%	9%	6%	7%
<i>Revenue by geography:</i>				
North America	64%	62%	65%	64%
Europe	31%	33%	30%	31%
Asia	5%	5%	5%	4%
Units shipped (mn)	3.0	5.4	12.3	10.6
Change (y-y)	31%	78%	128%	55%
Revenue per unit (\$)	339	329	259	231
Change (y-y)	3%	-3%	-21%	-20%

INVESTMENT HIGHLIGHTS

- **Leader in personal navigation devices (PNDs)**, with 55% market share in North America and 20% share in Europe (#2 behind TomTom). Industry shipments have slowed sharply after growing 100% in the U.S. and 40% in Europe earlier this year.
- **Deals with auto makers and car rental firms** have boosted Garmin’s market presence. The company has deals with Ford, Honda, and Volvo, as well as National Car Rental and Alamo Car Rental.
- **Acquisitions of European distributors** have doubled Garmin’s European share since early 2007.
- **Planned nüvifone launch in 2009.** The nüvifone is a mobile device that seeks to integrate the navigation and communication experience.
- **Leading-edge proprietary technology**, protected by more than 330 U.S. patents and 190 U.S. patent applications pending; and more than 40 foreign patents and 32 foreign patent applications pending.
- **Units, revenue, and EBIT up 55%, 25% and 5%**, respectively, YTD. Growth continues to be driven primarily by the auto/mobile and outdoor/fitness segments, while the marine segment has lagged.
- **Guiding for 2008 revenue of \$3.6 billion (+13%)**, down from prior guidance of \$3.9 billion (+23%), with EPS of \$3.78 (excluding forex translation).
- **Repurchased \$625 million of stock YTD.**
- **Stock price implies 13% trailing FCF yield, 5x trailing P/E and 6x forward P/E.**

INVESTMENT RISKS & CONCERNS

- **ASP declines have approximated 25% recently** and are expected to do so through yearend 2008. Offsetting the declines are unit volume increases, component cost reductions, and greater efficiency. Inflation could make lower costs tough to sustain.
- **Marine and aviation segments have slowed** due to higher fuel prices and economic weakness.
- **\$8 billion Nokia acquisition of Navteq**, which supplies digital map data for vehicle navigation and location-based services to Garmin under a deal that runs through 2019. Garmin renewed the Navteq deal in late 2007 and abandoned a proposal to buy Navteq competitor Tele Atlas. Nokia competes with Garmin, calling into question the long-term viability of Garmin’s Navteq partnership.
- **€ billion TomTom acquisition of Tele Atlas.** Top Garmin competitor TomTom took control of Tele Atlas in June 2008. This deal puts both major providers of digital map data—Navteq and Tele Atlas—into the hands of Garmin competitors.
- **Dependence on Global Positioning System (GPS).** GPS is a satellite-based navigation and positioning system consisting of a constellation of orbiting satellites operated by the U.S. Department of Defense. The DoD does not currently charge for access to the satellite signals, but it is conceivable the government could decide to do so in the future.

COMPARABLE PUBLIC COMPANY ANALYSIS¹

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
MOT	9,247	6,288	.2x	1.0x	68x	29x
NOK	47,854	44,007	.6x	10.3x	6x	7x
RIMM	22,620	21,052	2.5x	5.7x	n/a	n/a
TOM2.AS	762	2343	1.2x	n/m	3x	4x
GRMN	3,856	3,317	.9x	2.0x	5x	6x

¹ TomTom and privately-held Magellan, Mio, Navigon are closest comps.

MAJOR HOLDERS

CEO Min Kao 20% | Other insiders 26% | Cap Re 5%

RATINGS

- VALUE** Intrinsic value materially higher than market value? ☆☆☆☆☆
- MANAGEMENT** Capable and properly incentivized? ☆☆☆
- FINANCIAL STRENGTH** Solid balance sheet? ☆☆☆☆☆
- MOAT** Able to sustain high returns on invested capital? ☆☆☆☆☆
- EARNINGS MOMENTUM** Fundamentals improving? ☆☆☆☆☆
- MACRO** Poised to benefit from economic and secular trends? ☆☆☆
- EXPLOSIVENESS** 5%+ probability of 5x upside in one year? ☆☆☆☆☆

THE BOTTOM LINE

Garmin is the worldwide leader in personal navigation devices, ahead of Dutch provider TomTom, which has a leveraged balance sheet and is struggling. Garmin continues to grow revenue, and while unit growth has slowed, the market for personal navigation devices continues to benefit from consumer adoption. Profits have stagnated due to rapid ASP erosion; however, price declines appear likely to moderate, enabling the company to continue reasonably strong performance even in a weak economic environment. We believe the stock has been “orphaned” as momentum investors have fled. We value Garmin at \$35-65 per share, based on a range of 10x estimated 2009 earnings to 10x estimated normalized earnings.

...additional insight into GRMN:

WHAT ARE THE SHARES WORTH?

- **We value Garmin at \$35-65 per share**, based on the valuation analysis summarized below. The wide range of fair value reflects (1) the difficulty of balancing the potential earnings impact of the current slowdown and the continued positive long-term growth outlook for personal navigation devices; and (2) the virtually impossible task of predicting the multiple of earnings Garmin will deserve in the future. We reflect this dual challenge in fairly conservative assumptions.

Garmin — Valuation Summary

(\$ in millions, except per share data)

Value of excess marketable assets:¹

	Low Value	High Value
Cash and equivalents	\$522	\$522
Marketable securities	18	18
Long-term marketable securities	309	309
Net cash and investments	\$849	\$849
Cash needed to run business ²	(200)	(100)
Total	\$649	\$749

Value of core business:

2009 estimated EPS ex. interest income	3.15	
Fair value multiple of 2009E adjusted EPS	10x	
Estimated EBIT power in 2-3 years		1,600
Fair value multiple of EBIT power		8x
Total	\$6,552	\$12,800

Estimated fair value of GRMN per share	\$7,201	\$13,549
	\$35	\$65

¹ Based on balance sheet values as of September 27, 2008.

² Represents MOI estimate.

Source: Company filings, *The Manual of Ideas* estimates and analysis.

WHY THE SHARES MAY BE MISPRICED

- **Turnover in “style” of shareholder base.** While only a year ago Garmin was a favorite “momentum stock,” it now attracts investors who are both comfortable with a projected earnings decline and willing to own a business experiencing rapid technological change. In other words, the shares may not have found a natural “home” yet, but we believe they are now moving into the sweetspot of “magic formula” and low P/E investors.

GARMIN VERSUS TOMTOM – PND UNIT SHIPMENTS

	2004	2005	2006	2007
<i>PND unit sales (mn):</i>				
Garmin	2.3	3.0	5.4	12.3
TomTom	0.2	1.7	4.7	9.6
<i>Relative market shares:</i>				
Garmin	90%	64%	54%	56%
TomTom	10%	36%	46%	44%

Source: Garmin, TomTom, *The Manual of Ideas*.

TOP COMPETITOR TOMTOM – SNAPSHOT

- **TomTom is #1 PND supplier in Europe (45% market share) and #2 globally.** It derives more than three-quarters of revenue from Europe, with the rest primarily from North America. TomTom was founded in 1991, went public in 2005 (Amsterdam: TOM2.AS), and has ~3,500 employees today.
- **Explosive growth from 2002-07**, with revenue up from €8 million to €1.7 billion and net income up from €1 million to €317 million over the period.
- **Q3 pro forma revenue down 12% sequentially and down 10% y-y.** Favorable sequential but unfavorable y-y ASP trends are evident from the fact that TomTom shipped 2.5 million PND units in Q3, down 18% sequentially and up 17% y-y.
- **Guiding for 2008 PND market size of 18 million units in Europe and 18 million units in North America**, down from TomTom previous market guidance for 20 million units in each market. TomTom expects to comprise 12-13 million of the estimated 36 million units sold globally, resulting in estimated revenue of €1.6-1.7 billion to TomTom, with 40% gross and 20% operating margins.
- **Acquired digital mapping provider Tele Atlas for €3 billion in August**, creating a strategic challenge for Garmin, which relies on mapping data provided by Navteq, which Nokia acquired for \$8 billion.
- **Weak balance sheet**, with negative tangible book, \$263 million of cash and \$1.6 billion of debt.

TomTom Stock Performance Since IPO

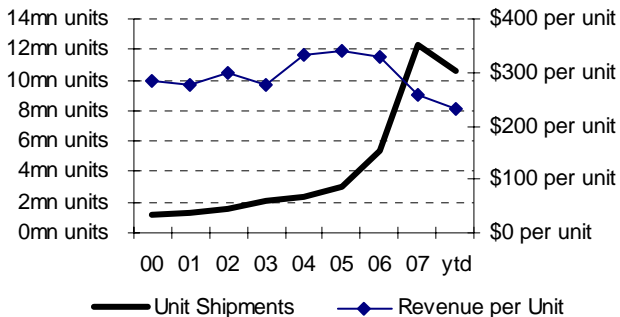


Source: TomTom, *The Manual of Ideas*.

SHIPMENT VOLUME AND ASP TRENDS

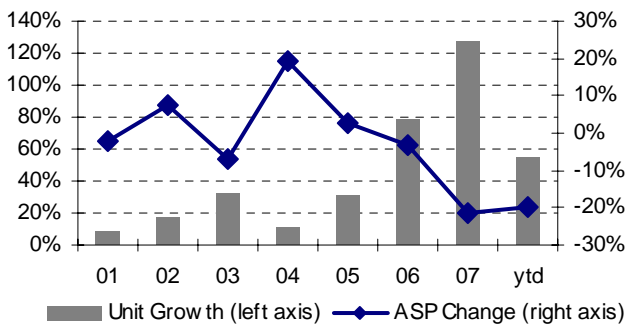
- **Unit shipments grew 128% in 2007 on a 21% decline in ASPs.** Unit growth slowed to 55% in the first nine months of 2008, while ASPs eroded 20%.

Garmin—Unit Shipments and ASPs, 2000-08 YTD



Note: YTD data is for the nine months ended September 30, 2008.
Source: Company, *The Manual of Ideas*.

Garmin—Unit Growth and ASP Changes, 2001-08 YTD



Note: YTD data is for the nine months ended September 30, 2008.
Source: Company, *The Manual of Ideas*.

MANAGEMENT’S VIEW OF BUSINESS

Notes from 3Q08 earnings call on October 29:

- **Business environment:** “the reason we had to drop our numbers from our earlier guidance was October; we definitely saw a slowdown;” in PND market, Europe has slowed “more dramatically” than U.S.; PND remains “hot category— it will still be one of the pushes for the holiday season when you look at shelf space and number of SKUs;” “very strong promotional emphasis for PNDs for the holidays”
- **Q3 review:** 19% revenue growth on 43% shipment growth and 17% ASP decline; “solid” growth in automotive and outdoor fitness; gross margin eroded 260 bps y-y, but “exceeded our earlier expectations as ASP declines moderated and price reductions were largely offset by lower product cost;” gross margin eroded 150 bps sequentially but would have been “nearly flat” excluding currency; EPS down 2% assuming constant currency rates
- **Q3 review—automotive and mobile:** 21% revenue growth, driven by “strong” unit growth and “moderating” price declines; Garmin has top three PNDs and seven of top ten PNDs in the U.S.

- **Q3 review—outdoor fitness:** 35% revenue growth, helped by market share gains
- **Q3 review—aviation:** +9%, “as shipments to OEM offset weakness in portable and retrofit markets”
- **Q3 review—marine:** 8% revenue decline, as higher fuel prices have weakened marine industry; gaining share in OEM and dealer-installed markets
- **Q3 review—by geography:** 29% North American revenue growth, 9% European revenue growth, 21% Asian revenue decline; Asia down due to “timing of several sales programs... we do continue to expect healthy double-digit growth in our APAC markets”
- **2008 guidance:** revised down – “some markets are slowing,” “weaker international currencies add additional pressure on our revenues and margins;” expect revenue of \$3.6 billion (+13%), 24% EBIT margin and EPS of \$3.78 (flat y-y) including gain on TeleAtlas shares (based on 19% tax rate)
- **2009 outlook:** market will be “different, with higher penetration rates as we go into the year, but still unit growth and less ASP decline;” ASP may erode less due to (1) already low prices and (2) already thin margins realized by competitors, leaving limited room for price cuts; U.S. PND unit growth: “not prepared to give 2009 guidance, but... do not see any reason why we shouldn’t see at least 20% unit growth;” PND margin may see “slight reduction... should still see [PND] margins of about 30%”
- **ASP dynamics:** -17% in Q3; ASP stable or up y-y in outdoor fitness, aviation and marine; PND ASP decline continues “in line with our earlier forecast”
- **Inventory:** to fall \$150 million in Q4; at Q3-end, inventory was “more lean as retailers look to reduce their... exposure and delay cash expenditures”
- **nüvifone:** on track for 1H09 launch; signed deals “with some key carriers” (including carrier subsidies); breadth and depth of LBS capabilities are “superior to any other device on the market;” expects to be competitive versus Apple and RIM in features and pricing; gross margin should be 30-35%; one million units shipped in first twelve months after release would be “acceptable”
- **PND market size and growth:** U.S. and Europe are 20 million units each, with 60% growth in North America and 20% in Europe; while growth is down, “the PND market is still growing at a healthy pace in comparison to other categories;” at Q3-end, North American penetration is in mid teens while Europe is above 20%; mix of new to replacement sales is 80%/20% (replacement sales expected to increase as market matures); average life of PND device is 3-5 years (likely to come down with price)
- **Garmin PND market share:** grew to 54% in North America and >20% in Europe in Q3
- **Share repurchases:** bought back 14.7 million shares for \$624 million YTD; authorized additional \$300 million on October 29
- **Miscellaneous:** employs 1,700+ engineers globally

KHD Humboldt Wedag (NYSE: KHD)

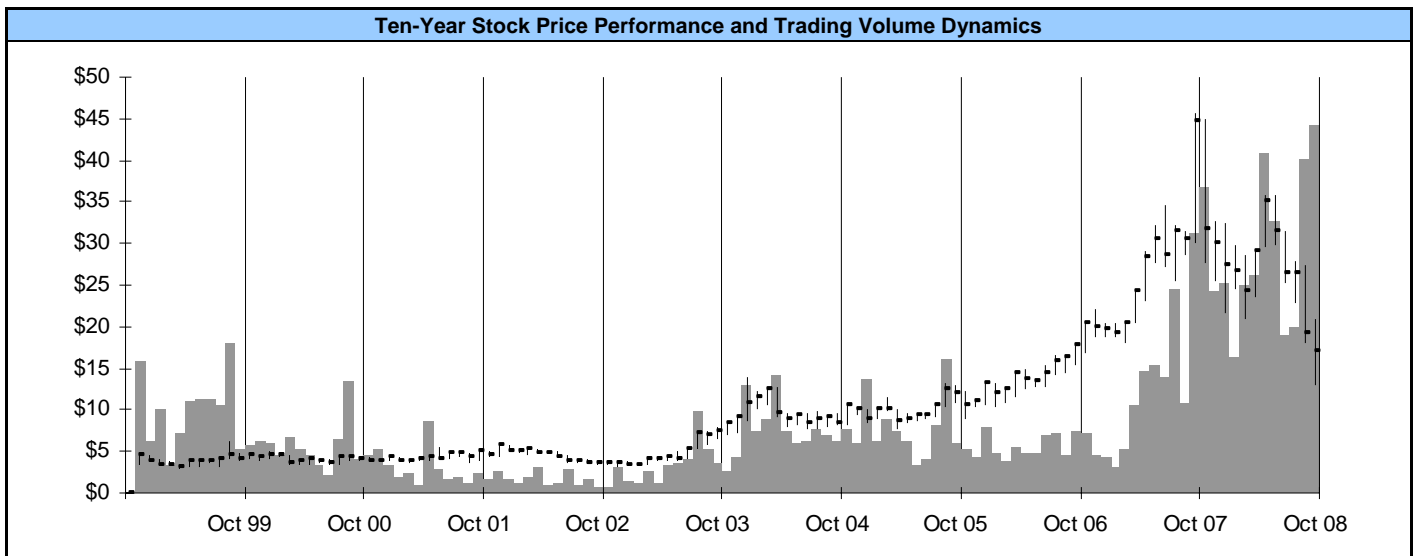
Capital Goods: Construction & Agricultural Machinery

Hong Kong SAR, China, 60-4-683-8286

<http://www.khdhumboldt.com>

Trading Data	Consensus EPS Estimates			Valuation	
Price: \$9.10 (as of 11/14/08)		Month	# of	P/E FYE 12/31/07	6.4x
52-week range: \$7.26 - \$35.79				P/E FYE 12/31/08	4.3x
Market value: \$278 million				P/E FYE 12/31/09	5.1x
Enterprise value: -\$118 million				P/E FYE 12/31/10	7.7x
Shares out: 30.5 million				EV / LTM revenue	-0.2x
				EV / LTM EBITDA	n/a
				EV / LTM EBIT	-1.4x
				P / tangible book	0.8x
Ownership Data	Latest Quarterly EPS Surprise			Greenblatt Criteria	
Insider ownership: 22%				LTM EBIT yield	-73%
Insider buys (last six months): 0				LTM pre-tax ROC	n/m
Insider sales (last six months): 0					
Institutional ownership: 44%					
# of institutional owners: 153					

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	9/30/08	9/30/07	9/30/08
Revenue	214	284	410	187	384	459	580	638	150	194
Gross profit	66	99	76	31	52	72	86	116	21	37
EBIT	44	47	50	15	31	43	53	86	15	32
Net income	43	51	49	37	25	30	34	70	12	31
Diluted EPS	1.60	1.85	1.79	0.47	1.01	1.04	1.42	2.31	0.64	1.01
Cash from ops	65	21	37	60	67	43	130	114	35	(23)
Capex	0	0	0	2	3	3	4	3	(0)	1
Free cash flow	65	21	37	58	65	40	127	111	35	(24)
Cash & investments	159	178	165	263	113	243	370	408	285	408
Total current assets	336	422	235	471	462	513	634	709	558	709
Intangible assets	28	16	16	20	0	0	0	0	0	0
Total assets	395	447	405	604	610	748	789	848	717	848
Short-term debt	0	0	9	27	5	6	0	0	0	0
Total current liabilities	42	87	154	253	249	316	396	412	348	412
Long-term debt	98	69	27	14	6	16	14	13	12	13
Total liabilities	149	161	186	334	325	430	482	496	424	496
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	246	285	218	269	285	319	307	352	293	352
EBIT/capital employed	33%	32%	69%	n/m	52%	>100%	n/m	n/m	n/m	n/m



BUSINESS OVERVIEW

KHD operates in two segments: *Industrial Plant Engineering and Equipment Supply* provides technologies, equipment, and engineering for cement, coal, and minerals processing. The segment also builds plants that produce clinker, cement, clean coal, and minerals. *Resource Property* consists of a mining sublease on which the Wabush iron ore mine is situated that commenced in 1956 and expires in 2055.

The company spun off Mass Financial, representing KHD's former financial services and merchant banking business, in January 2006. KHD completed several other strategic actions subsequent to the Mass Financial spin-off.

SELECTED OPERATING DATA

FYE December 31	2005	2006	2007	YTD 9/30/08
Δ revenue	120%	28%	44%	14%
Δ order intake	n/a	55%	19%	28%
Δ order backlog (period end)	n/a	70%	38%	39%
<i>% of revenue by segment:</i>				
Industrial plant engineering ¹	100%	100%	100%	100%
Iron ore mine royalty ²	0%	0%	0%	0%
<i>% of pre-tax income by segment:</i>				
Industrial plant engineering ¹	84%	95%	93%	85%
Iron ore mine royalty ²	14%	12%	25%	27%
Corporate and other	2%	-7%	-18%	-13%
<i>% of industrial plant engineering revenue by customer group:</i>				
Cement	90%	84%	89%	86%
Coal and minerals	10%	16%	11%	14%
<i>% of industrial plant engineering revenue by geography:</i>				
Americas	7%	19%	20%	n/a
Asia	21%	26%	34%	n/a
Europe and Russia	23%	18%	21%	n/a
Middle East	42%	34%	21%	n/a
Africa and other	6%	4%	4%	n/a

¹ Includes industrial plant engineering and equipment supply.
² KHD has a royalty interest in the Wabush iron ore mine. "Income from interest in resource property" is earned from an unincorporated JV operating in Canada. KHD does not report any revenue related to this JV.

INVESTMENT HIGHLIGHTS

- **Third-largest player with 20% global market share, based on new contracted cement kiln capacity**, behind Danish firm FL Smidth (29%) and Chinese firm Sinoma (28%), and ahead of German firm Polysius (part of ThyssenKrupp). Unlike cement manufacturers, KHD is a service provider operating under an asset-light business model.
- **Low exposure to U.S., which represented 6% of KHD backlog going into 2008.** The Middle East, where cement consumption is growing 10-15%, was 33% of backlog. Asia, where consumption is growing 10%+, accounted for 29% of backlog. Russia and Eastern Europe, where consumption is growing 10-15%, represented 29% of backlog.

- **Backlog amounts to 2.3 years of LTM revenue**, providing several quarters of visibility.
- **Holds 471 patents**, including innovations in kiln design, pyro processing, calciners, coolers, grinding technologies, and separators and roller presses.
- **Chairman Michael Smith (59) has a history of shareholder value creation.** Smith's M&A, corporate finance and global taxation background have benefited investors, as he has created value through various entities over the years, including MFC Bancorp, Mass Financial, Sasamat Capital, Cathay Merchant Group, and Blue Earth Refineries.
- **KHD owns non-core assets**, including an ore mine royalty interest (LTM income of \$27 million); preferred shares of Mass Financial of \$86 million; and (3) net cash and equivalents of \$395 million.
- **Stock price implies 40% trailing FCF yield**, 4x trailing P/E and 5x forward P/E.

INVESTMENT RISKS & CONCERNS

- **Q3 orders down 65% y-y** due to "delays in project awards by customers revisiting their financing alternatives in light of credit market dynamics."
- **Downturn expected to persist.** According to KHD, "Many of our customers are facing liquidity problems. Some have approached us to discuss renegotiating contracts... we should expect some projects to be delayed, others cancelled and a decrease in the number of project opportunities."
- **Outlook scrapped:** "...we are not in a position at this time to confirm our guidance on earnings and order intake for 2008 which we gave [on April 2]"
- **Tax rate likely to increase over time.** Smart tax planning and NOLs have historically kept KHD's tax rate in a range of 5-10%. Management expects the rate to increase to about 20% going forward.

MAJOR HOLDERS

Chairman Smith <1% (may own more through various vehicles) | CEO Busche <1% | Peter Kellogg 21% (long-time association with Smith) | Fidelity 6% | Apis 5%

RATINGS

VALUE Intrinsic value materially higher than market value?	☆☆☆☆☆
MANAGEMENT Capable and properly incentivized?	☆☆☆☆☆
FINANCIAL STRENGTH Solid balance sheet?	☆☆☆☆☆
MOAT Able to sustain high returns on invested capital?	☆☆☆
EARNINGS MOMENTUM Fundamentals improving?	☆☆☆☆☆
MACRO Poised to benefit from economic and secular trends?	☆☆☆☆☆
EXPLOSIVENESS 5%+ probability of 5x upside in one year?	☆☆☆☆☆

THE BOTTOM LINE

KHD is a rare cyclical magic formula stock we find compelling. The business has existed for more than a century, and KHD is a proven innovator. Growth exploded in recent years, as cement plant engineering services and equipment experienced strong global demand. Chairman Michael Smith has a proven track record of efficient capital allocation. The market is myopically focused on the outlook for cement engineering while completely ignoring KHD's excess assets. We value KHD at \$25-37 per share, based on a sum-of-the-parts valuation analysis that considers the company's \$481 million in net cash, investments and Mass Financial preferred shares; the Wabush iron ore interest; and the core cement engineering business.

...additional insight into KHD:

WHAT ARE THE SHARES WORTH?

- We value KHD at **\$25-37 per share**, based on the sum-of-the-parts valuation summarized below.
- In addition to strong upside potential, we note **significant downside protection**, with estimated excess cash and investments of \$331-381 million. Our calculation of excess assets conservatively excludes \$100-150 million, which we estimate is needed to run the core cement engineering business.

KHD — Sum-of-the-Parts Valuation Summary

(\$ in millions, except per share data)

	Low Value	High Value
Value of excess net assets:¹		
Cash and equivalents	\$373	\$373
Short-term cash deposits	27	27
Securities	9	9
Restricted cash	31	31
Preferred shares of Mass Financial	86	86
Long-term debt	(13)	(13)
Pension liability	(32)	(32)
Net cash and investments	\$481	\$481
Cash needed to run business ²	(150)	(100)
Total	\$331	\$381

Value of iron ore interest:

LTM earnings to KHD	\$27	
Fair value multiple of LTM earnings	5x	
Annualized Q3 earnings to KHD		\$35
Fair value multiple of ann. Q3 earnings		5x
Total	\$133	\$175

Value of cement engineering business:

LTM pre-tax segment income	85	
LTM corporate/other expenses	(12)	
LTM net interest income ³	(13)	
Fair value multiple of LTM pre-tax income	5x	
Annualized Q3 pre-tax segment income		145
Annualized Q3 corporate/other expenses		(11)
Annualized Q3 net interest income ³		(16)
Fair value multiple of ann. Q3 income		5x
Total	\$296	\$593

Estimated fair value of KHD per share	\$759	\$1,148
	\$25	\$37

¹ Based on balance sheet values as of September 30, 2008.
² MOI estimate of cash needed to run engineering business; reflects deferred revenue liability, which could become cash-draining amid order slowdown.
³ A portion of net interest income is subtracted from segment income to reflect the separate consideration of excess assets in our valuation analysis.
 Source: Company filings, *The Manual of Ideas* estimates and analysis.

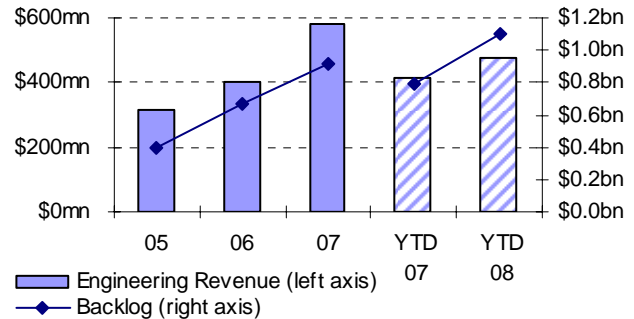
WHY THE SHARES MAY BE MISPRICED

- Investors not looking beyond current slowdown in cement engineering business. KHD's earnings report on November 12 spooked investors due to a 65% y-y drop in Q3 order intake and concerns about potential order cancellations. While the Q3 result represents a sharp reversal from earlier strength in orders, investors are myopically focusing on the current woes of cement engineering business, ignoring (1) the long-term earning power of the engineering business, (2) very large excess assets, and (3) the valuable Wabush iron ore interest.

OVERVIEW OF SELECTED OPERATING DATA

KHD – Engineering Revenue and Backlog, 2005-YTD'08

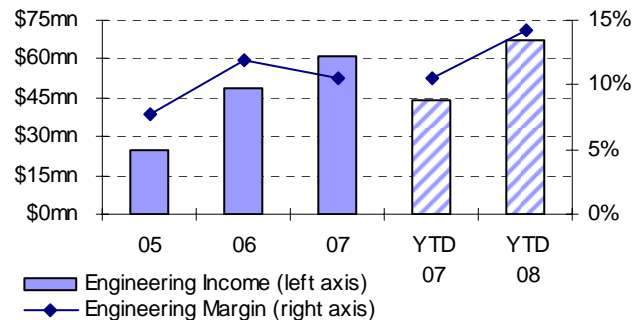
The company has grown cement plant engineering revenue rapidly in recent years, with backlog reaching \$1.1 billion as of September 30. While the large backlog bodes well for near-term revenue, KHD saw a sharp decline in Q3 order intake, and management expects that some customers will seek to delay or cancel projects.



Notes: Engineering revenue equals total revenue, as iron ore income is accounted for below the revenue line. Backlog represents period-end backlog. YTD represents period from January 1 through September 30.
 Source: Company, *The Manual of Ideas*.

KHD – Engineering Income and Margin, 2005-YTD'08

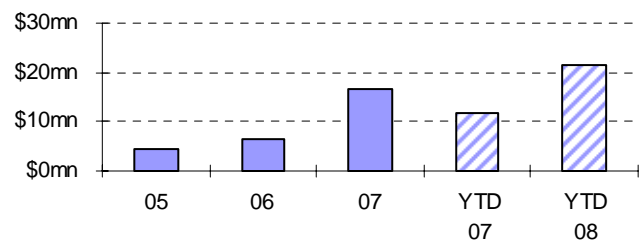
Engineering pre-tax margin has expanded since 2005, causing income growth to outstrip revenue growth over the same time period. Margins may get squeezed going forward, as the company attempts to keep customers from postponing or cancelling projects.



Notes: Income and margin represent pre-tax segment income and margin; corporate and other expenses are excluded from segment income. YTD represents period from January 1 through September 30.
 Source: Company, *The Manual of Ideas*.

KHD – Iron Ore Royalty Income, 2005-YTD'08

The company's income from an interest in the Wabush iron ore mine has grown as iron ore prices have risen, with YTD income reaching \$22 million and Q3 income reaching \$9 million.



Notes: YTD represents period from January 1 through September 30.
 Source: Company, *The Manual of Ideas*.

MANAGEMENT’S VIEW OF BUSINESS

Notes from 3Q08 earnings call on November 12:

- **Operating environment:** “rapidly changing;” expects credit shortage to negatively impact global construction and infrastructure markets; past trend of robust demand growth to “moderate;” customers facing “unprecedented” challenges; some customers have approached KHD to renegotiate contracts; customer capex spending likely to decline; KHD “should expect some projects to be delayed, some projects to be cancelled, and a general decrease in the number of project opportunities”
- **Management response to weak environment:** changing focus from “business growth” to “sustaining equity” during uncertainty; expects to develop plan to cut costs by yearend (will present plan to shareholders); a key objective is to preserve cash by operating in cash flow-neutral way (“excluding working capital movements”)
- **Q3 review:** *order intake* down 65% due to project award delays (55% of orders from Middle East, 23% from Russia and Eastern Europe) – intake weakened progressively throughout Q3; *backlog* of \$1.1 billion at Q3-end (39% from Russia and Eastern Europe, 27% from Asia, 26% from Middle East) – initial assessment is that backlog solidity is “reasonable” (but also “dynamic” and “changing”)
- **Outlook:** “not in position to confirm” prior guidance for earnings and order intake; “don’t have a feel” for how quickly business may pick up again
- **Balance sheet:** majority of cash is held in Austrian banks with strong credit ratings (government has announced intention to support banks if necessary); largest portion of cash is denominated in euros; \$100 million set aside in dollars for business growth
- **M&A strategy:** “hesitant” to spend cash
- **Iron ore:** income up due to price increases; mine output has been relatively consistent in recent years
- **Investment in Mass Financial preferred shares:** negotiating with Mass to distribute to KHD shareholders a portion or all of KHD’s interest in Mass by way of newly created common shares in Mass; mechanism will likely be conversion of a portion of KHD shares held into shares of Mass

ROYALTY INTEREST IN WABUSH IRON ORE MINE

(0% of 2007 revenue, 25% of pre-tax income)

- **KHD’s income from Wabush mine correlates closely with iron ore prices.** As prices have risen, KHD’s income from its interest in Wabush has increased, from \$4 million in 2005 to \$6 million in 2006 and \$17 million in 2007. For an excellent primer on iron ore supply, demand and pricing drivers, see the April 2008 letter by the chairman and president of Leucadia National (NYSE: LUK): <http://tinyurl.com/moi14> (pages 2-4).

- **KHD participates in royalty interest in Wabush iron ore mine sublease,** which expires in 2055.
- **Description of Wabush mine,** adopted from Cleveland Cliffs (CLF) 10-K dated February 29: “The mine and concentrator are located in Wabush, Labrador, Canada, and the pellet plant is located in Pointe Noire, Quebec. The Wabush mine has been in operation since 1965. Over the past five years, the mine has produced 3.8-5.2 million tons of iron ore pellets annually. CLF own 27% of Wabush, ArcelorMittal subsidiary Dofasco owns 29% and U.S. Steel Canada owns 45%.” In March, Dofasco sued U.S. Steel Canada and CLF to compel them to complete the sale of their interests to Dofasco.
- **Holder of royalty interest receives royalties from an unincorporated JV that operates the mine.** The JV pays a royalty that was set in 1987 at a base rate of C\$1.685 per ton, with escalations as defined by agreement. In 2005, KHD sued the JV participants for alleged underpayment of royalties.
- **Demand for iron ore is driven by raw material requirements of integrated steel producers.** Demand for blast furnace steel is cyclical and influenced by macroeconomic factors.

Wabush Iron Ore Mine

	2005	2006	2007
Iron ore shipments (mn tons)	4.9	4.1	4.8
Pre-tax income to KHD (\$mn)	4.3	6.4	16.6

Major Iron Ore Producers

URL	1Q08 Production (mn tons)	Market Share ¹
Vale do Rio vale.com	83	42%
Rio Tinto riotinto.com	37	19%
BHP Billiton bhpbilliton.com	28	14%
Kumba kumba.co.za	8	4%
LKAB lkab.com	6	3%
Others ²	36	18%

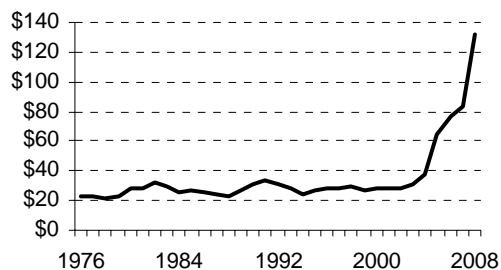
Source: EconStats, *The Manual of Ideas*.

¹ Represents approximate share of ocean trade in iron ore.

² Represents estimates.

Iron Ore Prices, 1976-2008¹

(\$ per ton)



Source: EconStats, CVRD, Wall Street Journal, steel producers.

¹ Represents Brazil-to-Europe prices. Contracts are generally made in the spring/early summer between iron ore and steel producers. Prices shown are prices arranged at the beginning of May of each year. They represent price of fines, i.e., the most heavily-traded category of iron ore.

MEMC Electronic Materials (NYSE: WFR)

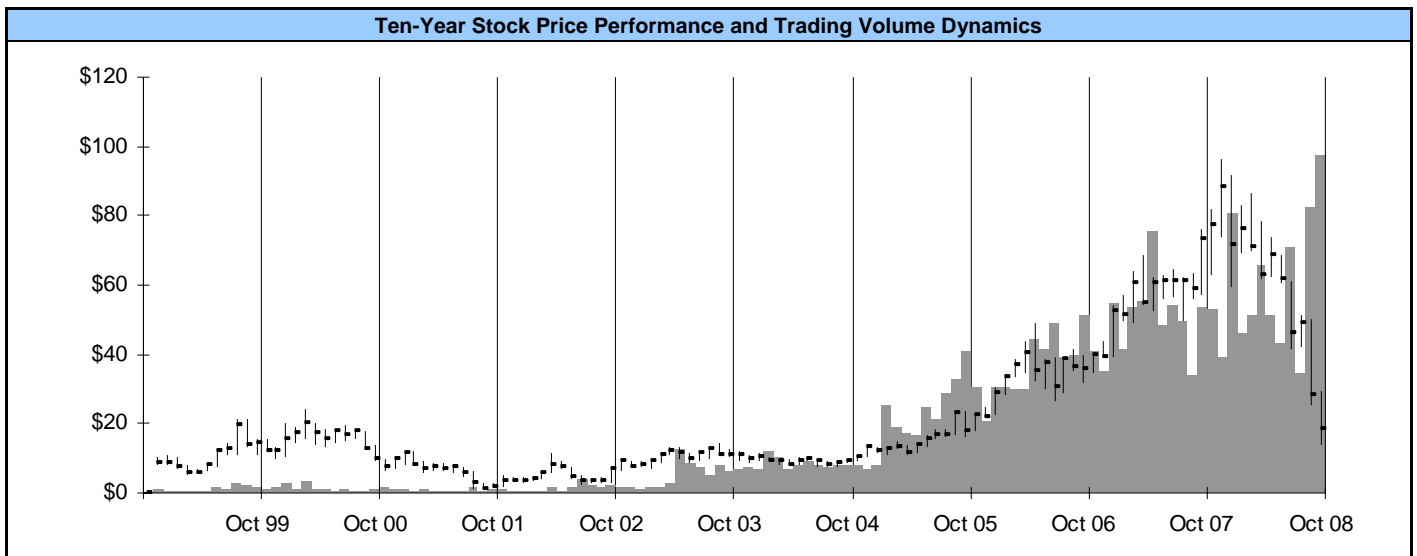
Technology: Semiconductors, Member of S&P 500

St. Peters, MO, 636-474-5000

<http://www.memc.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$15.34 (as of 11/14/08)		Month	# of		P/E FYE 12/31/07	4.3x
52-week range: \$13.79 - \$96.08					P/E FYE 12/31/08	4.3x
Market value: \$3.4 billion					P/E FYE 12/31/09	3.7x
Enterprise value: \$2.4 billion					P/E FYE 12/31/10	3.3x
Shares out: 224.5 million					EV / LTM revenue	1.1x
					EV / LTM EBITDA	n/a
					EV / LTM EBIT	2.5x
					P / tangible book	1.7x
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 1%	Date	Actual	Estimate		LTM EBIT yield	40%
Insider buys (last six months): 1	10/23/08	\$0.86	\$0.88		LTM pre-tax ROC	>100%
Insider sales (last six months): 0						
Institutional ownership: 89%						
# of institutional owners: 1337						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	9/30/08	9/30/07	9/30/08
Revenue	618	687	781	1,028	1,107	1,541	1,922	2,115	473	546
Gross profit	(51)	174	233	370	367	689	1,001	1,105	239	270
EBIT	(219)	65	143	199	257	558	850	943	200	228
Net income	(523)	(22)	117	226	249	369	826	694	152	183
Diluted EPS	(7.51)	(0.17)	0.53	1.02	1.10	1.61	3.56	3.00	0.65	0.80
Cash from ops	(33)	76	99	258	321	528	917	756	267	115
Capex	50	22	67	146	163	148	276	346	71	73
Free cash flow	(83)	54	31	112	158	379	641	410	195	42
Cash & investments	107	166	131	92	154	586	1,316	1,120	1,213	1,120
Total current assets	264	364	365	409	436	900	1,590	1,429	1,473	1,429
Intangible assets	4	4	0	0	0	0	0	0	0	0
Total assets	549	632	727	1,028	1,148	1,766	2,887	2,985	2,513	2,985
Short-term debt	76	124	72	43	18	5	5	6	5	6
Total current liabilities	222	286	244	254	225	258	444	523	416	523
Long-term debt	149	161	59	116	35	29	26	25	28	25
Total liabilities	574	656	533	585	437	599	852	905	835	905
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	(25)	(25)	194	443	711	1,167	2,035	2,080	1,678	2,080
EBIT/capital employed	-104%	30%	52%	45%	46%	90%	>100%	>100%	n/m	n/m



BUSINESS OVERVIEW

MEMC provides silicon wafers for semiconductor and solar applications. It has global R&D and manufacturing facilities. Customers include semi device and solar cell makers. MEMC sells wafers from 100-300mm and intermediate products such as polysilicon and silane gas. The company has 200+ U.S. and 450+ foreign patents. Samsung and Yingli Green Energy each accounted for 10%+ of revenue in 2007. Texas Pacific Group acquired the company from E.ON in 2001 and sold its stake in several transactions through 2007.

SELECTED OPERATING DATA

FYE December 31	2005	2006	2007	YTD 9/30/08
Change in wafer ASPs	-3%	10%	-41%	-41%
<i>% of revenue by product type:</i>				
Wafers	90%	81%	78%	n/a
Excess polysilicon raw material	10%	19%	22%	n/a
<i>% of revenue by geography:</i>				
U.S.	31%	34%	24%	n/a
China	3%	14%	21%	n/a
Korea	17%	12%	16%	n/a
Taiwan	20%	18%	17%	n/a
Other	29%	22%	22%	n/a

INVESTMENT HIGHLIGHTS

- **18% CAGR in silicon wafer shipments from 1990-2007**, driven by growth in semiconductor units and solar megawatts. The wafer market is expected to grow from \$10 billion (80/20 semi/solar split) in 2005 to \$32 billion (45/55) in 2010. Semi devices and solar cells are made from wafers.
- **Capital-intensive yet high-ROIC business.** MEMC operates several production facilities with 8,000MT of targeted annual polysilicon capacity. Net PP&E was \$976 million as of September 30. Capex was \$276 million in 2007 and \$242 YTD.
- **\$15-18 billion of contracts in place.** In July, MEMC amended a ten-year solar wafer deal with Conergy, reducing volume from \$7-8 billion to \$4 billion. MEMC also announced a \$3-3.5 billion ten-year “take-or-pay” solar wafer deal with Tainergy. Customers make deposits in advance of deliveries.
- **Wafer volume drives revenue growth**, with volume increases driven by new wafers and higher shipments of existing wafers. Prices declined 41% in 2007 due to a mix shift, with new 156mm wafers depressing the average price, while existing wafers and intermediate products realized higher prices.
- **Strong balance sheet**, with \$1.3 billion of net cash and investments as of September 30.
- **Repurchased four million shares for \$270 million** since May 2007 on total authorization of \$1 billion.

- **Stock price implies 12% trailing FCF yield**, 5x trailing P/E and 4x forward P/E.

INVESTMENT RISKS & CONCERNS

- **Expects Q4 revenue to drop 2-11% to \$475-525 million**, down from prior guidance for growth of 1-12%. The company expects gross margin of 48% and opex of \$27 million (lower than previous estimate of \$41 million due to forfeiture of options).
- **Weak semiconductor application demand** due to customers reducing inventory. Solar demand has been “healthy,” although management stated on November 17 that macro weakness is increasingly having a “negative effect” on solar as well.
- **Nabeel Gareeb resigned as CEO on October 30** after six years with MEMC. Director Marshall Turner has stepped in until a new CEO is hired.
- **Unanticipated events can affect production.** In Q2, a premature failure of a heat-exchanger at the Merano, Italy facility reduced polysilicon output by 5%, causing Q2 results to miss guidance. The number of adverse events has increased as MEMC has expanded and ramped up production capacity.
- **Dependent on demand in semiconductor device and solar industries.** Weak end-market demand puts pressure on MEMC to cut prices and capacity.
- **Competitors** include Shin-Etsu Handotai, SUMCO, Siltronic, BP Solar, Evergreen Solar, Kyocera, REC Group, Sanyo, Sharp, and SolarWorld.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
BRCM	7,852	5,605	1.2x	3.0x	9x	11x
FSLR	9,470	8,913	8.8x	7.0x	30x	16x
MRVL	3,550	2,983	.9x	2.7x	7x	8x
SPWRA	2,193	2,322	1.8x	2.9x	11x	8x
STP	1,660	2,548	1.5x	2.0x	7x	5x
WFR	3,443	2,354	1.1x	1.7x	4x	4x

MAJOR HOLDERS

Insiders <1% | AXA 6% | Cap Re 4% | Barclays 4%

RATINGS

- VALUE** Intrinsic value materially higher than market value? ☆☆☆☆
- MANAGEMENT** Capable and properly incentivized? ☆☆☆
- FINANCIAL STRENGTH** Solid balance sheet? ☆☆☆☆☆
- MOAT** Able to sustain high returns on invested capital? ☆☆☆
- EARNINGS MOMENTUM** Fundamentals improving? ☆☆☆☆
- MACRO** Poised to benefit from economic and secular trends? ☆☆☆☆
- EXPLOSIVENESS** 5%+ probability of 5x upside in one year? ☆☆☆☆☆

THE BOTTOM LINE

MEMC is a technology company tapping into long-term semiconductor industry growth and global adoption of solar cells. Shares have declined as the outlook for semi cap equipment makers has deteriorated and management has slashed guidance (the CEO resigned in late October). We believe momentum-oriented investors have overreacted to the slowdown in growth. While semi cap equipment is highly cyclical, solar represents a major secular growth opportunity, one the market is currently ignoring. We value MEMC at \$30-36 per share, based on a range of 6x trailing EBIT to 10x estimated 2009 EPS.

...additional insight into WFR:

WHAT ARE THE SHARES WORTH?

- **We value MEMC at \$30-36 per share**, based on the valuation analysis summarized below. The company has \$1.3-1.4 billion in excess investments, providing meaningful downside protection and an opportunity to increase intrinsic value per share through stock repurchases. While earnings from the company's business are difficult to predict, MEMC should remain profitable even in a weaker macro environment. Shares appear grossly undervalued, even at multiples that do not reflect the company's long-term growth prospects.

MEMC Electronic Materials — Valuation Summary

(\$ in millions, except per share data)

Value of excess marketable assets:¹

	Low Value	High Value
Cash and equivalents	\$932	\$932
Short-term investments	187	187
Long-term investments	318	318
Long-term debt	30	30
Net cash and investments	\$1,468	\$1,468
Cash needed to run business ²	(200)	(100)
Total	\$1,268	\$1,368

Value of core business:

LTM EBIT	943	
Fair value multiple of LTM EBIT	6x	
2009 estimated EPS ex. interest income		3.00
Fair value multiple of 2009E adjusted EPS		10x
Total	\$5,659	\$6,840

Estimated fair value of WFR per share	\$6,927	\$8,208
	\$30	\$36

¹ Based on balance sheet values as of September 30, 2008.

² Represents MOI estimate.

Source: Company filings, *The Manual of Ideas* estimates and analysis.

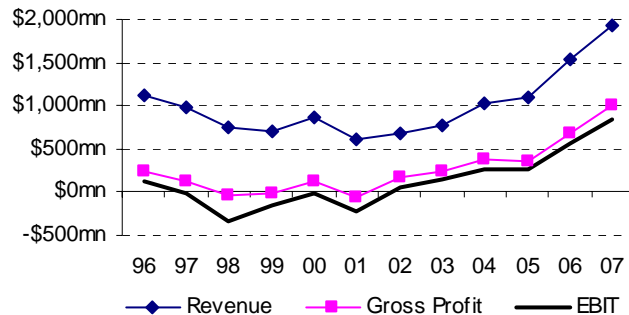
WHY THE SHARES MAY BE MISPRICED

- **Investors may overestimate cyclicity.** While MEMC remains a cyclical business, investors may not be giving the company enough credit for its strong market position in solar applications. The solar market appears likely to continue strong secular growth, mitigating the negative impact of the traditional semiconductor downcycle.
- **Departure of momentum investors over the past year,** as the notion that MEMC can continue strong growth unaffected by traditional semiconductor cyclicity has been exposed as a myth. The shares have until recently remained too expensive for value investors. The latter may also be uncomfortable owning a company with a moat that depends to a large degree on continued technology leadership.
- **Unexpected hit from hurricane Ike.** The company lost fifteen days of production at its Pasadena factory, forcing a downward revision to Q3 estimates. While this is obviously a short-term issue, it seems that it affected some investors' willingness to own the shares during Q3.

REVENUE AND MARGIN ANALYSIS

WFR – Revenue, Gross Profit and EBIT, 1996-07

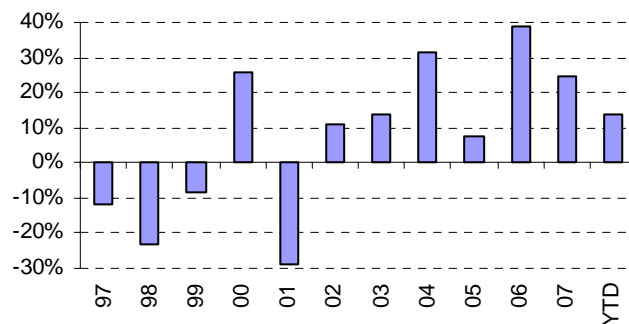
MEMC results have exhibited significant historical volatility, reflecting the cyclical nature of the semiconductor capital equipment industry. However, as MEMC's sales into the solar market have grown, MEMC has added a strong secular growth component to its operating profile.



Source: Company, *The Manual of Ideas*.

WFR – Y-Y Revenue Growth, 1997-YTD'08

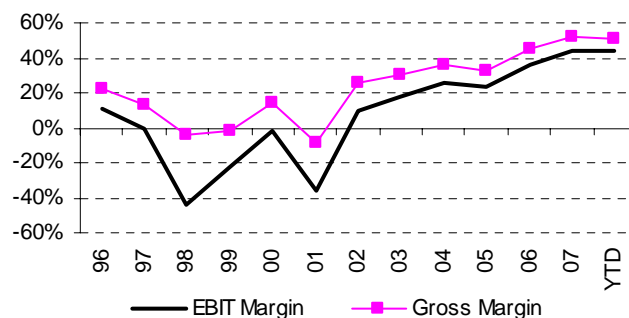
MEMC's highly volatile growth profile reflects the cyclicity of the semiconductor capital equipment industry. However, even as many cap equipment makers are posting revenue declines in 2008, MEMC has managed to continue growing. While the company is still exposed to cyclicity, it should also continue to benefit from secular growth in the solar industry.



Source: Company, *The Manual of Ideas*.

WFR – Gross and EBIT Margin, 1996-YTD'08

MEMC's profit margins have risen in recent years to levels that are unlikely to be sustained through the downcycle in the semiconductor capital equipment industry. However, the company may be in a position to maintain respectable margins due to continued strength in solar applications.



Source: Company, *The Manual of Ideas*.

MANAGEMENT'S VIEW OF BUSINESS

Notes from 3Q08 earnings call with CEO Gareeb and CFO Hannah on October 23:

- **Operating environment:** solar application demand continues to be “healthy;” semiconductor application demand is “weak, mostly due to customer inventory reduction efforts in light of uncertain macro economic conditions” (result: “significant sequential reduction in semiconductor wafer demand”); “while it takes quite a bit more polysilicon to make up the equivalent revenue by producing wafers for solar applications, our increased polysilicon production capability demonstrated in [Q3] and our market positioning should allow us to show continued sequential growth in [Q4] while improving our margin profile”
- **1H08:** polysilicon production was negatively impacted due to technical issues related to Pasadena expansion in Q1 and equipment failures in Q2
- **Q3:** Revenue of \$546 million came in above post-hurricane guidance of \$530 million ± \$10 million, due to “rapid ramp following the hurricane;” quarter included four weeks of impacted production; Pasadena factory did incur “any significant physical or structural damage;” delivered “significant” quantity of short-term wafers (spot production)
- **Q4 outlook:** operations have returned to pre-hurricane levels; expect revenue of \$540-600 million (sequential growth of up to 10%), gross margin “over 50% in spite of reduced utilization of our manufacturing facilities and price reductions,” and opex of \$41 million; semiconductor wafer demand expected to decline 20-30% sequentially, with pricing down mid to high single digits; revenue growth expectation noteworthy because the company needs to sell twice as much poly for solar application as it does for semiconductor application in order to generate equivalent revenue (revenue guidance would have been \$590-650 million assuming constant mix between semiconductor and solar); revenue guidance includes 2-3 weeks of production “buffer”
- **2008:** Revenue related to solar application expected to exceed \$1 billion for the first time; capex expected to be 15% of less of revenue
- **Production capacity:** key driver of revenue; first step is adding capacity in manufacturing facilities, second step is utilizing such capacity (typically ramped up over 3-6 month period); currently installed capacity should allow company to achieve quarterly revenue of \$800-900 million based on traditional semiconductor/solar mix, or revenue of \$720-810 million based on expected Q4 mix; these run rates might be achievable by 2Q09 (important: company is not giving 2009 guidance at this time)

- **Pricing:** spot poly prices “stayed pretty healthy” in Q3; no clear indications on Q4 pricing yet (spot poly sales occur in last month of the quarter); majority of contracts will come up for price renegotiation in December (pricing likely to depend on customer consumption expectations for February and March)
- **Potential customer issue (Gintech) [raised in Q&A]:** \$3-4 billion deal with Gintech, which may have difficulty funding capacity expansion, but has so far paid MEMC “on time;” this is a potential revenue risk rather than receivables risk, as Gintech has deposited cash with MEMC; if customers such as Gintech are unable to pay the company, MEMC would keep deposits (triple digit millions in the case of largest customers—included in liability section of balance sheet, plus off-balance-sheet letters of credit), look to sell poly in spot market and enter into new long-term deals (current prices are “way higher” than prices specified in certain long-term arrangements)
- **Competitive position:** industry-leading asset turnover; “continued growth in spite of the sharp inventory corrections in the semiconductor application market in [1H08] highlights the benefits of MEMC’s unique positioning as a vertically integrated wafer supplier to multiple markets, especially as we achieved a significant milestone of having revenue generated by solar applications exceeding \$1 billion in 2008, in spite of our spot polysilicon sales declining as a percentage of sales;” [analyst question:] competitors such as GCL have difficulty raising capital—is potential effect of this factored into guidance? [answer:] no
- **Share repurchases:** bought back 2.5 million shares in Q3; more than \$500 million remains on \$1 billion total repurchase authorization
- **Potential acquisitions:** some competitors getting weaker; “keeping our eyes wide open;” “want to stay in our core competency of making wafers”
- **Wafer gross margin profile** (from highest to lowest gross margin): (1) short-term spot poly, (2) short-term 156 millimeter wafer, (3) longer term 156 millimeter wafers and 300 millimeter wafers, (4) 200 millimeter and smaller diameter wafers
- **Miscellaneous:** pension obligation was fully funded as of September 30

Microsoft (Nasdaq: MSFT)

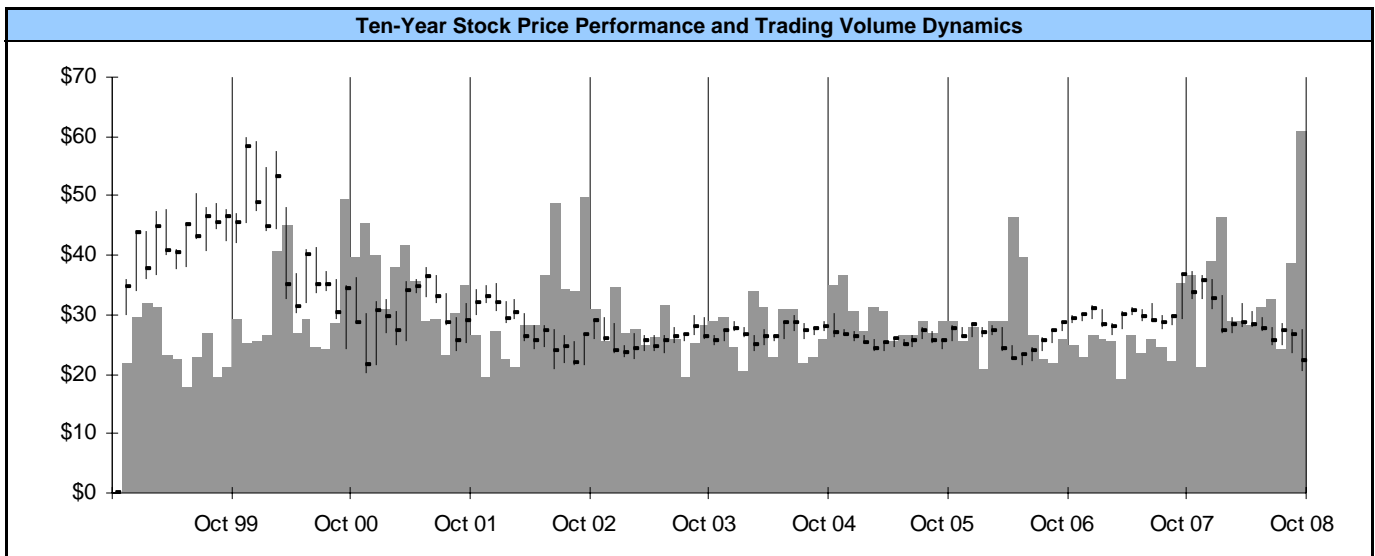
Technology: Software & Programming, Member of S&P 500

Redmond, WA, 425-882-8080

<http://www.microsoft.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$20.06 (as of 11/14/08)		Month	# of		P/E FYE 6/30/08	10.7x
52-week range: \$18.74 - \$36.72		<u>Latest</u>	<u>Ago</u>	<u>Ests</u>	P/E FYE 6/30/09	9.9x
Market value: \$178.4 billion	This quarter	\$0.51	\$0.55	30	P/E FYE 6/30/10	8.8x
Enterprise value: \$159.7 billion	Next quarter	0.50	0.53	26	P/E FYE 6/30/11	7.7x
Shares out: 8,895.6 million	FYE 6/30/09	2.02	2.11	33	EV / LTM revenue	2.6x
	FYE 6/30/10	2.29	2.38	30	EV / LTM EBITDA	n/a
	FYE 6/30/11	2.60	2.73	4	EV / LTM EBIT	7.2x
	LT EPS growth	11.2%	11.2%	7	P / tangible book	9.2x
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 13%	<u>Date</u>	<u>Actual</u>	<u>Estimate</u>		LTM EBIT yield	14%
Insider buys (last six months): 1	10/23/08	\$0.48	\$0.47		LTM pre-tax ROC	n/m
Insider sales (last six months): 28						
Institutional ownership: 61%						
# of institutional owners: 3545						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	6/30/02	6/30/03	6/30/04	6/30/05	6/30/06	6/30/07	6/30/08	9/30/08	9/30/07	9/30/08
Revenue	28,365	32,187	36,835	39,788	44,282	51,122	60,420	61,719	13,762	15,061
Gross profit	22,666	26,128	30,239	33,757	36,632	40,429	48,822	49,948	11,087	12,213
EBIT	3,952	8,395	8,952	14,409	16,064	18,499	22,180	22,204	5,834	5,927
Net income	5,355	7,531	8,168	12,254	12,599	14,065	17,681	17,765	4,289	4,373
Diluted EPS	0.48	0.69	0.75	1.12	1.20	1.42	1.87	1.90	0.45	0.48
Cash from ops	14,509	15,797	14,626	16,605	14,404	17,796	21,612	19,104	5,878	3,370
Capex	770	891	1,109	812	1,578	2,264	3,182	3,450	510	778
Free cash flow	13,739	14,906	13,517	15,793	12,826	15,532	18,430	15,654	5,368	2,592
Cash & investments	38,652	49,048	60,592	37,751	34,161	23,411	23,662	20,722	21,574	20,722
Total current assets	48,576	58,973	70,566	48,737	49,010	40,168	43,242	37,202	35,853	37,202
Intangible assets	1,669	3,512	3,684	3,808	4,405	5,638	14,081	14,190	11,869	14,190
Total assets	67,646	81,732	94,368	70,815	69,597	63,171	72,793	65,117	65,645	65,117
Short-term debt	0	0	0	0	0	0	0	1,975	0	1,975
Total current liabilities	12,744	13,974	14,969	16,877	22,442	23,754	29,886	24,383	22,744	24,383
Long-term debt	0	0	0	0	0	0	0	0	0	0
Total liabilities	15,466	16,820	19,543	22,700	29,493	32,074	36,507	31,523	33,510	31,523
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	52,180	64,912	74,825	48,115	40,104	31,097	36,286	33,594	32,135	33,594
EBIT/capital employed	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m	n/m



BUSINESS OVERVIEW

Microsoft, founded in 1975, is the world's largest software firm. It operates in five segments: *Client* (Windows OS), *Server and Tools* (Windows & SQL Server), *Online Services* (MSN), *Microsoft Business* (Office, Project, Visio, Exchange, Live Meeting), and *Entertainment and Devices* (Xbox, Zune, Windows Mobile, Windows Embedded).

SELECTED OPERATING DATA

FYE June 30	2006	2007	2008	1Q09
<i>% of revenue by segment:</i>				
Client	30%	29%	29%	28%
Server & Tools	21%	22%	22%	23%
Online Services Business	6%	5%	5%	5%
Microsoft Business Division	33%	33%	32%	33%
Entertainment and Devices	9%	11%	12%	12%
<i>Revenue growth by segment:</i>				
Client	10%	15%	13%	2%
Server & Tools	16%	15%	18%	17%
Online Services Business	-2%	6%	32%	15%
Microsoft Business Division	9%	13%	15%	20%
Entertainment and Devices	38%	26%	34%	-6%
Δ revenue	11%	15%	18%	9%
Δ deferred revenue ¹	19%	16%	21%	16%
<i>EBIT margin by segment:</i>				
Client	79%	77%	77%	73%
Server & Tools	33%	33%	35%	32%
Online Services Business	5%	-25%	-38%	-68%
Microsoft Business Division	67%	66%	65%	66%
Entertainment and Devices	-27%	-32%	5%	7%
Total EBIT margin	37%	36%	37%	-7%
<i>% of revenue by geography:</i>				
U.S.	63%	61%	59%	n/a
Other countries	37%	39%	41%	n/a
<i>Revenue growth by geography:</i>				
U.S.	10%	12%	15%	n/a
Other countries	14%	21%	24%	n/a

¹ Represents y-y change in period-end deferred (unearned) revenue. Deferred revenue was \$13.5 billion at 1Q09-end, equal to one-fifth of annual revenue.

INVESTMENT HIGHLIGHTS

- **Parlayed ownership of PC operating systems into leadership** in enterprise software, Internet services, and gaming. The company now generates almost as much EBIT from business software as it does from Windows OS. While MSN online services and Xbox are not yet contributing to profitability, they have the potential to become major profit drivers.
- **Sales, EBIT, EPS up 18%, 21%, 32% in FY08.** Performance drivers included Windows Vista, Office 2007, server software, and Xbox 360.
- **Authorized \$40 billion repurchase in September;** has returned \$115 billion to shareholders through buybacks and dividends in the last five years.

- **FY09 (June) guidance for double-digit growth:** Revenue of \$65-66 billion (up 7-10% y-y), EBIT of \$24-26 billion (up 8-13%), and EPS of \$2-2.10 (up 7-12%). Revenue growth by segment is expected to be 2-6% in Client, 15-17% in Server & Tools, 10-13% in Online Services, 12-13% in the Business Division, and -3%-flat in Entertainment.
- **Cheaper than EBIT-to-EV yield suggests.** As MSN and Xbox are still roughly breaking even, their value is not reflected in the EBIT-to-EV yield metric. As a result, investors should value MSN and Xbox based on metrics other than trailing earnings.
- **Stock price implies 9% trailing FCF yield,** 11x trailing P/E and 10x forward P/E.

INVESTMENT RISKS & CONCERNS

- **Competitive threats** from Google, open source software, SaaS, etc. Microsoft is aggressively trying to win business away from Google and appears to be the front runner on a competitive deal to supply search and advertising on Verizon mobile phones.
- **Lower-than-expected demand** for Vista, Office or Xbox 360 could significantly slow top-line growth.
- **Pursuit of Yahoo** may reflect limited high-ROC reinvestment opportunities and concerns regarding Google. Microsoft does not plan to rebid for Yahoo.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
GOOG	97,580	83,168	4.0x	4.5x	16x	14x
ORCL	87,110	85,326	3.7x	n/m	11x	10x
YHOO	14,994	11,780	1.6x	2.1x	26x	23x
MSFT	178,445	159,698	2.6x	9.2x	10x	9x

MAJOR HOLDERS

Bill Gates 9% | Steve Ballmer 4% | Other insiders <1% | Barclays 4% | State Street 3% | Cap Re 3%

RATINGS

- VALUE** Intrinsic value materially higher than market value? ☆☆☆☆☆
- MANAGEMENT** Capable and properly incentivized? ☆☆☆☆☆
- FINANCIAL STRENGTH** Solid balance sheet? ☆☆☆☆☆
- MOAT** Able to sustain high returns on invested capital? ☆☆☆☆☆
- EARNINGS MOMENTUM** Fundamentals improving? ☆☆☆☆☆
- MACRO** Poised to benefit from economic and secular trends? ☆☆☆☆☆
- EXPLOSIVENESS** 5%+ probability of 5x upside in one year? ☆☆☆

THE BOTTOM LINE

Microsoft is quite possibly the world's best business, as reflected by the company's global ubiquity, virtually unassailable market position in operating systems, strong management, and ability to generate enormous profits while employing no capital in the business. While Microsoft is cheap based on 10x estimated FY09 headline EPS, the undervaluation becomes even more apparent if one considers the fact that the company's balance sheet remains highly deleveraged and that valuable businesses, such as MSN and Xbox, are not yet contributing to headline EPS. We value Microsoft at \$41-54 per share, based on the sum-of-the-parts valuation analysis summarized on the next page. Our estimate ascribes no value to the company's recently announced \$40 billion stock repurchase plan, which should be highly accretive to EPS.

...additional insight into MSFT:

WHAT ARE THE SHARES WORTH?

- We value Microsoft at **\$41-54 per share**, based on the sum-of-the-parts valuation analysis summarized below. Upside to our value estimate could come from share repurchases and better-than-expected performance of the Xbox and MSN.com businesses.
- **Deserves premium valuation** due to defensible moat and stability of earnings and free cash flow.

Microsoft — Sum-of-the-Parts Valuation Summary¹

(\$ in millions, except per share data)

	Low Value	High Value
Value of excess marketable assets.²		
Cash and equivalents	\$9,004	\$9,004
Short-term investments	11,718	11,718
Long-term investments	4,381	4,381
Short-term debt	1,975	1,975
Net cash and investments	\$27,078	\$27,078
Cash needed to run business ³	(2,000)	(1,000)
Total	\$25,078	\$26,078
Value of Client:		
LTM EBIT	12,856	12,856
Fair value multiple of LTM EBIT ⁴	9x	12x
Total	\$115,704	\$154,272
Value of Business Division:		
LTM EBIT	12,904	12,904
Fair value multiple of LTM EBIT ⁵	8x	10x
Total	\$103,232	\$129,040
Value of Server and Tools:		
LTM EBIT	22,642	22,642
Fair value multiple of LTM EBIT ⁶	8x	10x
Total	\$181,136	\$226,420
Value of Entertainment and Devices:		
LTM revenue	8,025	8,025
Fair value multiple of LTM EBIT ⁷	1x	3x
Total	\$8,025	\$24,075
Value of Online Services Business:		
LTM revenue	3,313	3,313
Fair value multiple of LTM EBIT ⁸	2x	5x
Total	\$6,626	\$16,565
Value Offset of Corporate Overhead:		
LTM operating loss	(6,847)	(6,847)
Fair value multiple of LTM loss	8x	10x
Total	(\$54,776)	(\$68,470)

Estimated fair value of MSFT per share	\$385,025	\$507,980
	\$41	\$54

¹ Does not include incremental value of \$40 billion buyback plan.
² Based on balance sheet values as of September 30, 2008.
³ Represents MOI estimate.
⁴ Multiples reflect near-monopoly status and 14% FY08 EBIT growth.
⁵ Multiples reflect very strong margin profile and 15% FY08 EBIT growth.
⁶ Multiples reflect strong margin profile and 26% FY08 EBIT growth.
⁷ Multiples reflect strong Xbox market position and 34% FY08 revenue growth.
⁸ Multiples reflect large online opportunity and 32% FY08 revenue growth.
 Source: Company filings, *The Manual of Ideas* estimates and analysis.

WHY THE SHARES MAY BE MISPRICED

- Viewed as unexciting by many technology investors, despite 18% revenue growth in FY08.
- **Headline earnings ignore value of Xbox and MSN businesses**, making a sum-of-the-parts valuation analysis necessary to judge fair value.

POTENTIAL EPS ACCRETION FROM SHARE REPURCHASES

- We estimate EPS accretion of **\$0.11-\$0.13 over the next twelve months (NTM)**, assuming \$40 billion spent on incremental share repurchases and an average price paid of \$26-30 per share.
- **Microsoft treasurer George Zinn:** "...strong credit quality coupled with investors' current appetite for high quality paper provides a unique opportunity for the company to establish its first-ever commercial paper program and enhance its capital structure." (September 22, 2008)
- **The following analysis shows EPS accretion sensitivity** to various assumptions of repurchase amount and purchase price per share.

NTM Shares Repurchased

(\$ and shares in millions, except per share data)

Price paid per share	NTM Repurchase Amount		
	\$20,000	\$40,000	\$60,000
\$20.00	1,000	2,000	3,000
\$22.00	909	1,818	2,727
\$24.00	833	1,667	2,500
\$26.00	769	1,538	2,308
\$28.00	714	1,429	2,143
\$30.00	667	1,333	2,000
\$32.00	625	1,250	1,875
\$34.00	588	1,176	1,765



NTM Weighted-Average Shares Outstanding^{1,2}

(\$ in millions, except per share data)

Price paid per share	NTM Repurchase Amount		
	\$20,000	\$40,000	\$60,000
\$20.00	8,880	8,380	7,880
\$22.00	8,925	8,471	8,016
\$24.00	8,963	8,547	8,130
\$26.00	8,995	8,611	8,226
\$28.00	9,023	8,666	8,309
\$30.00	9,047	8,713	8,380
\$32.00	9,068	8,755	8,443
\$34.00	9,086	8,792	8,498

¹ Based on 9.4 billion diluted shares outstanding currently.

² Assumes weighted average repurchase date six months from today.



NTM EPS Accretion From Incremental Buybacks^{3,4}

(\$ in millions, except per share data)

Price paid per share	NTM Repurchase Amount		
	\$20,000	\$40,000	\$60,000
\$20.00	\$0.09	\$0.20	\$0.31
\$22.00	\$0.08	\$0.17	\$0.27
\$24.00	\$0.07	\$0.15	\$0.24
\$26.00	\$0.06	\$0.13	\$0.21
\$28.00	\$0.06	\$0.12	\$0.19
\$30.00	\$0.05	\$0.11	\$0.17
\$32.00	\$0.05	\$0.10	\$0.15
\$34.00	\$0.04	\$0.09	\$0.14

³ Assumes 2.0% interest rate and 40% effective tax rate.

⁴ Assumes NTM net income of \$20.0 billion (prior to lost interest income).

MANAGEMENT'S VIEW OF BUSINESS

Notes from 1Q09 call with CFO Liddell on October 23:

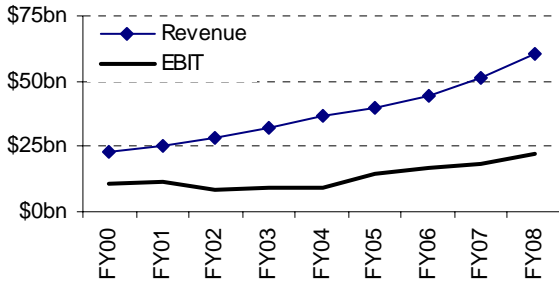
- **Macroeconomic environment...** “clearly weakened throughout the quarter;” deterioration in spending “has continued into October”
- **Management focus:** (1) maintain total-ownership-cost leadership of software; (2) improve operating efficiency, including opex reduction of \$400-500 million (lower headcount, lower marketing, lower capex); invest in “strategic opportunities,” including expansion in emerging markets
- **Market share:** “continue to forecast outgrowing the market regardless of the economic conditions”
- **FY09 guidance—revenue:** \$64.9-66.4 billion, up 7-10%; “still foresee an increase in demand for our products and the potential to drive revenue and [EPS] growth from high single to low double-digits for this financial year;” at top end, guidance assumes “mild recession” and “relatively modest growth rate for all IT-based products;” at bottom end, assumes “deeper recession” and “end-season lower growth for IT;” revenue growth guidance by segment: Client up 2-6% (assumes PC unit growth of 8-12%, with 6-12% in 2H09), Server & Tools up 15-17% (driven by Server platform), Business Division up 12-13% (driven by Office, SharePoint, Dynamics and Unified Communications), Online up 10-13% (assumes online ad growth of 15%), Entertainment Devices down 3% or flat (due to Xbox 360 pricing cuts, offset by unit volume growth); unearned revenue at end of FY09 expected to be up 2-5% y-y
- **FY09 guidance—EBIT:** \$24.4-25.5 billion
- **FY09 guidance—EPS:** \$2-2.10; assumes effective tax rate of 26.5% (150 bps lower than previous expectations)
- **1Q09 review:** revenue, EBIT and EPS met or exceeded high end of guidance despite a “very challenging environment;” unearned revenue at quarter end was up 16% y-y
- **1Q09 review—Client:** revenue up 2%, 400 bps below guidance; drivers: PC unit growth was 10-12%, but growth of traditional PCs was several percentage points below expectations, offset by growth in low-end netbook segment (traditional PC growth in mature markets was flat to low single digit, while emerging markets showed double-digit growth across all segments); OEM revenue was down 1% even as licenses grew 8%; commercial and retail licensing grew 20%
- **1Q09 review—Server & Tools:** revenue up 17%; annuity licensing grew faster than non-annuity, boosting quarter-end unearned revenue 28%; consulting and support services revenue up 19%
- **1Q09 review—Online:** revenue up 15%; ad revenue grew 15% (search ads outperformed display ads)

- **1Q09 review—Business Division:** revenue up 20%, 400 bps above guidance; business revenue grew 16%, driven by “strong sales of enterprise agreements and Client access license suites”
- **1Q09 review—Entertainment & Devices:** revenue down 6%, exceeded high end of guidance; difficult comp due to year-ago launch of Halo 3 was mitigated by stronger Xbox 360 console sales (units of 2.2 million grew 20% y-y and outperformed PS3 sales by 100,000+ units); Xbox Live membership of 14+ million has roughly doubled in each of past two years; segment EBIT margin expanded by 100+ bps
- **Impact of netbooks on Windows licenses:** “too early to determine the extent to which the new netbooks segment is cannibalizing the traditional consumer PC market sales or simply capturing a new market opportunity, so we believe that there are likely aspects of both;” revenue realization from netbooks is “lower than we traditionally get from the consumer segment... it does impact our overall revenue per license”
- **Change in ability to forecast Client segment results due to greater segmentation of PC market:** “you have quite different dynamics in the business market, the consumer, non-netbooks market, the consumer netbooks market and the emerging country version of all of those as well; quite different growth rates, quite different realizations and quite different dynamics driving that; so it becomes, if you like more complicated from a forecasting point of view but a more interesting marketplace”
- **Share repurchases and dividends:** Authorized new \$40 billion program; repurchased 223 million shares for \$6 billion in 1Q09; accretion from buybacks will be partially offset by lower investment income (not only as a result of cash spent on repurchases but also as a result of a lower yield on the investment portfolio)
- **Currency impact on revenue:** 1/3 of revenue is in dollars in North America; 1/3 is in dollars but sold internationally (mainly OEM sales); 1/3 is sold in local currency internationally; FY09 revenue should not be impacted materially by currency swings as company is “pretty much fully hedged”
- **M&A strategy:** “continue to be a net acquirer of businesses,” with focus on small and medium-sized companies (did not discuss Yahoo)
- **Miscellaneous:** issued commercial paper at interest cost of less than 1%

REVENUE, PRODUCTIVITY AND PROFIT MARGINS

MSFT – Revenue and EBIT, FY 2000-2008

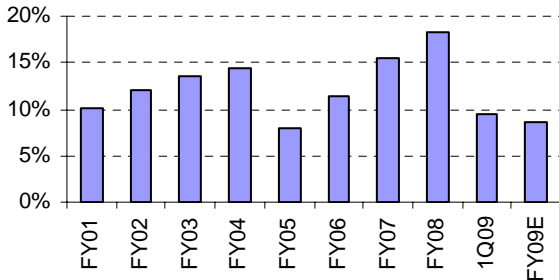
Microsoft has posted steady revenue growth even as operating income has experienced some volatility, particularly in the years following the bursting of the Internet bubble.



Source: Company, *The Manual of Ideas*.

MSFT – Y-Y Revenue Growth, FY 2001-2009E

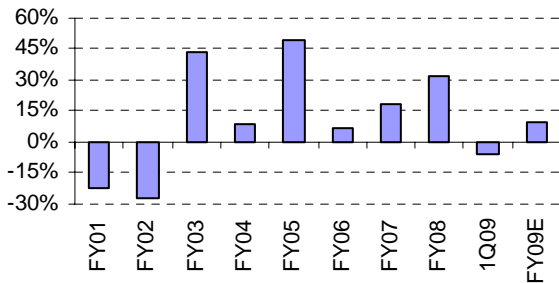
The company has posted steady though unspectacular growth this decade, helped by emerging businesses such as Xbox and MSN. Management is guiding for 7-10% revenue growth in FY09.



Source: Company, *The Manual of Ideas*.

MSFT – Y-Y EPS Growth, FY 2001-2009E

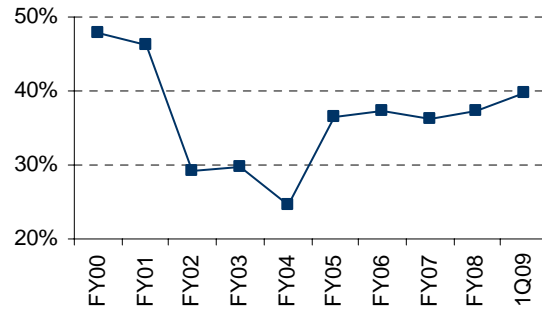
EPS growth has been volatile this decade, driven by major new product releases and investments in emerging businesses. While EPS declined 6% y-y in 1Q09, management is guiding for full-year fiscal 2009 EPS growth of 7-12%. The company has quite a bit of latitude in influencing FY09 EPS due to the large size and accretive nature of the share repurchase plan announced in September.



Source: Company, *The Manual of Ideas*.

MSFT – EBIT Margin, FY 2000-Q1 2009

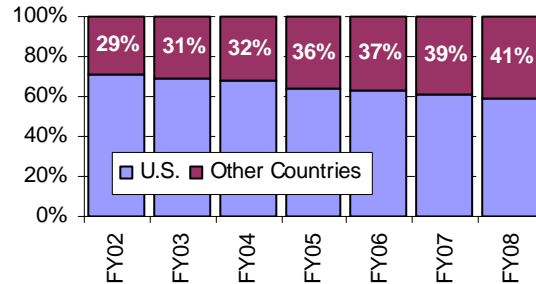
After fluctuating significantly during and after the Internet bubble, Microsoft's operating margins have stabilized in the 35-40% range in recent years. Competitive and economic pressures are exerting downward pressure on margins, while margin expansion in the Xbox and MSN businesses could lead to overall margin expansion.



Source: Company, *The Manual of Ideas*.

MSFT – Revenue by Geography, FY 2002-2008

International revenue has grown steadily, both in absolute terms and as a percentage of overall revenue. International revenue grew from \$8 billion in FY02 to \$24 billion in FY08, a 20% CAGR.



Source: Company, *The Manual of Ideas*.

SEGMENT #1: CLIENT

(29% of FY08 revenue, 77% EBIT margin)

- **Comprises Windows OS**, including Vista, XP, Media Center, and Tablet PC Edition. The segment leads the ongoing development of Windows and manages relationships with PC makers.
- **Key revenue driver is worldwide PC shipments**, with OEMs accounting for 80% of revenue.
- **Competitors include Unix and Apple's operating system**. Linux is available for free under a general public license, with variants sold by HP, IBM and Sun. Apple has gained share, particularly in the U.S. consumer segment where it has benefited from the enormous success of the iPod and iPhone.
- **Released Windows Vista in FY07**, with advances in security, digital media, and user interfaces.

SEGMENT #2: SERVER AND TOOLS

(22% of FY08 revenue, 35% EBIT margin)

- **Includes Windows Server operating system**, Microsoft SQL Server, Microsoft Enterprise Services, Visual Studio, System Center products, Forefront security products, and Biz Talk Server.
- **Revenue from multi-year licensing deals (45% of revenue)**, fully packaged product and transactional volume licensing programs (25%), OEM licenses (10%), and services (20%).
- **Competitors in server operating systems include** (1) vertically integrated computer makers such as HP, IBM, Sun, which sell versions of Unix along with hardware; (2) companies such as Novell and Red Hat, which provide versions of Linux; and (3) server virtualization providers such as VMware.
- **Competitors in enterprise-wide computing include** (1) companies that provide J2EE-compliant solutions, including IBM and Sun; (2) server application providers such as CA, IBM and Oracle; (3) open source software, including Linux, Apache, MySQL, and PHP; and (4) Java middleware, including JBoss, Geronimo and Spring Framework.
- **Other competitors include** (1) System Center competitors HP, BMC, CA, and IBM; (2) Forefront competitors McAfee, Symantec and Trend Micro; (3) Adobe, BEA, Borland, IBM, Oracle, Sun, and the Eclipse open source project, which compete against Microsoft products for software developers.
- **Released new versions of Windows Server and Visual Studio in FY08; plans to release new version of SQL Server in FY09**. Windows Server includes virtualization technologies that compete with VMware's software offerings.

SEGMENT #3: ONLINE SERVICES BUSINESS

(5% of FY08 revenue, -38% EBIT margin)

- **Consists of MSN online portals, Live Search**, an online advertising platform for web publishers and advertisers, Hotmail email, instant messaging, and AvenueA Razorfish media agency services.

- **Revenue primarily from online ads** and secondarily from subscriptions and transactions related to paid services, as well as ancillary services.
- **Competitors include AOL, Google and Yahoo**, whose Internet search and media properties connect users and advertisers. Google leads in online ad revenue related to search and syndication.
- **Launched new releases of Windows Live and adCenter in FY08**. It also acquired aQuantive, a next-generation advertiser and publisher solution.

SEGMENT #4: BUSINESS

(32% of FY08 revenue, 65% EBIT margin)

- **Includes Microsoft Office, Project, Visio, SharePoint Server, Exchange Server, Live Meeting, Tellme, and other business software**.
- **90%+ of revenue from Office system offerings**, with growth driven by new Office features and new offerings in areas such as content management, collaboration, and unified communications.
- **80% of revenue from businesses, 20% from consumers**. Businesses buy Office through volume licensing, with revenue driven by the number of workers using Office (not highly correlated with PC shipments). Consumers buy products through OEMs in connection with new PC shipments.
- **Competitors to Office system products include** Apple, Corel (WordPerfect), Google (Apps), IBM (Smartsuite, Notes, Workplace), Novell, Oracle, Red Hat, and Sun. OpenOffice.org provides a free cross-platform application. Web-based offerings such as AjaxWrite, gOffice, iNetOffice, SimDesk, ThinkFree, and wikiCalc also compete with Office. However, the alternatives generally lack rich functionality and are marketed with low-priced PCs.
- **Competitors to business management products (Microsoft Dynamics) include** Intuit and Sage in the SMB market, and Oracle and SAP in the enterprise market. These competitors have much greater market share and stronger product offerings than do competitors in the Office market segments.

SEGMENT #5: ENTERTAINMENT AND DEVICES

(12% of FY08 revenue, 5% EBIT margin)

- **Includes Xbox 360 console and games, Zune, Mediaroom, mice and keyboards, Windows Mobile software, and Windows Embedded device OS**.
- **Competitors to Xbox video game consoles include** Sony's PlayStation and Nintendo's Wii. Zune competes with Apple's iPod. Windows Mobile software Apple, Nokia, Openwave, Palm, Qualcomm, RIM, and Symbian.
- **Released Xbox 360 in 2005**, while Nintendo and Sony released new versions of their consoles in 2006. The console life cycle averages 5-7 years.

Net 1 Ueps Technologies (Nasdaq: UEPS)

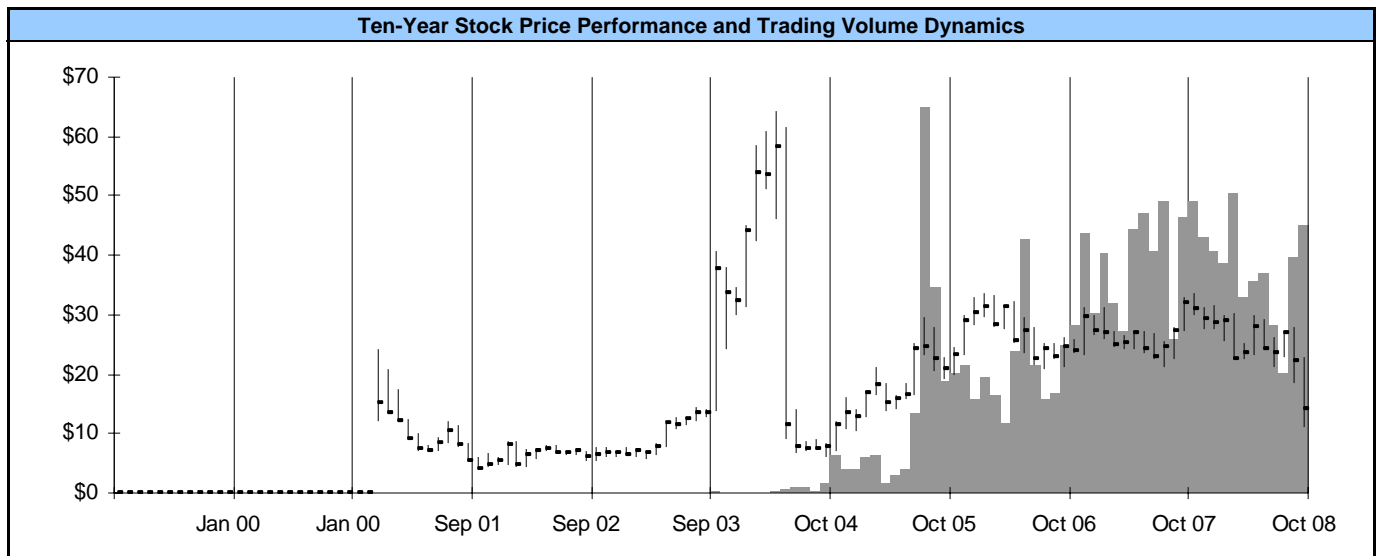
Technology: Computer Services

Johannesburg, South Africa, 27-11-343-2000

<http://www.net1ueps.co.za>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$10.97 (as of 11/14/08)		Month	# of		P/E FYE 6/30/08	7.3x
52-week range: \$9.88 - \$33.28		<u>Latest</u>	<u>Ago</u>	<u>Ests</u>	P/E FYE 6/30/09	5.8x
Market value: \$641 million	This quarter	\$0.45	\$0.52	3	P/E FYE 6/30/10	5.1x
Enterprise value: \$509 million	Next quarter	0.46	0.52	3	P/E FYE 6/30/11	4.8x
Shares out: 58.4 million	FYE 6/30/09	1.90	2.01	4	EV / LTM revenue	1.9x
	FYE 6/30/10	2.14	2.31	4	EV / LTM EBITDA	4.1x
	FYE 6/30/11	2.29	2.84	2	EV / LTM EBIT	4.6x
	LT EPS growth	18.0%	18.0%	1	P / tangible book	4.2x
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 16%	<u>Date</u>	<u>Actual</u>	<u>Estimate</u>		LTM EBIT yield	22%
Insider buys (last six months): 0	11/6/08	\$0.42	\$0.49		LTM pre-tax ROC	>100%
Insider sales (last six months): 2						
Institutional ownership: 67%						
# of institutional owners: 321						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	6/30/02	6/30/03	6/30/04	6/30/05	6/30/06	6/30/07	6/30/08	9/30/08	9/30/07	9/30/08
Revenue	52	75	131	176	196	224	254	262	60	68
Gross profit	38	49	92	126	146	170	187	190	45	49
EBIT	13	19	36	71	90	97	110	112	26	27
Net income	9	13	13	45	59	64	87	95	18	26
Diluted EPS	0.27	0.37	0.38	0.80	1.03	1.11	1.50	1.65	0.31	0.45
Cash from ops	12	18	42	38	76	66	119	46	40	(33)
Capex	2	7	3	3	2	4	4	6	1	3
Free cash flow	10	11	39	35	74	62	115	39	40	(36)
Cash & investments	n/a	54	80	108	190	172	273	246	216	246
Total current assets	n/a	79	117	151	241	248	346	370	289	370
Intangible assets	n/a	12	26	23	20	118	99	207	118	207
Total assets	n/a	98	153	182	270	376	454	588	417	588
Short-term debt	n/a	0	0	0	0	0	0	110	0	110
Total current liabilities	n/a	20	48	34	43	55	77	185	69	185
Long-term debt	n/a	0	0	0	0	4	4	5	4	5
Total liabilities	n/a	28	57	45	61	95	114	231	112	231
Preferred stock	n/a	0	0	0	0	0	0	0	0	0
Common equity	n/a	71	96	137	209	281	340	358	305	358
EBIT/capital employed	n/a	>100%	>100%	>100%	>100%	>100%	>100%	>100%	n/m	n/m



BUSINESS OVERVIEW

Net 1 provides a proprietary universal electronic payment system (UEPS) to the underbanked in developing economies. It operates in four segments, primarily in South Africa:

The transaction-based activities segment earns fee income from a state welfare distribution service in South Africa, and transaction processing for retailers, utilities and banks.

The smart card accounts segment derives revenue from a fixed monthly fee for the provision of smart card accounts.

The financial services segment provides short-term loans on a principal basis and life insurance on an agency basis. It generates interest income and initiation and services fees.

The hardware, software and technology segment derives revenue from sales of hardware, SIM cards, cryptography, SIM card licenses, and hardware rentals to merchants.

SELECTED OPERATING DATA

FYE June 30	2006	2007	2008	1Q09
<i>% of revenue by segment:</i>				
Transaction processing	60%	62%	60%	59%
Smart card accounts	18%	15%	14%	13%
Financial services	8%	5%	3%	3%
Technology sales	14%	17%	22%	25%
<i>Revenue growth by segment:</i>				
Transaction processing	13%	19%	10%	6%
Smart card accounts	4%	-5%	4%	-6%
Financial services	-20%	-30%	-27%	-18%
Technology sales	52%	47%	44%	60%
Total revenue growth	11%	14%	13%	13%
<i>EBIT margin by segment:</i>				
Transaction processing	52%	57%	55%	54%
Smart card accounts	45%	45%	45%	45%
Financial services	43%	30%	23%	18%
Technology sales	63%	16%	21%	24%
Corporate	-6%	-3%	-2%	-4%
Total EBIT margin	46%	43%	43%	40%
Total net income margin ¹	30%	28%	34%	39%

¹ Includes foreign exchange gains and losses and other transitory items.

INVESTMENT HIGHLIGHTS

- **UEPS could enable four billion people with limited bank access to transact electronically.** Four million out of 18 million unbanked South Africans receive welfare on Net 1 smart cards.
- **UEPS uses smart cards that operate in real-time but offline,** unlike prevalent systems that require immediate network access. UEPS users can transact in remote areas when a portable smart card reader is available. UEPS can also be used for banking, health care, money transfers, voting, and ID.
- **CEO Serge Belamant (54) and CFO Herman Kotze (38)** have been with the company or predecessors since 1989 and 2000, respectively.

- **Selected by Central Bank of Ghana as country’s common electronic payment platform.** Net 1 also provides a customized banking and payment system to a government-affiliated consortium in Iraq.
- **Expanding into Namibia and Botswana through JVs that operate smart card-based systems; and into Colombia and Vietnam** to operate virtual top-up solutions for mobile prepaid airtime vending.
- **BGS acquisition accelerates entry into Russia.** Net 1 acquired 80% of BGS for €72 million and 40K shares in August. BGS’ largest customer and 20%-owner is Sberbank, the largest bank in Russia.
- **Authorized \$50 million buyback** two weeks ago.
- **Guiding for 15% adjusted EPS growth in FY09.**
- **Stock price implies 6% trailing FCF yield, 6x trailing P/E and 5x forward P/E.**

INVESTMENT RISKS & CONCERNS

- **Two-thirds of revenue affected by South African tender.** The South African Social Security Agency recently conducted a tender for the distribution of welfare grants. Net 1 filed proposals in May 2007. In November 2008, SASSA terminated the tender process without any awards. As a result, Net 1 retained contracts with five provincial governments through March 31, 2009 – and probably beyond. However, the long-term outcome remains unclear.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
DFS	4,545	-4,076	-1.6x	0.8x	6x	8x
GPN	2,948	2,871	2.1x	37.5x	15x	14x
MA	18,569	15,833	3.3x	16.1x	16x	14x
TSS	2,393	2,348	1.2x	4.9x	9x	9x
V	45,825	42,105	6.7x	38.8x	20x	17x
UEPS	641	509	1.9x	4.2x	6x	5x

MAJOR HOLDERS

CEO Belamant 4% | Other insiders 1% | Brait S.A. 16% | General Atlantic 11%

RATINGS

VALUE Intrinsic value materially higher than market value?	☆☆☆☆☆
MANAGEMENT Capable and properly incentivized?	☆☆☆☆
FINANCIAL STRENGTH Solid balance sheet?	☆☆☆☆☆
MOAT Able to sustain high returns on invested capital?	☆☆☆
EARNINGS MOMENTUM Fundamentals improving?	☆☆☆☆
MACRO Poised to benefit from economic and secular trends?	☆☆☆
EXPLOSIVENESS 5%+ probability of 5x upside in one year?	☆☆☆☆

THE BOTTOM LINE

Net 1 has developed an electronic payment solution for the underbanked in developing countries. The company’s system addresses the needs of four billion people, an enormous addressable market. While Net 1 faces the long-term risk of losing government-related revenue in South Africa (two-thirds of revenue), a competitive bidding process was terminated in early November, with Net 1 retaining all contracts on existing terms. Revenue and earnings continue to grow despite global macro weakness. We value the company at \$20-30 per share, based on a range of 10x trailing EBIT to 15x forward EPS.

...additional insight into UEPS:

WHAT ARE THE SHARES WORTH?

- **We value Net 1 at \$20-30 per share**, based on the valuation analysis summarized below. We believe a mid teens multiple of after-tax income is justified in the case of Net 1 due to the recurring revenue nature of the company's business, high returns on capital and continued growth in revenue and profits.

Net 1 UEPS — Valuation Summary

(\$ in millions, except per share data)

Value of excess marketable assets:¹

	Low Value	High Value
Cash and equivalents	\$246	\$246
Short-term loan facility	(\$110)	(\$110)
Net cash and equivalents	\$136	\$136
Cash needed to run business ²	(\$100)	(\$50)
Total	\$36	\$86

Value of core business:

LTM EBIT	\$112	
Fair value multiple of LTM EBIT	10x	
Estimated NTM EPS ex. interest income		\$1.90
Fair value multiple of NTM adjusted EPS		15x
Total	\$1,118	\$1,682

Estimated fair value of UEPS per share	\$1,154	\$1,767
	\$20	\$30

¹ Based on balance sheet values as of September 30, 2008.

² Represents MOI estimate.

Source: Company filings, *The Manual of Ideas* estimates and analysis.

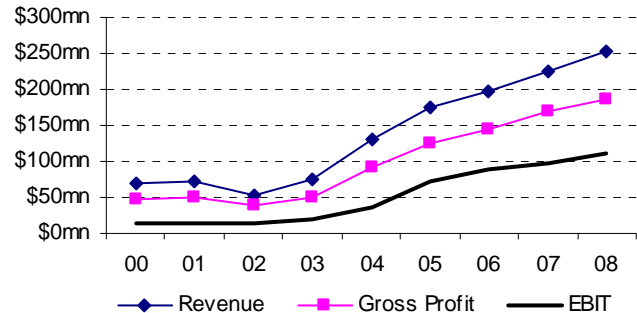
WHY THE SHARES MAY BE MISPRICED

- **Stigma against financial services-related companies targeting low-income consumers.** At first glance, Net 1 appears to be exposed to a highly undesirable consumer demographic in South Africa and other countries. However, Net 1's main clients are South African governmental entities, and the company is not exposed to the credit risk of consumers using Net 1-processed payment cards. Net 1 is not a lender but a pure-play payment processor with an attractive recurring revenue model. We believe the market may be missing this important feature of the company's model.
- **Undue fear of potential loss of South African contracts.** We believe much of the uncertainty related to the company's contracts for the distribution of welfare grants was lifted on November 6 when the company announced that the government has decided to terminate the related competitive tender process. The market may not yet have appropriately digested this positive news.

REVENUE AND MARGIN ANALYSIS

UEPS – Revenue, Gross Profit and EBIT, FY 2000-08

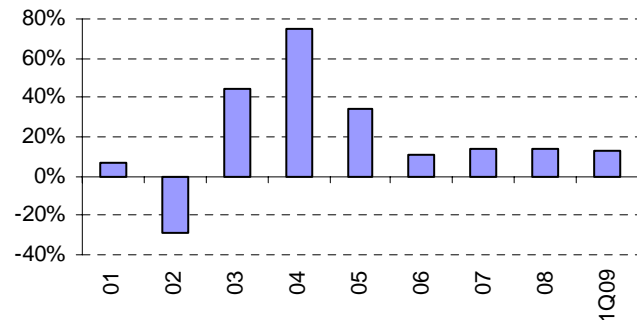
Net 1 has performed well over the past six years, as its proprietary payment system has enjoyed greater acceptance in South Africa and, more recently, in Ghana and Iraq. Net 1 derived two-thirds of revenue from contracts with South African provincial governments in 2007.



Source: Company, *The Manual of Ideas*.

UEPS – Y-Y Revenue Growth, FY 2001-1Q09

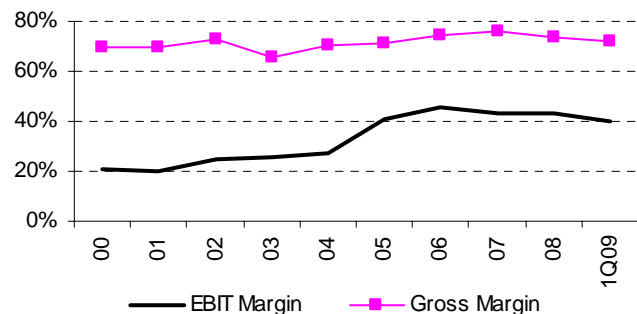
Net 1 has reported revenue growth in the low to mid teens since FY06, as its relationships with South African provincial governments have matured while transaction volumes have continued to increase. The company's recent expansion beyond South Africa, including the acquisition of BGS in Russia in August 2008, may accelerate growth.



Source: Company, *The Manual of Ideas*.

UEPS – Gross and EBIT Margin, FY 2000-1Q09

Net 1 has enjoyed strong gross and operating margins throughout this decade. EBIT margin has surpassed 40% in recent years, a level that will be difficult to maintain over a long period of time. However, any margin erosion appears likely to occur slowly and to be more than offset by increases in revenue.



Source: Company, *The Manual of Ideas*.

UPDATE ON SOUTH AFRICAN CONTRACTS FOR DISTRIBUTION OF WELFARE GRANTS (two-thirds of revenue)

- **Contracted with five provincial governments covering total of four million beneficiaries.** In 1998, Net 1 acquired four of the contracts, which were originally awarded from 1992-97. Net 1 was awarded an additional contract in 2002. It implemented smart cards from 2000-04 and rolled out merchant acquiring capability in 2004-05.
- **45% share of distribution of welfare grants in South Africa.** Main competitors are the South African Post Office and the formal banking sector.
- **South African tender concluded without new awards in November 2008.** The South African Social Security Agency (SASSA) recently conducted a competitive tender that could have displaced Net 1 from one or more of its five contracts. However, Net 1 announced on November 3 that SASSA had decided to make no awards, to terminate the procurement process, and to defer a decision about commencing a fresh tender process.
- **All five contracts expire in March 2009.** Net 1 stated the following in a press release on November 6: “We believe that SASSA’s statement to defer a decision about commencing a fresh tender process will necessitate a further extension of our current contracts. The terms and conditions of our current service level agreements will probably remain unchanged during any extension period.”

MANAGEMENT’S VIEW OF BUSINESS

Notes from 1Q09 earnings release dated November 6:

- **Operating environment:** Net 1 performing well despite “disruptions in the financial markets and concerns about a weakening global economy;” “do not share the prevailing negative global sentiment towards emerging markets as our technology is focused on these territories and remains in demand, especially when the weaknesses of traditional banking systems have become patently clear”
- **1Q09 review:** “very pleased” with results
- **FY09 guidance:** maintain 15% fundamental EPS growth outlook on constant currency basis; GAAP EPS growth to “exceed 25% on a constant currency basis as a result of the change in tax rates and the foreign exchange gains on a short-term investment”
- **Strategy:** “...focused on the globalization of our technology by following a disciplined approach to new markets, through careful evaluation of new opportunities. Where we believe it makes sense, we will use partnerships or make acquisitions to accelerate our entry into new markets.
- **South Africa tender cancellation:** “SASSA may decide to extend our current contracts on a short term renewal basis. We have the capacity to operate this business without compromising our high service levels regardless of the period, or frequency, of any extension periods granted.”

- **South Africa welfare payment business:** “anticipate beneficiary growth of approximately 6% per annum” (growth is “fairly lumpy”)
- **BGS:** “core business consists of developing and integrating smart card-based offline and online financial transaction systems;” “customers in Russia, Ukraine, Uzbekistan, India and Oman;” “emphasis on significantly expanding the application of our technology in the Russian Federation and the CIS Republics”
- **Wage payment system in partnership with Grindrod Bank:** “target markets for the wage payment system are the un-banked and under-banked wage earners in South Africa, estimated at five million people;” in 1Q09, signed deal with largest security and guarding services provider in South Africa, with 20,000 employees (expects to complete enrollment of all employees 3Q09-end)
- **Ghana:** continued delivery of POS devices and smart cards under Bank of Ghana deal in 1Q09
- **Iraq:** first transaction in August; project is pilot with 100K beneficiaries (40K issued payment cards so far); to earn “ongoing transaction and license fees, as well as payments for the provision of outsourcing services and the sale of hardware”
- **VTU technology and business model:** VTU (virtual top up) technology “enables prepaid cell users to purchase additional airtime simply, securely and conveniently through the distribution of airtime value from a vendor’s cellular handset to that of the customer;” “derive revenue from the sale of VTU licenses to mobile operators and we have recently established VTU businesses in Colombia and Vietnam, where we are minority shareholders”
- **Sales process:** sales cycles are “unpredictable and often stretch over a period of years. It is therefore particularly difficult to provide clear short term visibility on our international prospects and the specific product, application or business model that will ultimately be implemented in a specific country...;” sales and marketing teams focus on specific regions of Africa, the Middle East and Central and Eastern Europe; “plan to introduce dedicated teams for South America and Asia...”
- **New patents:** “application... will allow any mobile phone user to effect payments that are generally referred to as “card not present” payments completely securely, through the utilization of a once off, disposable, virtual credit or debit card”
- **Proposed abolishment of secondary taxation on companies in South Africa:** secondary taxation may be phased out in 2010; “expect the proposed replacement of STC with a dividend tax to reduce our current fully distributed rate of 34.55% to 28%. Under US GAAP, we apply the fully distributed tax rate of 34.55% to our deferred taxation assets and liabilities; not yet determined if Net 1 would qualify for treaty relief available to foreign shareholders

Premier Exhibitions (Nasdaq: PRXI)

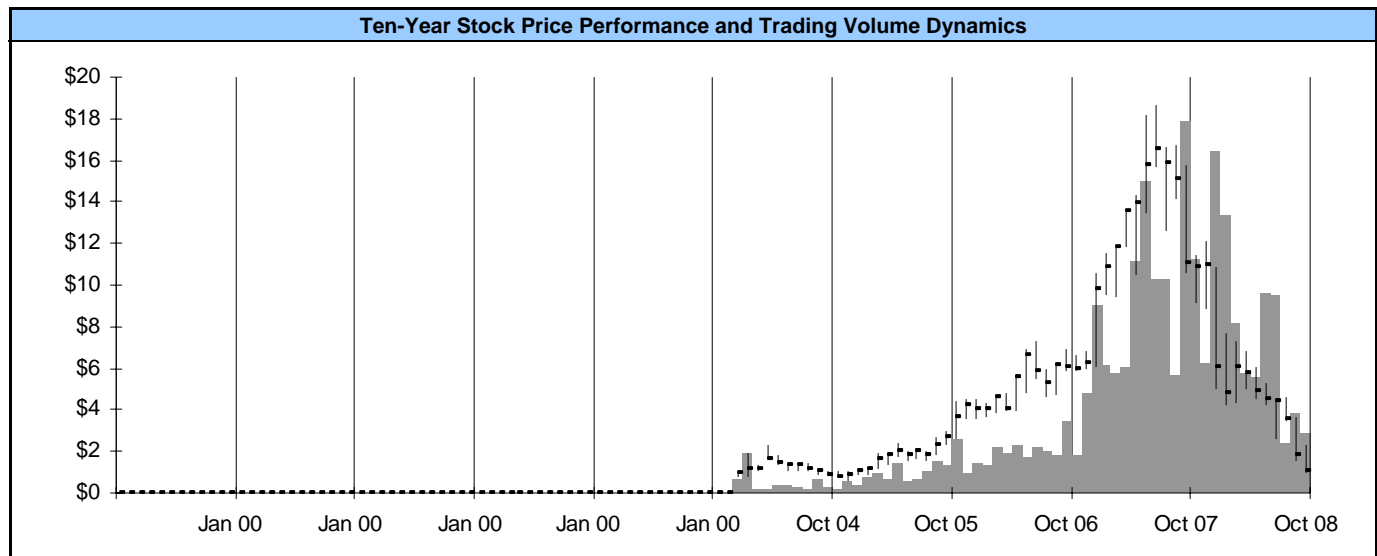
Atlanta, GA, 404-842-2600

Services: Recreational Activities

<http://www.prxi.com>

Trading Data	Consensus EPS Estimates			Valuation		
Price: \$0.78 (as of 11/14/08)		Month	# of	P/E FYE 2/29/08	2.1x	
52-week range: \$0.74 - \$12.08		<u>Latest</u>	<u>Ago</u>	<u>Ests</u>		
Market value: \$23 million	This quarter	\$0.03	\$0.03	4	P/E FYE 2/28/09	19.5x
Enterprise value: \$14 million	Next quarter	0.01	0.01	4	P/E FYE 2/28/10	4.3x
Shares out: 29.2 million	FYE 2/28/09	0.04	0.04	4	P/E FYE 2/28/11	n/a
Ownership Data	FYE 2/28/10	0.18	0.18	3	EV / LTM revenue	0.2x
Insider ownership: 13%	FYE 2/28/11	n/a	n/a	0	EV / LTM EBITDA	1.6x
Insider buys (last six months): 4	LT EPS growth	17.5%	17.5%	2	EV / LTM EBIT	3.0x
Insider sales (last six months): 0	Latest Quarterly EPS Surprise			Greenblatt Criteria		
Insider sales (last six months): 0	<u>Date</u>	<u>Actual</u>	<u>Estimate</u>	LTM EBIT yield	34%	
Institutional ownership: 34%	10/7/08	\$0.03	\$0.01	LTM pre-tax ROC	29%	
# of institutional owners: 82						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	2/28/02	2/28/03	2/29/04	2/28/05	2/28/06	2/28/07	2/29/08	8/31/08	8/31/07	8/31/08
Revenue	3	3	3	7	13	30	62	64	16	15
Gross profit	3	3	3	4	10	22	41	35	12	7
EBIT	(7)	(1)	(1)	(2)	3	12	18	5	8	1
Net income	(7)	(1)	(1)	(2)	5	7	12	4	6	1
Diluted EPS	(0.40)	(0.04)	(0.06)	(0.12)	0.19	0.24	0.37	0.10	0.17	0.03
Cash from ops	(0)	3	(1)	(0)	2	12	17	7	5	(1)
Capex	0	1	0	1	2	2	5	11	2	5
Free cash flow	(0)	2	(1)	(1)	0	9	12	(4)	3	(6)
Cash & investments	0	2	1	1	5	17	18	9	26	9
Total current assets	4	3	1	4	10	25	28	24	37	24
Intangible assets	0	0	0	1	4	3	10	12	5	12
Total assets	9	8	7	10	22	35	51	53	50	53
Short-term debt	0	0	0	0	1	0	0	0	0	0
Total current liabilities	2	2	1	3	3	2	4	6	5	6
Long-term debt	0	0	0	0	0	0	0	0	0	0
Total liabilities	2	2	1	3	3	2	4	6	5	6
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	7	7	6	7	20	33	47	46	46	46
EBIT/capital employed	-277%	-79%	-440%	-444%	83%	>100%	>100%	29%	n/m	n/m



BUSINESS OVERVIEW

Premier develops touring, museum-quality exhibitions presented in museums, exhibition centers, and other venues. The exhibitions, including *Bodies...The Exhibition* and *Titanic: The Artifact Exhibition*, have attracted 20 million visitors. Since 1994, Premier subsidiary RMS Titanic has been Salvor-in-Possession of the wreck of the Titanic, as ordered by a federal district court. RMS has conducted multiple expeditions, recovering 5,500 artifacts.

Revenue sources include exhibition ticket sales, merchandise sales, licensing activities, and sponsorship agreements.

SELECTED OPERATING DATA

FYE February 28	2006	2007	2008	1H09
<i>% of revenue by theme:</i>				
Bodies	37%	72%	81%	67%
Titanic	63%	28%	19%	<33% ¹
<i>% of revenue by type:</i>				
Exhibition	94%	96%	96%	85%
Merchandise and other	6%	4%	4%	15%
<i>% of revenue by geography:</i>				
U.S.	80%	96%	79%	n/a
International	20%	4%	21%	n/a

¹ Titanic accounted for the vast majority of non-Bodies revenue in 1H09.

INVESTMENT HIGHLIGHTS

- **Bodies attended by more than five million visitors since FY05**, including in New York, Las Vegas, San Diego, Prague, and Sao Paulo. In FY08, Premier presented 15 separate human anatomy exhibitions at 28 venues. The exhibitions include displays of dissected human bodies kept from decaying through a process known as plastination. The 2005 acquisition of Exhibitions International gave Premier multi-year licenses and exhibition rights to multiple human anatomy exhibitions.
- **Exclusive right to recover objects from the Titanic due to Salvor-in-Possession status.** Public interest in the Titanic story remains strong 96 years after she set sail, and Premier’s Titanic exhibitions have attracted audiences in 60+ venues worldwide. In 1993, Premier acquired Titanic Ventures, which started exploring the Titanic wreck site in 1987.
- **New exhibitions include *Dialog in the Dark* (“world without sight”) and *Sports Immortals* (memorabilia).** The exhibitions will be conducted under long-term licensing deals and are expected to open in late FY09. *Sports Immortals* will present sports memorabilia consisting of one million artifacts from great athletes. *Dialog in the Dark* will “provide insight and experience to the paradox of learning to ‘see’ without the use of sight.”

- **16% holder Mark Sellers demands firing of CEO Arnie Geller** due largely to poor performance.
- **Repurchased \$7 million of stock in FY08.**
- **Stock price implies negative trailing FCF yield, 8x trailing P/E and 4x forward P/E.**

INVESTMENT RISKS & CONCERNS

- **Performing “well below” expectations**, with sharp declines in per-venue gross margin, sharp rise in opex and weak international results from *Bodies*.
- **Resignations of CEO Eskowitz and legal counsel Wainger in August.** Arnie Geller (66), who served as CEO prior to Eskowitz, was reappointed CEO. The changes followed a demand for two Board seats by 16% shareholder Mark Sellers. (Premier appointed a new CFO, Bud Ingalls, in February.)
- **May not retain Titanic Salvor-in-Possession rights indefinitely.** While the U.S. Court of Appeals for the Fourth Circuit in 2006 recognized Premier’s exclusive right to recover objects from the Titanic site, the same court left Premier with *non-exclusive* rights to photograph and film the wreck site. In order for Premier to maintain Salvor-in-Possession status, it “must maintain a presence over the wreck site as interpreted by the courts.” In addition, an international treaty that does not recognize Premier’s Salvor-in-Possession rights was signed by the U.K. in 2003 and the U.S. in 2004. The treaty has yet to take effect, however, as the U.S. has not enacted implementing legislation.
- **Bodies comprised 81% of revenue in FY08.** The exhibitions have several competitors. In addition, in May, Premier settled an NYAG inquiry into the sourcing of specimens, allowing the company to operate the exhibition without interruption.

MAJOR HOLDERS

CEO Geller 10% | Other insiders 3% | Mark Sellers 16% | GSAM 8% | W. & J. Gasparrini 8% | Morgan Stanley 7%

RATINGS

VALUE Intrinsic value materially higher than market value?	☆☆☆☆☆
MANAGEMENT Capable and properly incentivized?	☆
FINANCIAL STRENGTH Solid balance sheet?	☆☆☆☆
MOAT Able to sustain high returns on invested capital?	☆☆☆☆
EARNINGS MOMENTUM Fundamentals improving?	☆☆
MACRO Poised to benefit from economic and secular trends?	☆☆☆
EXPLOSIVENESS 5%+ probability of 5x upside in one year?	☆☆☆☆☆

THE BOTTOM LINE

Premier’s revenue has exploded in recent years due to the success of the Bodies exhibitions. The company has misstepped recently, allowing the cost structure to get out of hand. However, with involvement by 16% holder Mark Sellers, Premier should be able to improve execution. While the company may not remain salvor-in-possession of the Titanic wreck site in the long term, it owns 2,000 recovered artifacts, appraised at \$46 million but on the books for only \$3 million. We value Premier at \$1.50-7.50 per share, reflecting earnings uncertainty. At the low end, we ascribe zero value to the company’s ongoing business, zero value to the company’s net cash position of \$9 million, and \$46 million of value to the Titanic assets.

...additional insight into PRXI:

“Our existing exhibitions continue to attract strong attendance and our new exhibitions have the potential to achieve blockbuster results in the coming years. We are keenly focused on improving our core businesses, streamlining our overhead cost structure and increasing shareholder value.”

—Arnie Geller, Chairman and CEO

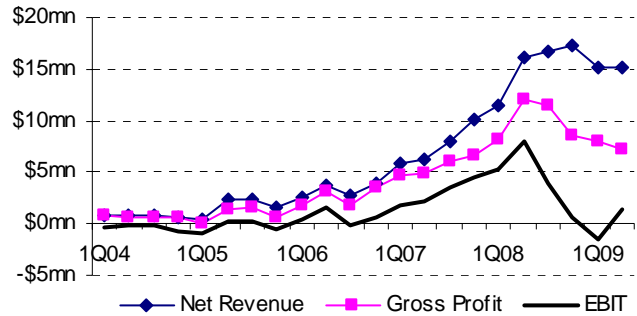
WHAT ARE THE SHARES WORTH?

- **We estimate value at \$1.50-7.50 per share.**
- **On the low end,** we ascribe zero value to the company’s ongoing business, zero value to the company’s net cash position of \$9 million, and \$46 million of value to the Titanic assets (equal to appraised value of 2,000 artifacts owned by Premier; includes neither >\$100 million appraised value of additional artifacts nor the value of potential future recoveries).
- **On the high end,** we estimate fair value at 15x normalized earning power of \$0.50 per share. While our estimate of earning power is highly subjective, we believe it is reasonably conservative considering the significant unrealized potential of the company’s new exhibitions, including Dialog, Sports Immortals and Star Trek. We note that the company achieved EPS of \$0.17 in 2Q08 (quarter ended August 31, 2007) before earnings declined sharply due to poor execution. 2Q08 results were achieved based solely on the Bodies and Titanic exhibitions. With other exhibitions in the pipeline, it is conceivable the company could surpass \$0.17 per quarter in the next 1-3 years (assuming strong management execution). As a result, our estimate of normalized EPS may ultimately prove conservative.
- **Premier shares are difficult to value** given the significant disparity between current earnings and likely earning power. With earnings highly sensitive not only to opex discipline but also to the ramp-up and execution of new exhibitions, it is impossible to project income with any certainty. However, with activist shareholder involvement and asset protection in the form of Titanic artifacts, the downside appears to be reasonably protected. As a result, we find the shares less speculative than might be assumed given the difficulty of projecting EPS.

REVENUE AND MARGIN ANALYSIS

Premier – Revenue, Gross Profit and EBIT, 1Q04-2Q09

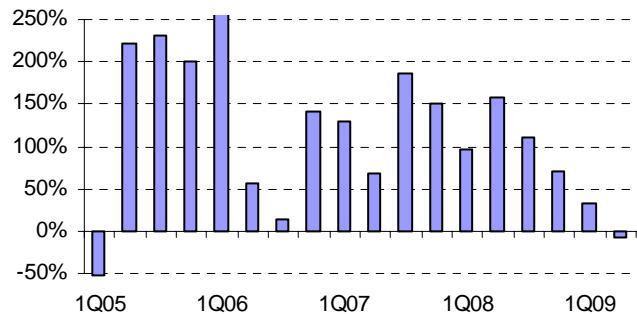
Premier scaled up dramatically from “startup mode” in FY04, as the Titanic and Bodies exhibitions came to market. The company lost its cost discipline in 2H08, with gross and operating profits declining dramatically even as revenue remained fairly stable. In a November 2008 letter to the board, major shareholder Mark Sellers decried the bloated cost structure and large payouts to executives.



Source: Company, *The Manual of Ideas*.

Premier – Y-Y Revenue Growth, 1Q05-2Q09

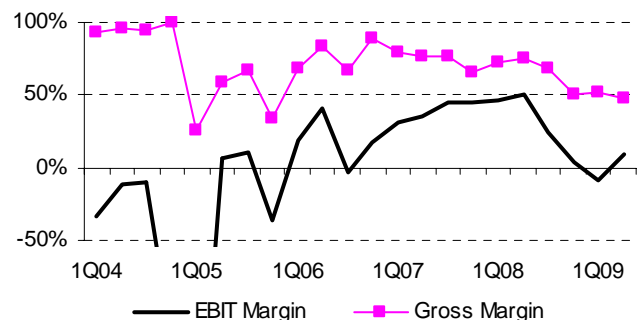
Premier showed explosive revenue growth without the need for significant capital investment from FY05-08. Revenue has stagnated recently, as some exhibitions have concluded while new ones have yet to ramp up. However, with Dialog, Sports Immortals and Star Trek in the pipeline — and the possibility of improved international execution of Bodies — Premier has a clear path to restoring growth.



Source: Company, *The Manual of Ideas*.

Premier – Gross and EBIT margin, 1Q04-2Q09

Gross margins have declined in recent quarters, as the company has shifted to operating more self-run venues (six in FQ2 versus three in the year-ago period). Even so, gross margin has declined below the company’s target for well north of 50%. EBIT margins have deteriorated even more dramatically in recent quarters, reflecting a bloated cost structure, including extremely generous executive pay.



Source: Company, *The Manual of Ideas*.

WHY THE SHARES MAY BE MISPRICED

- **Value of Titanic assets not reflected on balance sheet.** The company’s ownership of 2,000 Titanic artifacts is reflected in a \$3 million balance sheet asset even as the collection has been appraised at \$46 million. In addition, the company has not reflected any value for additional artifacts that are the subject of litigation (appraised at >\$100 million), nor for the potential value of future recoveries from the Titanic shipwreck site. As we approach the 100-year anniversary of the sinking of the Titanic in 2012, these assets may become even more highly prized.
- **Loss of investor confidence,** due to history of disappointing investor expectations and lavishing excessive pay on senior executives. Investors appear to have “written off” Premier, as the company has repeatedly ratcheted down expectations and failed to execute in line with its potential.
- **Market’s misjudgment of Mark Sellers’ intentions and staying power.** Sellers owns 16% of Premier and has come into the spotlight due to a *Wall Street Journal* article highlighting his hedge fund’s recent rocky performance (despite solid performance since inception). Some market participants may have mistakenly assumed that Sellers may be forced to exit his 16% position in Premier. However, Sellers appears not to be at risk of near-term redemptions and appears likely to see this investment through to an acceptable conclusion. We view Sellers as a capable, committed holder who is likely to serve as a positive catalyst.

EXHIBITIONS OVERVIEW

Exhibition	Timeline	Comments
Titanic (6 current exhibitions)	Named salvor-in-possession in 1994	2,000 artifacts carried at \$3 million but appraised at \$46 million; seeking salvage award on 3,500 additional artifacts, appraised at >\$100 million; additional value in potential future recoveries
Bodies (11 current exhibitions)	Signed deal for first exhibition in 2004	Accounted for 81% of revenue in FY08
Star Trek (1 current exhibition)	Opened in June in San Diego; looking for second venue	Exclusive rights to present exhibition worldwide; no capital investment required with 50/50 split of profits
Dialog in the Dark (1 current exhibition)	Announced in February; opened August 30 in Atlanta; second location under review	Sold out events in >20 countries in Europe, Asia, South America
Sports Immortals	Signed long-term licensing deal in March 2008; goal is to open at least one new exhibition by the end of FY09	>1 million artifacts from worlds of baseball, football, basketball, hockey, tennis, golf, Olympics

Source: Company, *The Manual of Ideas*.

MANAGEMENT’S VIEW OF BUSINESS

Notes from FQ2 earnings call on October 8:

- **State of company:** “these are very troubled times, but if any company should know about navigating in treacherous waters, it should be this company, and I can assure you that we’ve got a firm hand on the rudder and we’re proceeding very carefully”
- **FQ2 review:** 6% revenue decline on 15% attendance drop for Bodies and Titanic (despite increase in Bodies exhibitions from 11 to 19; “venue days of operation” were up 48%); average daily attendance per venue was down 40% to 704 attendees; several international exhibitions lost money; “while we are disappointed with our financial results for Q2 and the YTD results, we are pleased by the progress we are achieving and have achieved over the past several months toward both expansion and diversification of the company’s revenue and the right sizing of the company’s organizational structure”
- **Outlook:** does not provide specific guidance; FY09 “will be year of transition, but hopefully continued growth;” “suspect that we will see... the Bodies exhibitions begin to do well, and as our new product proves its capabilities, we’ll see our revenues and our profits move where they should be”
- **Pricing:** “may” lower ticket prices
- **Key initiatives:** (1) stringent cost controls – will see unspecified benefit of headcount reductions in FQ3 and beyond; (2) Star Trek exhibition: licensing relationship, opened on June 21, “off to a promising start;” (3) Dialog in the Dark: opened at end of August, “attendance has been slow to ramp up,” remains “very optimistic about the opportunity”
- **Bodies:** 62% of revenue in FQ2, down from 68% last year; “Bodies is certainly our biggest disappointment... over this past immediate period” – “reason for the disappointment for the most part is the international activity,” where it works with local partners; “Bodies exhibitions... are as important and as successful in their appeal to the general public throughout the world now as they were when we first introduced them, and two excellent examples of that are two exhibitions that just recently closed, one in Kansas City where our Bodies exhibition achieved attendance of approximately 250,000 people, and at the same time, Cincinnati was doing an excellent job at Union Station where we sold over 300,000 tickets;” opportunity to develop “large” market for corporate training programs
- **Titanic:** continue to do “well;” opening exhibition in Milwaukee – Titanic has never been to Milwaukee but company expects several hundred thousand in ticket sales due to popularity of venue; 100-year anniversary coming up in 2012, with opportunities in exhibitions, expeditions and merchandising from 2011 through 2013
- **Legal issue with regard to ownership of Titanic:** “we have the unfettered right to... ownership [of 1,800 objects]”; Norfolk federal district court “is now dealing with us on a salvage award for the other two-thirds of 5,500 objects that have not been awarded yet;” “the court will either have to award us money or the artifacts” (“no matter what happens or how that award is ultimately determined, it will not effect the 1,800 objects that we all ready own”)
- **Star Trek:** “sales team has been communicating with museums who have reacted very positively to wanting a Star Trek exhibition” – “over a dozen have expressed high interest” in U.S.
- **Dialog in the Dark:** “receiving the best reactions;” “will be around for many years in [five] permanent locations” in major U.S. markets; to benefit strongly from “word of mouth;” attendance could reach “7.5” on a scale on which Bodies reaches “10” – potential less than Bodies due to less efficient space utilization (Bodies can handle up to 20,000 people per day in a space that would handle only 2,000 people per day for Dialog, as latter requires people to move through sequentially in groups of ten)
- **Sports Immortals:** still being developed; “holding back from moving into the Luxor [in Las Vegas]... until we prove that we have [a] hit;” could eventually generate as much traffic as Bodies
- **Geller on CEO role:** “I didn’t come back to the company just to spend a couple of months and try to patch this company together; I’ve come back with the major commitment of being here and staying here;” “bringing this company back today to where it was is not a daunting task; it’s not a difficult task; all of our product is excellent product”
- **Self-run venues:** FY08 shift to operating more self-run venues (six in FQ2 versus three a year ago) impacts cost of sales and gross margin – self-run venues require more revenue than do partnered venues to break even; targeting margins of 50%+
- **Balance sheet:** cash down to \$9.2 million due to EBIT decline, MGR purchase and initiation of capital projects, including Luxor, Dialog and Sports
- **Capex:** \$3.5 million in FQ2 (versus \$700K a year ago) – \$1.8 million at Luxor, \$900K at Dialog in the Dark, and \$400K at Sports and Mortals; expects higher capex in 2H09 – \$10 million at Luxor, \$2-4 million at Dialog, \$2-4 million at Sports and Mortals, and \$1-2 million of maintenance capex
- **Liquidity:** \$10 million line of credit with Bank of America was fully available at FQ2-end, with option to increase to \$25 million (BofA must consent); may draw on line toward the end of FQ4 to meet growth capex requirements outlined above
- **Business model comment:** “investment costs for new exhibitions are all based upon trial and success before rollout; so when we open up a second, third or fourth exhibition, that’s because we know that we’ve already proven its ability for success”

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“We like stocks that generate high returns on invested capital where there is a strong likelihood that they will continue to do so. For example, the last time we bought Coca-Cola, it was selling at about 23 times earnings. Using our purchase price and today’s earnings, that makes it about 5 times earnings. It’s really the interaction of capital employed, the return on that capital, and future capital generated versus the purchase price today.”

—Warren Buffett

“All the world is a laboratory to the inquiring mind.”

—Martin Fischer

“The search for truth is more precious than its possession.”

—Albert Einstein

“It’s what you learn after you know it all that counts.”

—Harry Truman

“Man’s mind, once stretched by a new idea, never regains its original dimensions.”

—Oliver Wendell Holmes

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Syneron Medical (Nasdaq: ELOS)

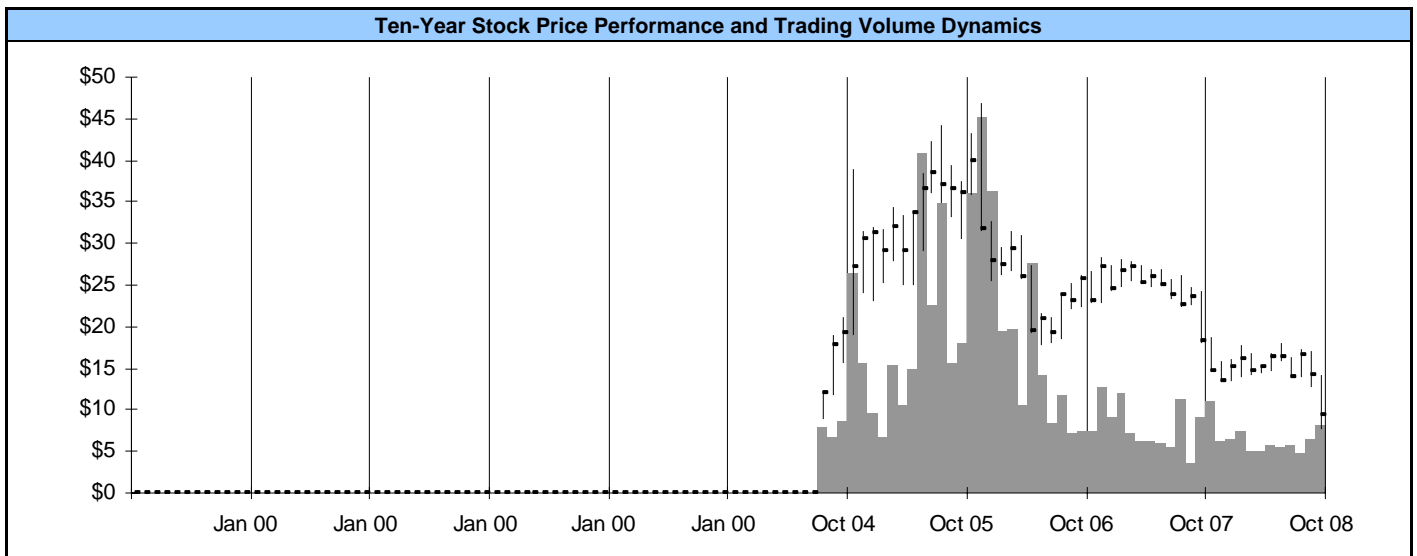
Health Care: Medical Equipment & Supplies

Yokneam Illit, Israel, 972-4-909-6200

<http://www.syneron.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$7.74 (as of 11/14/08)		Month	# of		P/E FYE 12/31/07	6.9x
52-week range: \$7.71 - \$18.04					P/E FYE 12/31/08	8.7x
Market value: \$215 million					P/E FYE 12/31/09	10.8x
Enterprise value: \$95 million					P/E FYE 12/31/10	6.1x
Shares out: 27.7 million					EV / LTM revenue	0.7x
					EV / LTM EBITDA	n/a
					EV / LTM EBIT	3.9x
					P / tangible book	0.9x
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 10%					LTM EBIT yield	26%
Insider buys (last six months): 0					LTM pre-tax ROC	70%
Insider sales (last six months): 0						
Institutional ownership: 65%						
# of institutional owners: 126						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	9/30/08	9/30/07	9/30/08
Revenue	1	12	35	58	87	117	141	139	33	29
Gross profit	0	10	31	51	76	99	114	108	26	22
EBIT	(1)	2	8	26	39	35	25	24	6	2
Net income	(1)	2	9	27	41	40	31	26	8	2
Diluted EPS	(0.24)	0.10	0.42	1.14	1.48	1.44	1.12	0.94	0.28	0.08
Cash from ops	(1)	2	14	23	31	37	48	43	7	0
Capex	0	0	0	1	1	1	2	2	1	0
Free cash flow	(1)	2	14	22	30	36	46	41	7	(0)
Cash & investments	n/a	4	18	94	133	103	168	120	135	120
Total current assets	n/a	8	25	107	166	153	222	179	196	179
Intangible assets	n/a	0	0	0	0	1	5	5	0	5
Total assets	n/a	9	27	110	170	225	269	290	266	290
Short-term debt	n/a	0	0	0	0	0	0	0	0	0
Total current liabilities	n/a	3	10	12	21	26	33	30	27	30
Long-term debt	n/a	0	0	0	0	0	0	0	0	0
Total liabilities	n/a	4	14	15	25	31	39	36	33	36
Preferred stock	n/a	0	0	0	0	0	0	0	0	0
Common equity	n/a	5	13	94	145	194	231	254	233	254
EBIT/capital employed	n/a	>100%	n/m	n/m	>100%	>100%	98%	70%	n/m	n/m



BUSINESS OVERVIEW

Syneron provides aesthetic medical products based on proprietary Electro-Optical Synergy (Elos) technology, which uses electrical and optical energy. The products are sold to physicians and target non-invasive procedures, including hair removal, wrinkle reduction, treatment of superficial vascular and pigmented lesions, and treatment of leg veins. Syneron has an installed base of 10,000 products.

SELECTED OPERATING DATA

FYE December 31	2005	2006	2007	YTD 9/30/08
<i>% of revenue by geography:²</i>				
North America	62%	57%	57%	52%
Other	38%	43%	43%	48%
<i>Revenue growth by geography:</i>				
North America	67%	22%	21%	-7%
Europe	30%	53%	20%	4%
Total revenue growth	51%	34%	21%	-2%
<i>% of revenue by type:</i>				
Product	93%	94%	91%	n/a
Service ¹	7%	6%	9%	n/a

¹ Service revenue should increase over time as the installed base grows.

² In 2007, 57% of revenue came from North America, 23% from Europe, 16% from Asia Pacific, and 4% from Israel and other countries.

INVESTMENT HIGHLIGHTS

- **20% global share in aesthetic medical products**, a market with favorable long-term trends. Syneron focuses on the growth segments of aesthetic medicine of body shaping and skin rejuvenation.
- **Innovative Elos technology.** Approaches that rely solely on optical energy limit the safety and efficacy of many procedures due to limited skin penetration and unwanted epidermal absorption. Elos makes it easier to target the tissue to be treated, and boosts safety through tracking of skin temperature.
- **Positive acceptance of minimally invasive LipoLite laser-assisted lipolysis product**, which was launched in February. Syneron delivered the first units in Q2, with volume shipments in Q3.
- **Adding recurring revenue stream to equipment sales business model.** The LipoLite Energy Access Program (LEAP) charges physicians a subscription fee for laser-assisted lipolysis treatment, foregoing up-front revenue for a more attractive stream over time. The company has also introduced a disposable element to Matrix RF (FDA approval pending).
- **Doron Gerstel (48) and Fabian Tenenbaum (34) became CEO and CFO, respectively, in 2007.** Gerstel was previously president of Syneron N.A. and Operations VP at Lumenis (formerly ESC Medical, founded by Syneron chairman Eckhouse).
- **\$219 million of net cash** and liquid investments.

- **Signed development and supply deal with P&G in early 2007**, with goal of commercializing home-use devices and topical compositions for better skin appearance. P&G will buy the devices exclusively from Syneron and sell them on a co-branded basis.
- **Repurchased 590,000 shares for \$9.1 million** under \$50 program authorized in November 2007.
- **Stock price implies 19% trailing FCF yield**, 8x trailing P/E and 11x forward P/E.

INVESTMENT RISKS & CONCERNS

- **Slowdown:** “Doctors are postponing decisions to make new capital equipment purchases and credit terms have tightened significantly.”
- **Gross margin in high 70s, roughly 20 points above industry average, may not be sustained.** Competitors include public companies Candela, Cutera, Cynosure, Thermage, and Palomar Medical, and private companies Lumenis Sciton, Reliant Technologies, UltraShape, and Alma Lasers.
- **Subject to FDA regulation.** Before a new Syneron device can be marketed in the U.S., it generally must receive 510(k) clearance, which usually lasts 3-12 months. Syneron must also comply with the FDA’s Quality System Regulation, which covers various aspects of bringing products to market.
- **CEO Gerstel, CFO Tenenbaum own <1% of Syneron**, while chairman Eckhouse owns 9%.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
CLZR	9	-18	n/m	0.1x	n/m	n/m
CUTR	111	13	.1x	1.0x	n/m	44x
CYNO	107	35	.2x	0.8x	5x	5x
PMTI	186	58	.6x	1.3x	102x	28x
THRM	50	4	.1x	0.9x	n/m	14x
ELOS	215	-4	n/m	0.9x	9x	11x

MAJOR HOLDERS

Chairman Eckhouse 9% | CEO, CFO and other insiders <1% | Baupost 11% | Brandywine 6% | RenTech 5%

RATINGS

- VALUE** Intrinsic value materially higher than market value? ☆☆☆☆☆
- MANAGEMENT** Capable and properly incentivized? ☆☆☆
- FINANCIAL STRENGTH** Solid balance sheet? ☆☆☆☆☆
- MOAT** Able to sustain high returns on invested capital? ☆☆☆
- EARNINGS MOMENTUM** Fundamentals improving? ☆☆☆
- MACRO** Poised to benefit from economic and secular trends? ☆☆☆☆☆
- EXPLOSIVENESS** 5%+ probability of 5x upside in one year? ☆☆☆

THE BOTTOM LINE

Syneron offers innovative products in the growing global market for aesthetic medical procedures. Investors appear to be ignoring the company’s earning power and emerging growth prospects, including new recurring revenue opportunities related to the LipoLite Energy Access Program and a potentially meaningful partnership with P&G. We value Syneron at \$14-18 per share, based on a sum-of-the-parts analysis that considers the company’s \$219 million in net cash and investments and values the aesthetic products business based on a range of 8x trailing EBIT to 8x estimated normalized EBIT.

...additional insight into ELOS:

WHAT ARE THE SHARES WORTH?

- **We value Syneron at \$14-18 per share**, based on the sum-of-the-parts analysis presented below.
- **Upside may come from share repurchases and higher earning power than estimated.** Earnings upside could come from the LipoLite Energy Access Program and the partnership with P&G.
- **Downside appears protected due to \$8 per share in net cash and liquid investments.** While markets can be irrational, a profitable, high-ROIC business should not trade at a negative enterprise value.

Syneron — Sum-of-the-Parts Valuation Overview

(\$ in millions, except per share data)

Value of excess liquid assets:¹

	Low Value	High Value
Cash and equivalents	\$21	\$21
Short-term marketable securities	99	99
Long-term marketable securities	98	98
Net cash and investments	\$219	\$219
Cash needed to run business ²	(20)	(10)
Total	\$199	\$209

Value of aesthetic products business:

LTM EBIT	24	
Fair value multiple of LTM pre-tax income	8x	
Estimate of normalized EBIT		35
Fair value multiple of normalized EBIT		8x
Total	\$194	\$280

Estimated fair value of ELOS per share	\$393	\$489
	\$14	\$18

¹ Based on balance sheet values as of September 30, 2008.

² Represents MOI estimate.

Source: Company filings, *The Manual of Ideas* estimates and analysis.

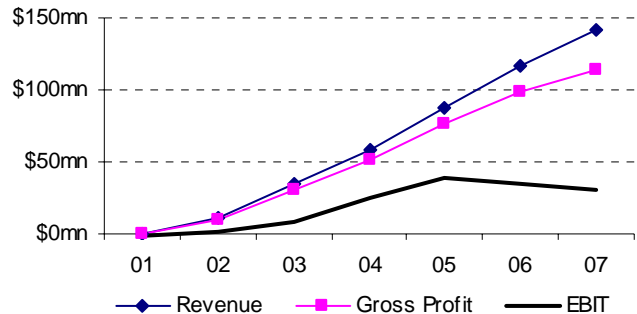
WHY THE SHARES MAY BE MISPRICED

- **Near-term business momentum has been negative**, giving investors little to get excited about. While most investors may agree that Syneron is undervalued at a market value roughly equal to net cash and investments, few investors consider a strong balance sheet sufficient reason to invest. Syneron shares may remain undervalued until the company gives investors reason to like the business again. Catalyst could include adoption of the LipoLite Energy Access Program or positive news related to the partnership with P&G.
- **Low-conviction selling?** Some value funds may have followed highly respected Baupost Group into Syneron without developing a level of conviction that would help them stick with the company through a period of weak fundamentals.
- **Adopted “poison pill” on November 11**, a move that both signals the Board’s concern about a potential hostile takeover bid and antagonizes shareholders who may want the company to operate under threat of a takeover, thereby putting more pressure on the incumbent Board to perform.

REVENUE AND MARGIN ANALYSIS

ELOS – Revenue, Gross Profit and EBIT, 2001-07

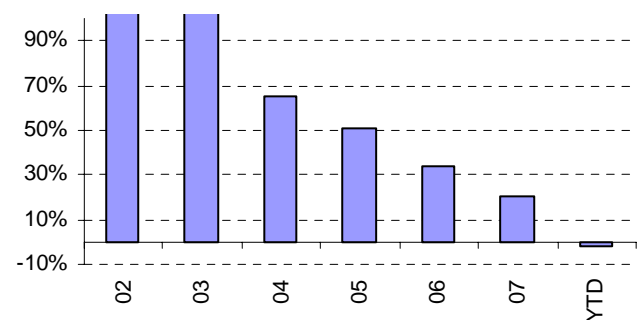
Syneron posted explosive growth until recently, with revenue increasing from virtually zero in 2001 to more than \$140 million in 2007, driven by rapid adoption of proprietary Elos aesthetic medical products. The company showed strong operating leverage in the first half of the decade, but EBIT has eroded since 2006.



Source: Company, *The Manual of Ideas*.

ELOS – Y-Y Revenue Growth, 2002-YTD’08

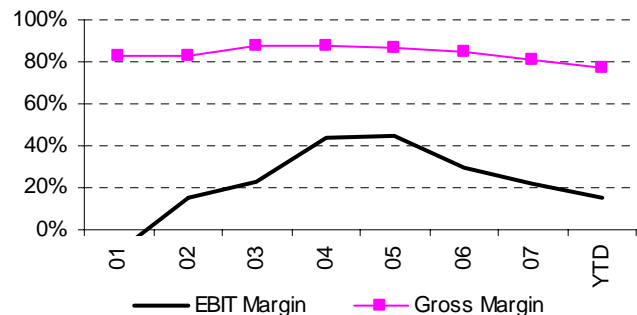
The company grew revenue more than twenty-fold in 2002 and doubled it again in 2003. While growth has steadily decelerated over the past six years, it remained quite strong until recently. YTD revenue has declined 2%, with Q3 revenue down 14% due to doctors increasingly postponing capital equipment purchases.



Source: Company, *The Manual of Ideas*.

ELOS – Gross and EBIT Margin, 2001-YTD’08

The value of Syneron’s proprietary technology is evident in the high gross margins the company has posted since ramping up sales in 2001. While gross margin declined to 77% YTD and 75% in Q3, it remains at a level that allows the company to maintain bottom-line profitability despite a sharp slowdown in sales.



Source: Company, *The Manual of Ideas*.

MANAGEMENT’S VIEW OF BUSINESS

Notes from Q3 earnings call dated November 11:

- **Operating environment:** “facing major macroeconomic and industry challenges;” lower consumer confidence has negatively affected doctors’ decisions to purchase capital equipment; credit tightening has made financing for equipment “more difficult;” industry consolidation is “more relevant” than in the past (will “definitely” happen in 2009) – some competitors have “real challenges, and it has to do with the amount of cash they have;” most weakness in U.S. and Western Europe
- **Q3 review:** revenue down 14%; diversified globally, with 53% of revenue from North America and 47% from various international markets; 75% gross margin; “overall stable ASP;” 7% GAAP and 10% non-GAAP EBIT margin, respectively
- **Outlook:** “cautious... until we see a clear sign of recovery;” sees “slight decrease in ASP;” expects Western European weakness to be partially offset by other international markets
- **Cost reduction:** taking steps to reduce cost structure, “recognizing potentially protracted nature of slowdown”: downsizing office in Canada (to result in 11% reduction in North American headcount, mostly in back office and support functions); “rationalizing” overhead in Europe – expects \$5 million of savings in 2009; will evaluate additional cost reduction opportunities
- **Business model-related comments:** *cost side:* utilizes flexible OEM production model that reduces capital outlay and overhead; *sales side:* “exploring ways to introduce a new business model” to enable doctors to access Syneron devices at “relatively low initial cost while still generating good levels of profitability for Syneron”
- **LEAP:** Syneron had previously introduced LipoLite Energy Access Program (LEAP) subscription program; doctors obtain LipoLite for \$30K instead of >\$100K – when initial energy allocation is depleted, doctors buy additional energy packets from Syneron; other new products also have recurring revenue components; “overall feedback we’re getting, mainly from existing customers... [has been] very positive;” “very pleased” with effort
- **R&D:** plans to use financial resources to continue investing in R&D (“essential for bringing products to market more quickly”); goal is to advance product pipeline in body shaping and facial applications

- **Inlight acquisition (announced November 4):** small U.S.-based laser technology company; innovative design will provide “cutting-edge clinical results at significantly lower cost than existing fractional laser technology;” Syneron made “relatively small [undisclosed] investment” – provides Syneron complementary technology that will allow company to launch new product platform with “minimal” lead time, i.e., in 1Q09, and generate incremental source of revenue
- **Procter & Gamble partnership:** “going according to plan;” “feel very strongly about the relationship and how it is moving forward”
- **Other activities:** pursuing joint ventures, including in China and South America

Tempur-Pedic International (NYSE: TPX)

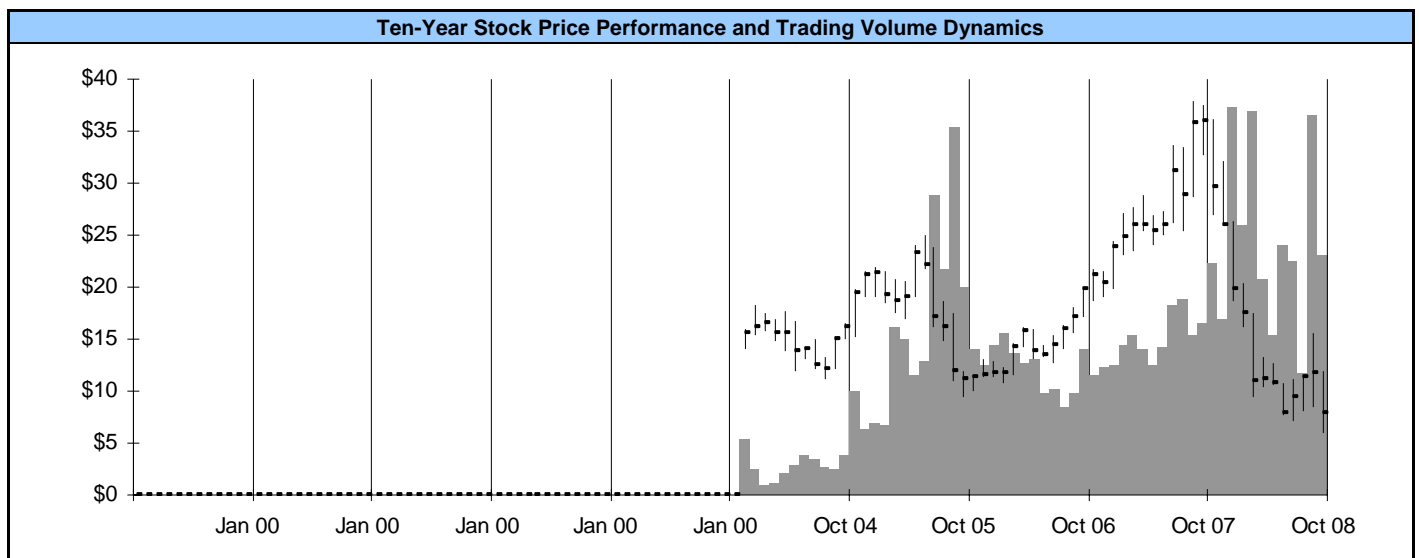
Consumer Cyclical: Furniture & Fixtures

Lexington, KY, 800-878-8889

<http://www.tempurpedic.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$6.72 (as of 11/14/08)		Month	# of		P/E FYE 12/31/07	3.9x
52-week range: \$6.04 - \$33.08					P/E FYE 12/31/08	7.2x
Market value: \$503 million					P/E FYE 12/31/09	7.6x
Enterprise value: \$934 million					P/E FYE 12/31/10	6.5x
Shares out: 74.8 million					EV / LTM revenue	0.9x
					EV / LTM EBITDA	n/a
					EV / LTM EBIT	5.3x
					P / tangible book	n/m
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 9%					LTM EBIT yield	19%
Insider buys (last six months): 0					LTM pre-tax ROC	59%
Insider sales (last six months): 0						
Institutional ownership: n/a						
# of institutional owners: n/a						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	9/30/08	9/30/07	9/30/08
Revenue	222	298	479	685	837	945	1,107	1,028	294	253
Gross profit	114	150	255	361	424	461	535	461	142	106
EBIT	30	40	83	146	186	199	244	176	68	43
Net income	12	17	38	75	99	112	142	98	39	24
Diluted EPS	1.52	2.14	0.39	0.73	0.97	1.28	1.74	1.29	0.49	0.32
Cash from ops	20	35	47	77	102	166	126	165	56	73
Capex	35	11	33	39	87	38	17	17	4	2
Free cash flow	(16)	24	14	38	15	128	109	149	52	71
Cash & investments	8	13	14	28	18	16	33	88	24	88
Total current assets	73	101	145	214	228	238	327	320	294	320
Intangible assets	19	250	289	277	274	269	267	267	268	267
Total assets	177	449	620	640	702	726	806	782	774	782
Short-term debt	11	14	11	9	31	20	0	0	0	0
Total current liabilities	51	70	91	99	121	132	127	146	155	146
Long-term debt	95	182	366	281	314	342	602	519	556	519
Total liabilities	148	297	498	426	476	512	758	698	746	698
Preferred stock	12	148	0	0	0	0	0	0	0	0
Common equity	17	3	123	214	226	213	48	84	28	84
EBIT/capital employed	29%	35%	58%	73%	68%	62%	70%	59%	n/m	n/m



BUSINESS OVERVIEW

Tempur-Pedic provides premium branded mattresses and pillows in two segments: *Domestic* consists of two U.S. factories and a distribution subsidiary. *International* consists of a factory in Denmark and distribution subs.

SELECTED OPERATING DATA

FYE December 31	2005	2006	2007	YTD 9/30/08
<i>% of revenue by geography:</i>				
Domestic	64%	66%	66%	63%
International	36%	34%	34%	37%
<i>Revenue growth by geography:</i>				
Domestic	25%	16%	17%	-15%
International	18%	8%	18%	2%
Total revenue growth	22%	13%	17%	-10%
<i>EBIT margin by geography:</i>				
Domestic	18%	19%	19%	9%
International	32%	29%	29%	23%
Total EBIT margin	23%	22%	22%	15%
<i>Revenue growth by channel:^{1,2}</i>				
Retail	31%	19%	21%	-8%
Direct	4%	-17%	-7%	-38%
Healthcare	-2%	-2%	12%	3%
Third party	-1%	12%	3%	2%
<i>Revenue growth by product:³</i>				
Mattresses	31%	15%	18%	-11%
Pillows	-9%	0%	12%	-9%
Other	27%	16%	18%	-3%
U.S. door count ⁴	n/a	6,050	6,350	6,800
International door count ⁵	n/a	4,450	4,990	5,100

¹ Products are sold through four distribution channels in each geographic segment: retail (furniture, specialty, and department stores), direct (direct response and Internet), healthcare (chiropractors, medical retailers, hospitals), and third-party distributors in countries with no owned subsidiaries.

² In 2007, the company derived 83% of revenue from the retail channel, 7% from direct, 5% from healthcare, and 5% from third-party distribution.

³ In 2007, the company derived 69% of revenue from mattresses, 13% from pillows, and 18% from other products (foundations, adjustable beds, etc.).

⁴ The company plans to increase door count to 7,000-8,000 "over time"; the total available market is estimated at 10,000 stores.

⁵ The company has identified 7,000 international stores as appropriate targets.

INVESTMENT HIGHLIGHTS

- **\$13 billion global mattress market**, with 22 million mattress unit sold in the U.S., and a similar number of mattresses sold outside the U.S., in 2007.¹ In addition, domestic pillow sales were \$1.1 billion, with roughly equivalent international sales.
- **Leader in growing specialty mattress category**, which comprises non-innerspring mattresses, including foam mattresses, airbeds, and waterbeds.
- **Comfort and health advantages over standard bedding products.** The company uses temperature-sensitive material that has a high density and conforms to the body to reduce neck and back pain. The company holds 70 U.S. and foreign patents.

¹ Source: Tempur-Pedic, International Sleep Products Association (ISPA).

- **Thomas Bryant (60) became CEO in 2006** after five years with Tempur-Pedic. He was previously CEO of Stairmaster. Other senior executives joined the company in the past two to five years.
- **Commencing "most extensive new product launch" in company history**, with new and upgraded products slated for launch globally.
- **Stock price implies 30% trailing FCF yield**, 5x trailing P/E and 8x forward P/E.

INVESTMENT RISKS & CONCERNS

- **Guiding for revenue and EPS decline of 14-16% and 43-48%, respectively, in 2008**, with estimated revenue of \$930-950 million and EPS of \$0.90-1.00, reflecting "the most challenging... environment in memory." Management reduced guidance when it reported Q3 results in October. Retail partners have reported store traffic "down sharply" in 2008, average selling prices have trended lower, and trends have weakened in several European markets.
- **Net debt of \$431 million at Q3-end.** The company has eliminated dividends and is reducing expenses and working capital. The goal is to "operate without risk of breaching our credit facility covenants even if the market continues to deteriorate."
- **Inflationary cost environment.** The company has experienced margin compression due in part to the rising cost of chemicals and proprietary additives.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
ETH	438	561	.6x	1.6x	12x	9x
ZZ	212	961	.6x	n/m	5x	5x
SCSS	23	77	.1x	1.5x	n/m	n/m
TPX	503	934	.9x	n/m	7x	8x

MAJOR HOLDERS

CEO Bryant 1% | Other insiders 2% | Invesco 25% | Amvescap 15% | TA Associates 7% | State Street 6% | Friedman Fleischer 6% | Munder 5%

RATINGS

VALUE Intrinsic value materially higher than market value?	☆☆☆☆☆
MANAGEMENT Capable and properly incentivized?	☆☆☆☆
FINANCIAL STRENGTH Solid balance sheet?	☆☆
MOAT Able to sustain high returns on invested capital?	☆☆☆☆☆
EARNINGS MOMENTUM Fundamentals improving?	☆☆
MACRO Poised to benefit from economic and secular trends?	☆☆
EXPLOSIVENESS 5%+ probability of 5x upside in one year?	☆☆☆☆☆

THE BOTTOM LINE

Tempur-Pedic is a wide-moat business with strong brand equity, pricing power, industry-leading cost structure, high returns on capital, and favorable long-term growth prospects. We believe investors underestimate the variability of the company's cost structure and the company's ability to service its debt in a difficult market environment. The discretionary nature of Tempur-Pedic's high-ticket products makes the stock an easily conceptualized short. The high short interest could, however, result in explosive stock price upside once the market refocuses on the company's significant normalized earnings power. We value Tempur-Pedic at \$11-18 per share, based on 7x trailing EBIT and 12x estimated normalized EPS.

...additional insight into TPX:

WHAT ARE THE SHARES WORTH?

- **We value Tempur-Pedic at \$11-18 per share**, based on the valuation analysis summarized below.
- **Our estimate is supported by an analysis of free cash flow.** FCF per share should exceed EPS by up to \$0.25 due to D&A significantly exceeding capex. FCF may be ~\$1.15 per share in 2009, implying an FCF yield of 6-11% based on our valuation range.

Tempur-Pedic — Valuation Summary

(\$ in millions, except per share data)

	Low Value	High Value
Negative value of net debt:¹		
Cash and equivalents	\$88	\$88
Long-term debt	(519)	(519)
Total	(\$431)	(\$431)
Value of core business:		
LTM EBIT	\$176	
Fair value multiple of LTM EBIT	7x	
Estimated normalized EPS power		\$2.00
Fair value multiple of EPS power		12x
Total	\$1,234	\$1,800

Estimated fair value of TPX per share	\$802	\$1,369
	\$11	\$18

¹ Based on balance sheet values as of September 27, 2008.
² Represents MOI estimate.
 Source: Company filings, *The Manual of Ideas* estimates and analysis.

WHY THE SHARES MAY BE MISPRICED

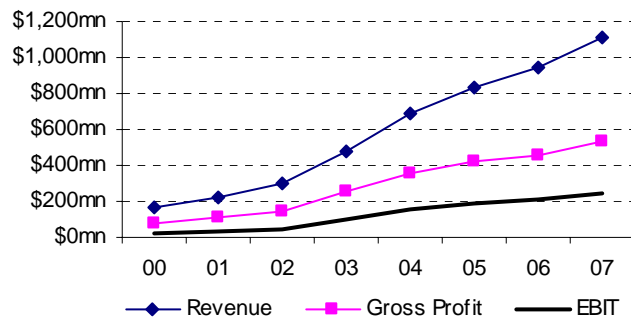
- **Fundamental underappreciation of company's superior operating model.** Tempur-Pedic is the lowest-cost producer in the mattress industry, with efficient production, low inventory requirements, and low overall capital intensity. This, coupled with strong brand recognition and preference by higher-end consumers, should enable the company to sustain superior returns on capital.
- **Large short interest; sellers may underestimate company's ability to remain profitable.** Tempur-Pedic fits the typical target profile of many short sellers: the company sells big-ticket consumer items dependent on discretionary spending. With pricing squeezed both on the input and output sides, management lowering guidance, and net debt of \$431 million, momentum appears to be favoring the short sellers' thesis. 19 million of 75 million outstanding shares were sold short as of October 28 (stock was until recently on NYSE list of Reg SHO threshold securities). The short sellers' aggressive stance against Tempur-Pedic has not only depressed the shares, but also opened the door to a massive short squeeze if/when their thesis is proven wrong.

- **Debt covenant worries.** Investors may be overly concerned about the potential for Tempur-Pedic to bust debt-related covenants. The company took on debt to recapitalize the balance sheet, spending more than \$500 million on share repurchases from 2005-07. Tempur-Pedic reduced debt by \$38 million in Q3 and is repatriating cash from overseas. The company must maintain a ratio of funded debt to trailing EBITDA of not more than 3x. The ratio stood at 2.45x at the end of Q3. Trailing EBITDA and funded debt are likely to decline going forward. With debt expected to be cut materially in the near term, the company appears highly likely to stay within the boundary of 3x debt to EBITDA.

REVENUE AND MARGIN ANALYSIS

TPX – Revenue, Gross Profit and EBIT, 2000-07

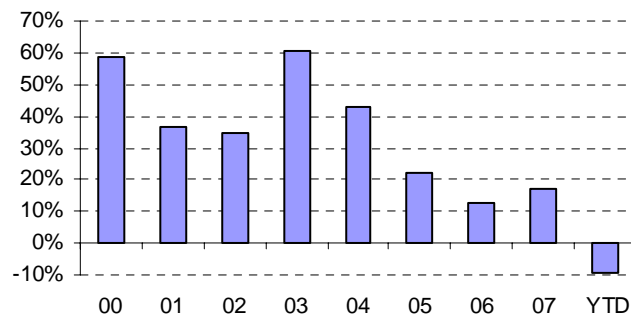
Tempur-Pedic posted strong growth through 2007, benefiting from a virtuous cycle of a differentiated product, high-return marketing expenditures, increasing brand recognition, market share gains, high-margin revenue, low working capital and capex requirements, and increasing cash flow available for sales and marketing.



Source: Company, *The Manual of Ideas*.

TPX – Y-Y Revenue Growth, 2000-YTD'08

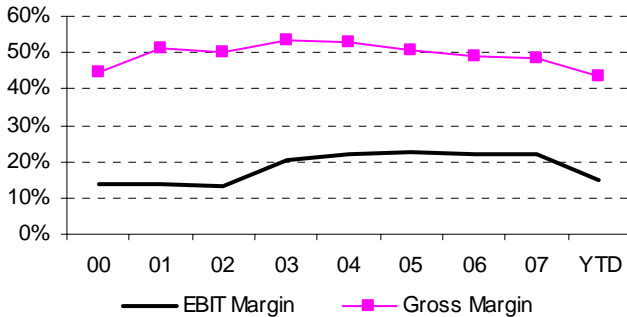
The company posted annual growth rates of 30-60% in the first half of the decade, with growth slowing from 2005-07 due to greater scale and market penetration. The YTD sales decline of 10% has primarily been caused by weak consumer spending. We do not believe the YTD result signals a departure from the company's long-term growth trend and expect Tempur-Pedic to resume growth when the macroeconomic outlook improves.



Source: Company, *The Manual of Ideas*.

TPX – Gross and EBIT margin, 2000-YTD’08

Tempur-Pedic has maintained operating margin well above 10% throughout this decade. While EBIT margin is down this year from 2007, it remains above 10% despite the YTD decline in sales. We believe this attests to the company’s variable cost structure and superior operating model. The company appears poised to maintain profitability even if sales continue to decline in a weak economic environment. We estimate long-term EBIT margin at roughly 20%.



Source: Company, *The Manual of Ideas*.

MANAGEMENT’S VIEW OF BUSINESS

CEO Sarvary and CFO Williams provided the following commentary on the 3Q08 earnings call on October 16:

- **Q3 performance:** “sales and earnings in line with our expectations”
- **Q4 outlook:** “Given the extraordinary events of recent weeks, the company now believes fourth quarter sales and earnings will fall below prior expectations;” projecting Q4 sales decline of 30%; “Christmas has always been a little bit seasonally slower for the mattress business... we’re not expecting any dramatic change, certainly not for the upside, this quarter”
- **Operating environment:** “most challenging economic environment in memory... no reason to assume this will improve in the short term”
- **Inventory:** “We have wrung out the inventory out of the system at this stage.”
- **Production volume:** “we were running productions significantly less than sales to bleed out the inventory;” “overall production volume is not dramatically different” in Q4 than in Q3
- **Debt reduction:** repatriating \$140 million from overseas; suspending dividend; “generated substantial benefit from working capital” and “reduced debt by \$38 million” in Q3; \$640 million credit facility in place, with “quite attractive” terms; intends to “de-leverage our domestic business while modestly leveraging our international business, thereby allowing for more rapid overall debt reduction;” “developing a lot of breathing room on... covenants”

- **Tempur-Pedic brand:** “spent over \$600 million building the brand during the last six years;” “trend toward the Tempur material is a very long-running trend;” “the fundamental, long-term demand is as strong as it ever was”
- **Long-term initiatives:** (1) “Historically we were a direct response company. Today we predominantly sell through retail. ...program currently underway to streamline our distribution network.” (2) “broaden and strengthen our [mattress] product line... meet the needs of premium consumers that we don’t currently address.” (3) improve gross margin.
- **Input price inflation:** raw material costs were “up substantially” y-y... “coping with cost increases in the vicinity of the mid-20%;” chemical cost increases “hit us a little harder than we [thought]... expecting that chemicals will continue to be high;” “significant cost pressure in the last quarter around diesel pricing... seeing some relief there so our freight cost is coming down” in Q4 versus Q3
- **Would you go below \$1,500 for a queen set?** “while I will never say never, at the moment we see no need for that;” “we are a premium product”
- **Market share:** based on Q2 ISPA data, the company gained share (Q3 data not yet available)**European business:** “...we saw some weakness in certain countries and we saw it spreading as the year progressed. In the third quarter we saw it spread even further. So basically now the entire European continent is suffering to some degree in terms of the economic weakness.”
- **Asian business:** “continues to perform very well”
- **Marketing budget:** “our anticipation is to maintain this 9% to 10% range, in a normal period, but we may move it from period to period, especially in environments like this”

Travelzoo (Nasdaq: TZOO)

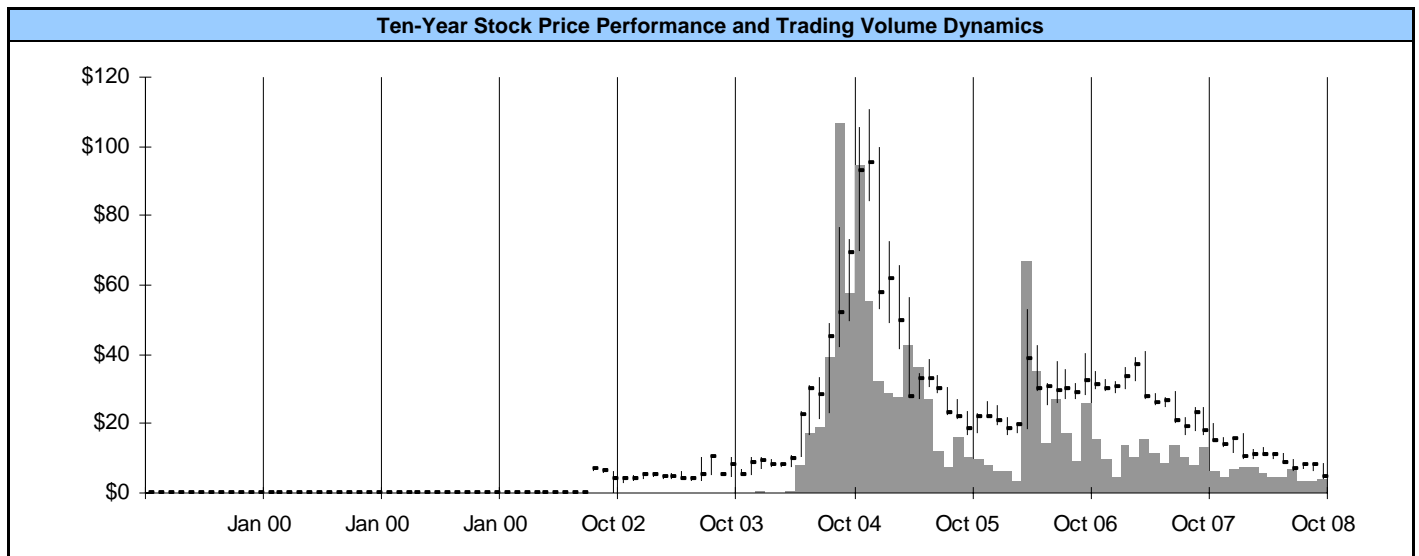
Technology: Computer Services

New York, NY, 212-484-4900

<http://www.travelzoo.com>

Trading Data	Consensus EPS Estimates				Valuation	
Price: \$4.48 (as of 11/14/08)		Month	# of		P/E FYE 12/31/07	7.9x
52-week range: \$4.11 - \$17.20		Latest	Ago	Ests	P/E FYE 12/31/08	n/m
Market value: \$64 million	This quarter	-\$0.12	-\$0.09	2	P/E FYE 12/31/09	n/m
Enterprise value: \$48 million	Next quarter	-0.03	0.03	2	P/E FYE 12/31/10	n/a
Shares out: 14.3 million	FYE 12/31/08	-0.40	-0.33	2	EV / LTM revenue	0.6x
	FYE 12/31/09	-0.06	0.27	2	EV / LTM EBITDA	n/a
	FYE 12/31/10	n/a	n/a	0	EV / LTM EBIT	9.4x
	LT EPS growth	n/a	n/a	0	P / tangible book	2.9x
Ownership Data	Latest Quarterly EPS Surprise				Greenblatt Criteria	
Insider ownership: 45%	Date	Actual	Estimate		LTM EBIT yield	11%
Insider buys (last six months): 129	10/27/08	-\$0.13	-\$0.09		LTM pre-tax ROC	>100%
Insider sales (last six months): 0						
Institutional ownership: 29%						
# of institutional owners: 81						

Operating Performance and Financial Position										
(\$ millions, except per share data)	Fiscal Years Ended							LTME	FQE	FQE
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	9/30/08	9/30/07	9/30/08
Revenue	6	10	18	34	51	70	79	81	20	19
Gross profit	6	9	18	33	50	69	77	78	20	18
EBIT	1	1	4	11	15	30	21	5	5	(0)
Net income	0	1	2	6	8	17	9	(4)	2	(2)
Diluted EPS	0.02	0.04	0.10	0.33	0.45	1.01	0.57	(0.28)	0.14	(0.13)
Cash from ops	1	1	2	5	8	17	10	(3)	1	(3)
Capex	0	0	0	10	0	0	1	3	0	2
Free cash flow	1	1	2	(6)	8	17	9	(6)	1	(5)
Cash & investments	1	1	4	37	44	34	23	16	24	16
Total current assets	2	3	6	43	55	43	36	30	36	30
Intangible assets	0	0	0	0	0	0	0	0	0	0
Total assets	2	3	7	43	56	44	37	35	37	35
Short-term debt	0	0	0	0	0	0	0	0	0	0
Total current liabilities	1	1	3	3	7	7	10	12	9	12
Long-term debt	0	0	0	0	0	0	0	0	0	0
Total liabilities	1	1	3	3	7	7	11	13	11	13
Preferred stock	0	0	0	0	0	0	0	0	0	0
Common equity	1	2	4	40	49	37	26	22	26	22
EBIT/capital employed	n/m	>100%	>100%	>100%	>100%	>100%	>100%	>100%	n/m	n/m



BUSINESS OVERVIEW

Travelzoo's free Internet media properties reach 12 million consumers in the U.S., Europe and Asia. The properties include the Travelzoo website, the Top 20 list of weekly deals, email alerts, and a travel search engine. Travelzoo publishes offers from 900 advertisers, with Travelzoo deal experts reviewing offers to find the best travel deals.

SELECTED OPERATING DATA

FYE December 31	2005	2006	2007	YTD 9/30/08
<i>Unpaid subscribers by geography (mn) (period end):</i>				
North America	9.4	10.2	11.0	11.1
Europe	0.3	0.7	1.4	2.1
Asia Pacific	--	--	0.2	1.1
<i>Unpaid subscriber growth by geography (mn) (period end):</i>				
North America	15%	9%	8%	2%
Europe	n/m	120%	111%	69%
Asia Pacific	n/m	n/m	n/m	>999%
Δ total subscribers	19%	12%	16%	17%
Δ total revenue	51%	37%	14%	3%
<i>Average subscriber acquisition cost (\$):</i>				
North America	2.66	2.10	3.16	4.03
Europe	1.86	2.17	4.04	4.44
Asia Pacific	n/a	n/a	2.88	2.98
<i>% of revenue by geography:</i>				
North America	99%	95%	93%	88%
Europe	1%	5%	7%	12%
Asia Pacific	0%	0%	0%	1%
<i>EBIT margin by geography:</i>				
North America	32%	47%	40%	32%
Europe	-148%	-49%	-89%	-91%
Asia Pacific	n/a	n/a	n/m	n/m
Total EBIT margin	29%	43%	26%	4%
<i>% of revenue by customer:</i>				
Travelport	12%	16%	15%	15%
Expedia	<10%	14%	11%	11%
Sabre	15%	<10%	<10%	<10%

INVESTMENT HIGHLIGHTS

- **\$1.3 billion in newspaper advertising by travel companies is moving to Internet.** Travelzoo is well-positioned to benefit from this transition. The company's revenue increased from \$18 million in 2003 to \$79 million in 2007, a 34% CAGR.
- **Profitable, non-capital-intensive U.S. business.** Travelzoo generated EBIT of \$17 million in North America YTD, while employing minimal capital.
- **Large global opportunity.** Travelzoo is attempting to replicate worldwide the success it has had in the U.S. Travelzoo entered the U.K. in 2005; Canada, Germany and Spain in 2006; Australia, China, France, Hong Kong, Japan, and Taiwan in 2007.

- **Founded and managed by Bartel brothers.** Chairman Ralph Bartel (42) founded Travelzoo in 1998 and served as CEO until September 2008 when Holger Bartel (41) assumed the role. Previously, Holger oversaw Travelzoo's operations in North America and worked at McKinsey.
- **Repurchased 1 million shares for \$20 million in 2007,** and 1 million shares for \$29 million in 2006.
- **Material insider buying above current price.**

INVESTMENT RISKS & CONCERNS

- **Global expansion may not work.** Travelzoo is losing money overseas as it attempts to scale. The company's model may not succeed abroad.
- **North America EBIT margin has declined** from 47% in 2006 to 40% in 2007 and 32% YTD.
- **Dependent on ad revenue.** Travelzoo may suffer if travel declines due to economic weakness, high oil prices, terrorist threats or other factors.
- **High ROIC has attracted new entrants,** while Google AdWords has lowered barriers to entry. Sherman's Travel is the #2 travel deals email distribution company, with four million subscribers.

COMPARABLE PUBLIC COMPANY ANALYSIS

(\$mn)	MV	EV	EV/Rev	P/TB	08 P/E	09 P/E
EXPE	2,238	2,723	.9x	n/m	6x	6x
GOOG	97,580	83,168	4.0x	4.5x	16x	14x
MSFT	178,445	159,698	2.6x	9.2x	10x	9x
OWW	250	767	.9x	n/m	n/m	n/m
PCLN	2,184	2,199	1.2x	13.5x	9x	9x
YHOO	14,994	11,780	1.6x	2.1x	26x	23x
TZOO	64	48	.6x	2.9x	n/m	n/m

MAJOR HOLDERS

Ralph Bartel 60% | Holger Bartel 1% | Other insiders <1%
| JP Morgan 10% | Coatue 4%

RATINGS

- VALUE** Intrinsic value materially higher than market value? ☆☆☆☆☆
- MANAGEMENT** Capable and properly incentivized? ☆☆☆☆☆
- FINANCIAL STRENGTH** Solid balance sheet? ☆☆☆☆☆
- MOAT** Able to sustain high returns on invested capital? ☆☆☆
- EARNINGS MOMENTUM** Fundamentals improving? ☆☆☆
- MACRO** Poised to benefit from economic and secular trends? ☆☆☆
- EXPLOSIVENESS** 5%+ probability of 5x upside in one year? ☆☆☆☆☆

THE BOTTOM LINE

Travelzoo is a good business run by capable insiders who have loaded up on shares this year. The market values Travelzoo's international startup operations materially below zero even though the company has a proven model and management knows Europe well (founder Ralph Bartel was educated in Germany and Switzerland). The downside appears limited as the Bartel brothers are heavily incentivized to create shareholder value. If international operations do not achieve desired profitability, management may shut them down and sell the U.S. business to a competitor such as Priceline.com. We value Travelzoo at \$25-26 per share, based on a probability-weighted scenario analysis that includes estimated ranges of annualized EBIT for North America and the rest of the world.

...additional insight into TZOO:

WHAT ARE THE SHARES WORTH?

- **We value Travelzoo at \$25-26 per share**, based on a probability-weighted scenario analysis that includes estimated ranges of annualized EBIT for North America and the rest of the world.
- **Normalized EBIT for North America and rest of the world (ROW) are key valuation drivers.** As Travelzoo generates strong EBIT in North America while investing heavily in global expansion, we value the company on a sum-of-the-parts basis. Travelzoo is a non-capital-intensive business with few excess assets, and the value of the enterprise depends on profit generation. While Travelzoo's 12 million-strong subscriber base and brand name may have strategic value to an acquirer, we have not used M&A transaction multiples in our analysis, as such a valuation might be too speculative.
- **In North America**, our most likely scenario (50% probability) has Travelzoo roughly maintaining normalized EBIT at approximately \$25 million per year. We assign a fair value multiple of 10x in such a scenario. If EBIT declines, we anticipate multiple contraction due to likely business model concerns. If EBIT increases, we anticipate multiple expansion due to likely renewed optimism regarding growth. Our analysis conservatively assumes that EBIT deterioration is more likely than EBIT growth.
- **In the rest of the world**, our most likely scenario (40% probability) has Travelzoo earning normalized EBIT of \$10 million, less than half the current North American EBIT run rate. This may be a fairly conservative assumption, as we see little reason why Travelzoo's international business, particularly in Europe, could not emulate the success achieved in the U.S. We have assigned a 5% probability to the scenario that Travelzoo continues to suffer an annualized operating loss of roughly \$20 million internationally. The company is highly likely to take decisive action to eliminate the operating loss even if international growth does not materialize, as the Bartel brothers own ~60% of Travelzoo shares.

WHY THE SHARES MAY BE MISPRICED

- **Steady-state EBIT materially understated.** Startup losses in Europe and Asia mask continued strong U.S. profitability.
- **High taxes lower net income yield.** As U.S. income is fully taxed and foreign losses generate no current tax benefit, effective tax rate is temporarily elevated, lowering the after-tax earnings yield.

Estimated Enterprise Value

(based on various scenarios of normalized EBIT)

(\$ in millions)

ROW	EV/EBIT Multiple	North America EBIT				
		\$10	\$20	\$25	\$30	\$40
EBIT		5x	8x	10x	12x	15x
-\$20	5x	-\$50	\$60	\$150	\$260	\$500
-\$10	5x	\$0	\$110	\$200	\$310	\$550
\$0	n/m	\$50	\$160	\$250	\$360	\$600
\$10	12x	\$170	\$280	\$370	\$480	\$720
\$20	15x	\$350	\$460	\$550	\$660	\$900



Probability-Weighted Enterprise Value

(sum of probability-weighted contributions of scenarios)

(\$ in millions)

ROW	EBIT	Probability	North America EBIT				
			\$10	\$20	\$25	\$30	\$40
			6%	25%	50%	15%	4%
-\$20	5%	\$0	\$1	\$4	\$2	\$1	
-\$10	10%	\$0	\$3	\$10	\$5	\$2	
\$0	25%	\$1	\$10	\$31	\$14	\$6	
\$10	40%	\$4	\$28	\$74	\$29	\$12	
\$20	20%	\$4	\$23	\$55	\$20	\$7	
			Probability-weighted enterprise value: \$344 million				



Estimated Equity Value per Share

(\$ and shares in millions, except per share data)

Probability-weighted enterprise value	\$344
Net cash	\$21
Estimated equity value	\$365
Shares outstanding	14.3
Estimated equity value per share	\$25.52

COMMENTS ON BUSINESS MODEL

- **Travelzoo employs virtually no capital in running the business.** The company has no inventory cost, as its services are entirely web-based. No elaborate infrastructure is required to create the services, resulting in minimal PP&E investment. The only major input is the time and effort of Travelzoo employees, yet the company does not depend on specific employees to maintain current operations (we do believe that the services of the Bartel brothers are crucial to growing value over time). Enterprise value is embedded primarily in the Travelzoo consumer brand, an online distribution channel (including email), and a 12 million-strong subscriber base. With this infrastructure in place, Travelzoo can maintain current operations at low cost, creating a quasi-recurring business model.

- **Per-employee performance metrics are quite impressive**, as the following table shows. Per-employee results have declined primarily due to the startup of international operations. The company could boost per-employee performance substantially if it opted to maintain rather than grow operations. However, we believe investment in new country-specific Travelzoo websites will earn favorable risk-adjusted returns for shareholders.

(\$'000)	2005	2006	2007	YTD 9/30/08
Revenue per employee	853	915	660	338
N.A. EBIT per employee	269	412	242	96
EBIT per employee	250	391	173	14

- **Advertiser-supported model, while highly profitable, creates perceived and real conflicts of interest.** Travelzoo makes money not from the consumers who rely on its media properties, but from travel companies who pay for inclusion in the company's Top 20 list and other properties. While Travelzoo claims that Top 20 deals are selected exclusively based on merit, there is a perceived and real risk that editorial decisions may be influenced by advertising revenue prospects. Most consumers appear to be unaware that Travelzoo relies heavily on payments for deals included in the Top 20. However, it is conceivable that existing competitors or new entrants could expose this fact over time, perhaps lessening the consumer appeal of Travelzoo's media properties.
- **Top 20 list may be less scalable than it appears.** The Travelzoo model appears almost infinitely scalable: once the Top 20 list is created, there is no marginal cost of emailing the list to incremental subscribers (leaving aside the cost of subscriber acquisition). However, the model contains a limit to scalability: Consumers must be able to book the deals presented on the Top 20 list; if too many consumers subscribe, too few may be able to benefit from the deals presented. This may force the company to forgo deals with low capacity in favor of large-scale but potentially less-favorable deals. For example, as the Top 20 list has grown to more than 10 million subscribers in the U.S., the company has been forced to limit small deals on the list. As the deals get bigger in terms of capacity, however, they may become less appealing. This dynamic puts a natural limit on the size of the Top 20 subscriber base in each country. An interesting way in which the company appears to be trying to address this is by customizing the Top 20 list for different types of subscribers (e.g., by residence location or travel preference). This customization happens largely behind the scenes, with users not explicitly asked to state their preferences. Of course, the (potential) existence of customized Top 20 lists means that an aggregate of more than 20 deals are selected each week, which may in turn dilute the quality of deals.

- **A corollary of the previous point is that Travelzoo is in a strong position to grow new-country Top 20 lists from a low base.** As the company launches new Top 20 lists, it has the luxury of including deals without much regard for capacity. As a result, the quality of the deals in startup countries may be higher than the quality of deals presented in the U.S. This quality advantage may make it easier for Travelzoo to grow by word of mouth in new countries, potentially helping to keep subscriber acquisition costs low. As a result, investors may overestimate the difficulty Travelzoo will encounter in scaling up new markets.

MANAGEMENT'S VIEW OF BUSINESS

Notes from 3Q08 earnings call on October 27:

- **Operating environment:** economy "definitely a challenging one" for advertisers; search volume and traffic to travel websites have been decreasing since September (even on seasonally adjusted basis); however, Travelzoo hotel business is doing "really, really well... seeing increased business there"
- **Response to weak environment:** Plans to cut costs in North America and "reduce the speed of our investments in Asia Pacific and Europe;" strategy of developing global brand remains "unchanged"
- **Q3 review:** "unsatisfactory results" in North America, "impacted more negatively than expected by a weak economy;" European revenue up 62% (September best month ever: hotels and cruises strong; number of search queries down); Asia revenue of ~\$200K; net loss widened due to European and Asian losses – not tax deductible, resulting in high effective tax rate; used \$3.4 million of cash in operations; 207 employees at Q3-end (104 in North America, 52 in Europe, 51 in Asia), up from 191 sequentially and up from 128 y-y
- **Q4 outlook:** does not provide guidance; acknowledged travel weakness but argued that Travelzoo provides even more value to advertisers when it is difficult to move inventory
- **International growth strategy:** dates back to 2005; management still believes expansion will increase shareholder value in the long term; international presence improves competitive position due to ability to (1) sell ad inclusions across different geographies and (2) perform local due diligence on quality and availability of travel deals (currently has producers and sales staff in 11 countries)
- **Competitive landscape:** no news; has faced new competitors in North America during past few years; none of them have Travelzoo's reach
- **Travelzoo's strengths:** "push media," such as Top 20 weekly email, create demand that is incremental to "pull" demand, i.e., potential travelers proactively searching for travel deals online; SuperSearch product leverages more than 2.8 million ratings from Travelzoo users

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