



# MARQUETTE UNIVERSITY

## Applied Investment Management (AIM) Program

### AIM Fund Investment Advisory Board Meeting

September 27, 2005

### AIM Fund Portfolio

<b>Student</b>	<b>Company Name</b>	<b>Ticker Symbol</b>	<b>Recommended Portfolio Weighting</b>
Auth	Progressive Gaming International	PGIC	2%
Trotter	Maidenform Brands	MFB	2%
Holtkamp	Vineyard National Bancorp	VNBC	2%
Hepp	Delta & Pine Land Company	DLP	2%
Jensen	LCA-Vision, Inc.	LCAV	2%
Wojs	Korn/Ferry International	KFY	2%
Berg	Edge Petroleum Corporation	EPEX	2%
Rawls	AudioCode	AUDC	2%
Zandt	Salem Communications	SALM	1%
Toellner	North Pittsburgh Systems Inc.	NPSI	1%
Cunningham	Quality Systems	QSII	1%
Kennedy	Pike Electric Corporation	PEC	1%
	Cash		80%
	Total Portfolio		100%

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## Progressive Gaming International Corporation

### PGIC

Price: \$13.62 (\$5.15-16.21)

Fiscal Year End Dec. 31

September 27, 2005

Russell 2000: 650.67 (558.36-688.51)

Ray Auth

*Established in 1986, PGIC develops and markets technology-based products for the gaming industry. The company is divided into three different segments. The slot and table segment was established to develop, acquire, manufacture and distribute proprietary games. The company's product sales business segment has been providing gaming products and equipment such as manufacturing signs, jackpot meters, and related products. The systems segment sells or leases electronic player tracking and slot machine and table game monitoring systems. The company is headquartered in Las Vegas and is run by their 39-year old CEO, Russell McMeekin.*

#### Recommendation:

I believe that PGIC has a solid business model that should produce 6-8% annual revenue growth. The earnings growth is expected to be approximately 40% for the next several years. This year's EPS is estimated to be \$.29 while next year's estimate is \$.65. With the gaming supplier industry expected to have continued strength in the coming years, PGIC should lead the way.

#### Investment Thesis:

- **Strong Industry Trends:** The gaming industry's growth trend is well above average. The gaming supplier sector, where casinos are seeking to roll out new gaming technology, is growing strongly. Along with new technology, the catastrophic Hurricane Katrina in 2005 should boost sales. All of the casinos in the Gulf Shores are likely to be rebuilt "better than before" as President Bush proclaimed. With the massive recovery effort of Hurricane Katrina, the gaming supplier industry will likely receive some windfall benefits.
- **Unique and largest gaming platform:** PGIC revealed the largest and most diverse offering of new gaming products since its inception at the Global Gaming Expo in Las Vegas in 2005. They are making the shift with the rest of the industry to move to technology-based games, including the Intelligent Table System, as well as CasinoLink. These include 30 new slot titles, race and sports book management software, event-within-event wagering, simulated event wagering, media content management, wireless gaming and an all new mystery jackpot system. They also are coming out with platform games such as "Rock and Roll All Nite", "Millionaire Madness", and "Rock Roll and Remember."

<u>Key Statistics: Sept. 2005</u>	
Weighting:	2%
Revenue:	96.37M
Profit Margin:	6.80%
Op. Margin:	13.78%
12 Month P/E:	46.17
Price/Book:	15.43
EPS Growth:	39.3%
Price/Sales:	3.62
Debt/EBITDA:	3.32
Debt/Capital:	52%
Sector	Consumer Services

#### Valuation

Annual revenue growth of 6-8% and earnings growth of almost 40% should continue into the future. Based on these growth estimates, the discounted cash flow model values PGIC at \$16.75. Compared with the market value of \$13.45, PGIC appears undervalued. Reuters assesses a fair value for PGIC at \$18.00 and Standard & Poor's gives the company a fair value of \$22.30. The P/E of PGIC stands at 46.17 which

is considerably higher than the industry average of 32.8. PGIC has a favorable forward PEG of .90. PGIC is a buy recommendation.

### Risks

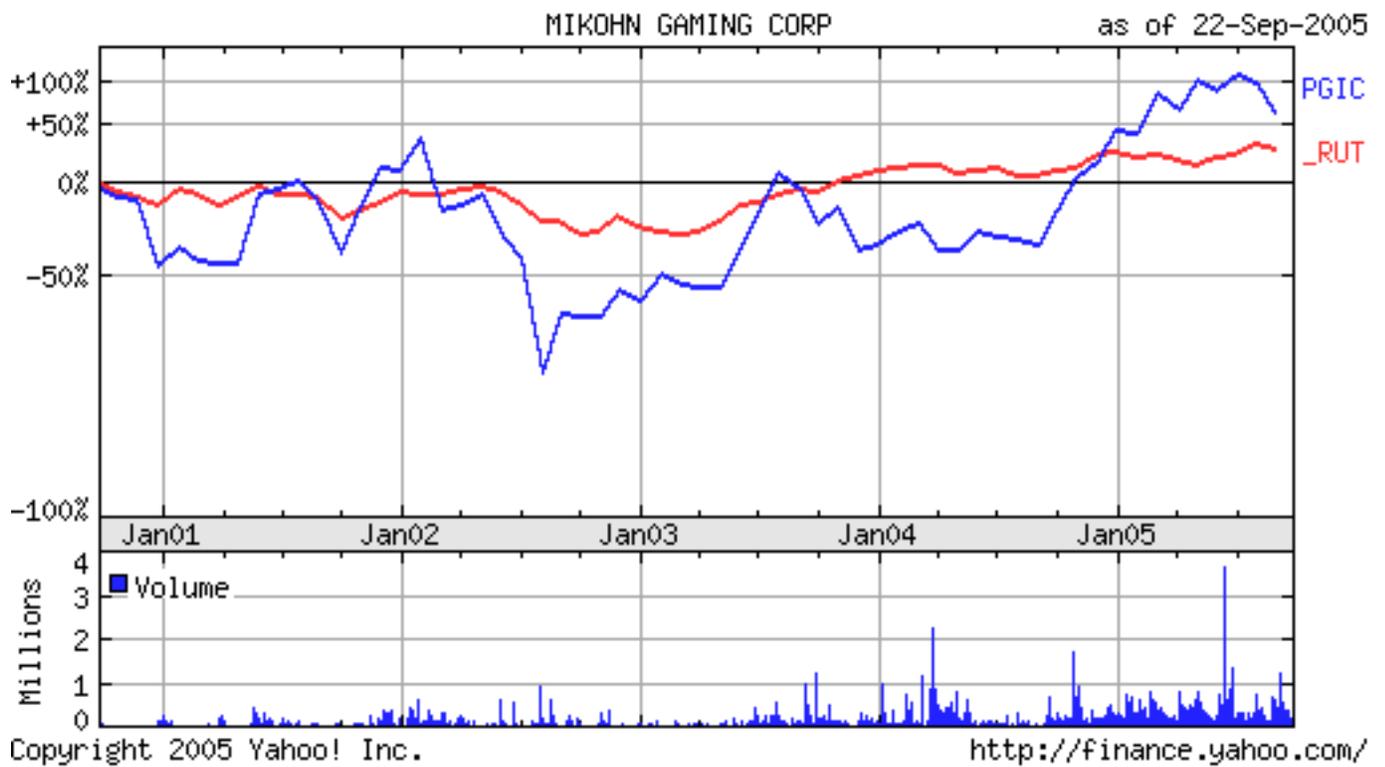
- Litigation is always a concern with companies dealing with gambling and casinos; and new regulatory changes could adversely affect PGIC.
- The capital expenditures of casinos should stay in line over the next few years; however, any decrease in capital expenditures could negatively affect profitability.
- Competition may become fierce in battling for sales in the aftermath of Hurricane Katrina by PGIC's competitors.
- A delay in rolling out new the Intelligent Table Systems or CasinoLink could cause a reduction in future sales.
- Greater than expected costs could be incurred whether or not the VirtGame acquisition is completed, which could negatively impact earnings.

### Management

The management team at PGIC is young and energetic. Mr. Russell McMeekin is the President and Chief Executive Office. He is receiving ample compensation of \$690,000. He has been CEO since 2002 and is only 39 years old.

### Outlook and Growth Assumptions

- I am expecting revenues to grow 6-8% for the next 3 years. With the new technology arriving, this could be a conservative estimate. PGIC has the platform to entertain rapid and robust revenue growth as high as 16% per year.
- PGIC's new Intelligent Table System was presented at the G2E 2005 Conference, where they received excellent reviews from all of the attendees. Their product ranked as the most impressive new offering at the conference, which highlights the powerful growth opportunity that PGIC possesses in the next twelve months.
- Earnings growth is even more robust for PGIC than sales growth. Earnings growth is expected to be about 40% annually over the next couple of years. Estimated EPS for next year is at \$.65 up from the estimated \$.29 for 2005.
- PGIC has recently approved a \$2.0 Million share repurchase program and they have currently bought back 254,000 shares. This should place upward pressure on the share price.
- PGIC is a good company to buy for the next twelve months. The potential for growth makes it a good strong opportunity and the analysts that follow the company believe it should outperform the market.



## Maidenform Brands

### MFB

Price: \$14.13 (13.27-20.74)

September 27, 2005

David Trotter

Russell 2000: 651.16 (558.36 – 688.51)

*Maidenform Brands, Inc., is a global intimate apparel company with a portfolio of established and well-known brands, top-selling products and an iconic heritage. Maidenform designs, sources and markets an extensive range of intimate apparel products, including bras, panties, and shapewear. The products are distributed through department stores, national chains, mass merchants, specialty stores, off-price retailers, company-operated outlets stores and the company's website. Some of the most recognized brands include Maidenform, Flexees, Lilyette, Self Expressions, Sweet Nothings, Bodymates, Rendezvous and Subtract.*

### Recommendation

I believe Maidenform will be able to achieve high to single digit sales growth, fueled by expanding distribution base and increased market penetration, over the next several years. The company will continue to improve the balance sheet as it reduces debt (about \$20 million a year). Maidenform has changed its business model from 10% outsourced manufacturing to 100%, resulting in 85% less workforce since 2000. MFB's business now only consists of marketing and design allowing it to expand its EBIT margins from -5% in 2000 to 10% in 2004. The price is a reasonable buy at a below average multiple compared to its peer group. I have given it a target price of \$19.50 and a lower limit of \$12.00.

#### Key Statistics

#### September 2005

Portfolio Weighting	2%
S&P Rating	N/A
Market Cap.	\$303 mill
LT Debt/Total Cap.	58%
Dividend Yield	0%
P/E Fiscal '05E*	13.52
P/E Fiscal '06E*	11.54

\*Includes NPV of NOLs

### Investment Thesis

- **Increased profitability.** The company is planning to pay down debt in the amount of \$20 million a year. I estimate that once the full effect of the outsourcing takes effect (last factories were closed in July '05) that EBIT margins will be able to reach around 14%.
- **Increased top line.** MFB currently distributes to most of the top mass channel and national chains including Wal-Mart, Target, Costco, Sears, and department stores. Sales will grow as MFB takes advantage of new store openings and increased shelf space. An example of shelf space expansion would be Wal-Mart; MFB currently represents less than 10% of the stores intimate apparel section creating opportunity for more market share penetration.
- **Introduction of new products.** MFB's new business model has allowed the company to do what it does well, design woman's intimate apparel. They are at the top of the industry when it comes to design. MFB's ability to consistently turn out new and innovative products will allow it to steal market share from competitors.

### Valuation

- **Earnings Multiple expansion.** Right now the company is currently trading at 11.5x 2006 EPS.\* MFB's competitors are currently trading at a mean of about 15.0x earnings, and they are also

growing slower than MFB. Given the higher growth and being the industry leader, MFB should have a higher multiple than its peers. If you gave the 2006 EPS a multiple of 15x, the price would be fairly valued around 19.50.\* (\*Includes NPV of NOLs equal to about \$1.00)

- **Discounted Cash flow.** Using discounted cash flows, I arrived at a price of about \$20.50. That assumes a discount rate of 9.5% and a long term growth rate of 13%. \$20.50 is inline with the other valuation methods.
- **Private Market Valuation.** Using a private market valuation model, I arrived at a price of \$25.53. Stocks tend to stick between 50% and 85% of there PMV, arriving at a price floor of \$12.77 and ceiling of \$21.70.

### Risks

- **Small group of customers.** 65% of MFB's sales in 2004 were from 10 of there customers.
- **Debt.** MFB has a lot of debt on there balance sheet because of the poor previous management. Even though the company has stated clearly that one of there top goals is to reduce debt, if the company stumbles for even the shortest moment it could find itself in some cash problems.

### Management

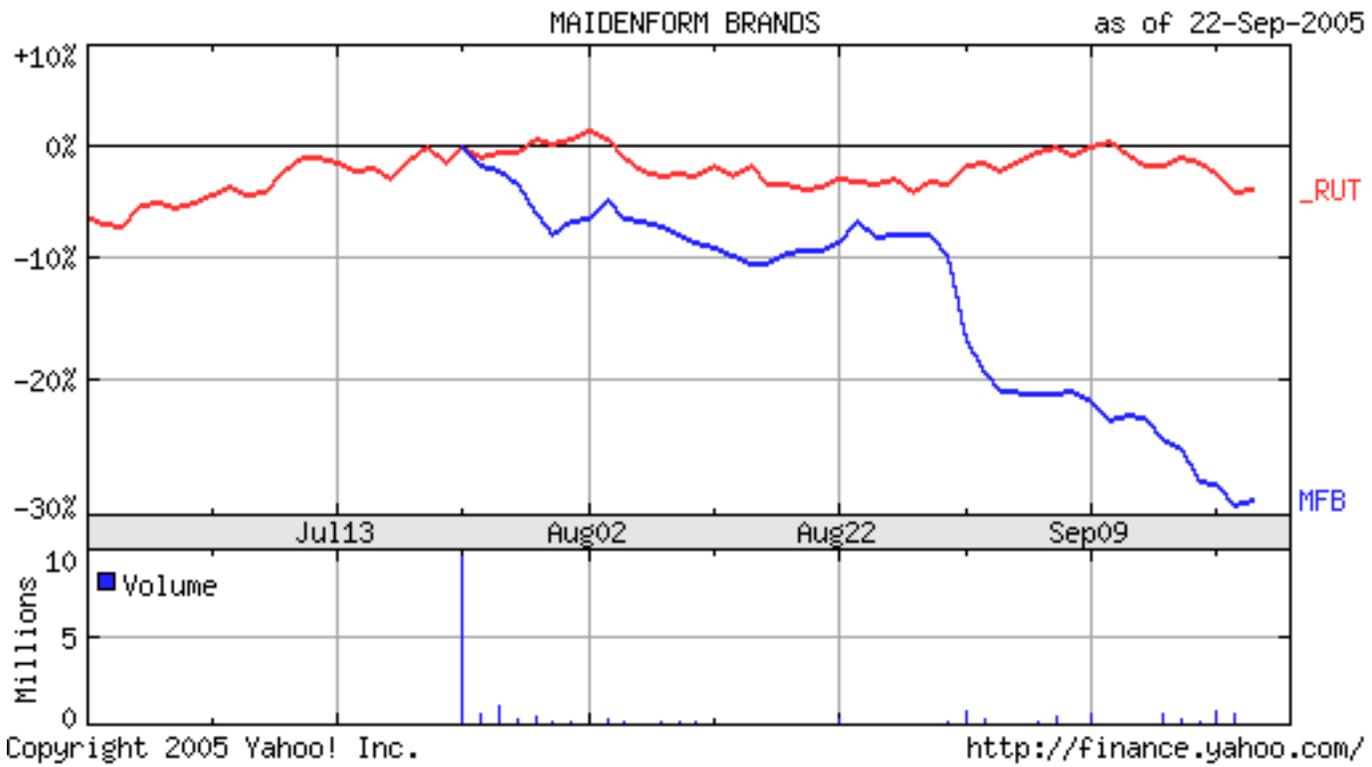
- Given the managements ability to turn the company around I'm confident they will be able to make the right choices going forward. Top management also has many years of experience in public companies.
- **Thomas J. Ward CEO & Chairman.** Ward has been CEO since July, 2001. Prior to joining MFB, Ward served as Chairman of Thomas Ward Associates, consulting with Coles Myer Ltd., and before that he was with Westpoint Stevens Inc. for 31 years. (35 years of experience)
- **Maurice S. Reznik President.** Prior to joining, Reznik was President of Warner's Intimate Apparel Group, a division of Warnaco, Inc.(25 years of experience)
- **Dorvin D. Lively CFO.** Lively has been CFO since November, 2004. Prior to joining, he served as Sr. VP and Corporate Controller of Toys "R" Us, Inc.(10 years of experience)

### Outlook and Growth Assumptions: <sup>1</sup>

- **Sales growth.** Assuming sales to grow 15% in 2005 to 388.5 compared to 337.1 in 2004. In 2006, I estimate that sales will grow by 9.6%. I think that sales will continue to grow between 6% and 9% for several years.
- **EPS growth.** I'm assuming that EPS will continue to grow around 15% for the next several years. Note that sales is growing slower than EPS because of the gradual decrease in SG&A to sales and the pay down of debt reducing interest expense.
- **Taxes.** MFB has a huge tax shield from all of the years they were losing money. It actually amounts to \$85 million over the next 15 years. The NPV of the cash flow is about \$1 of the current stock price and has been included in price to earnings estimates.
- MFB appears undervalued and a 2% portfolio weighting is recommended.

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<sup>1</sup> Pro forma, doesn't include one time items, reflects 40% corporate tax, although actual cash tax could be lower due to NOL's.



**Vineyard National Bancorp**  
**VNBC**  
**Price: \$29.65 (\$25.55 - \$35.00)**

**September 22, 2005**  
**Russell 2000: 647.35 (558.36 – 688.51)**

**Steve Holtkamp**

*Vineyard National Bancorp operates as the holding company for Vineyard Bank that offers community banking services in California. The bank engages in generating deposits and originating loans. Its deposit products include demand deposits, savings deposits, and time deposits. The bank provides commercial business and commercial real estate loans; single-family construction loans, such as tract and coastal loans; small business administration loans; income property loans; and consumer loans, such as personal loans, automobile loans, and individual lines of credit. It primarily invests in U.S. agency securities, mortgage-backed securities, and mutual funds. The bank offers its services to commercial businesses, retail community businesses, single-family residential developers and builders, individuals, and local public and private organizations. As of September 20, 2005, the bank operated 12 branch offices in Los Angeles, Orange, Riverside, San Bernardino, and San Diego counties of California and a loan production office in Anaheim, California. VNBC is headquartered in Rancho Cucamonga, California.*

**Recommendation**

Vineyard National Bancorp has a proven track record and into the near future I believe that they will be able to grow at 20% - 25% annually. Loan growth has been a major source of the company's growth and in the future VNBC will actually need to slow themselves down so that funding can catch up. VNBC has a main focus on total balance sheet effectiveness which produces good margins and high returns. Vineyard is currently undervalued about 20% and recent stock price movements have been upward. VNBC has a dividend yield of .83% and is a buy with a recommended weighting of 2%.

<u>Key Statistics</u>	<u>MRQ</u>
Weighting	2%
Market Cap (M)	278.74
Debt/ Equity	4.63
Dividend Yield	0.83%
NIM	4.36%
ROE	20.18%
ROA	1.25%
LTG Rate	23%
P/E '05E	14.75
P/E '06E	12.00
Morningstar Sector	Financial Services

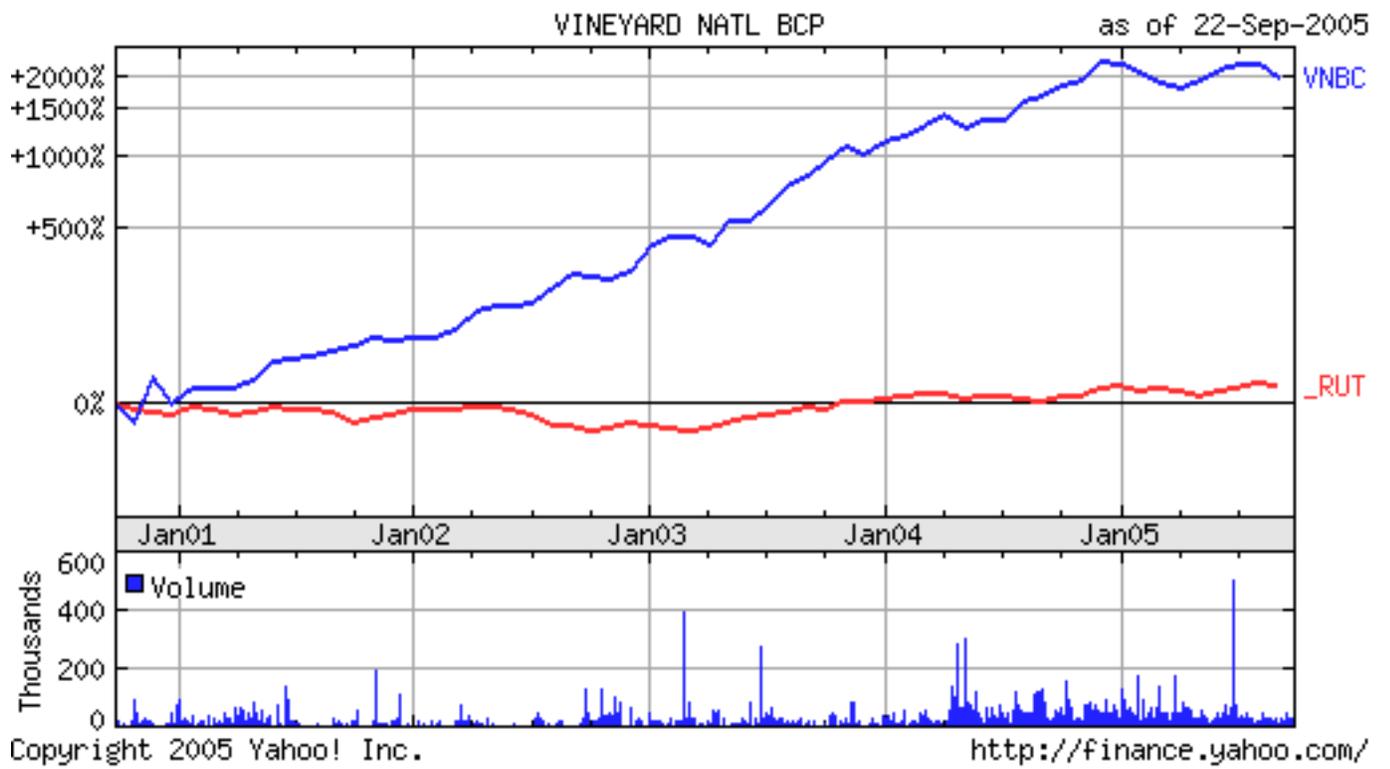
**Investment Thesis**

- Vineyard National Bancorp is a highly profitable fast growing bank located in the rapid growing markets of the inland empire of California. This area represents some of the most affordable housing in the region in support of the Los Angeles and Orange County areas. The bank has been able to grow earnings at an average of 50% over the past 5 years. This year's earnings are estimated to be a 30% growth and next year's earnings are estimated at 23% growth. VNBC achieves this success through the investment in high quality employees who know the market and have large incentives to perform. Loans have grown at an average rate of 80% for the past 3 years. In the bank's latest strategic move they have set their eyes on Marin County, which controls roughly 10% of all of California deposits. VNBC stock has appreciated 2,328% from October 2000 through 2Q 2005.
- Vineyard Bank has a goal of reaching 20% of deposit market share in each region that it serves, and a minimum level of 10%. The firm has already reached the minimum goal in 5 of the 9 markets in which it serves. This type of growth strategy has produced a 5 year CAGR on net income and diluted earnings of 118% and 79% respectively. VNBC has maintained a net interest margin of 4.36% in the MRQ; the peer median was 4.6% which are both good numbers on an industry-wide basis.

- VNBC is a financially sound institution despite fears of real estate froth in the Southern California market. Non performing assets / total assets was .29% in the MRQ and 0% in 2 of the last 3 years. Net charge offs/ loans was -.01% MRQ meaning that the firm recovered money on previously charged off loans. This number has averaged .03% in the past 3 years. The in depth relationships in which the bank has had with its customers is partly the reason for the low numbers, and also originators of loans are aggressive, but still stress credit quality. Total loan loss reserves / Nonperforming assets in the MRQ was 300% after an increase of reserves this quarter of \$850,000 to offset loan growth.
- Total deposits declined in the MRQ by 5%; however, most of the loss in deposits was interest bearing, while non-interest bearing deposits actually increased 3% sequentially. In the MRQ VNBC had approximately 60% of its funding come from the more expensive areas of time CD's and Federal Home Loan Bank borrowings. In coming quarters VNBC is planning to reach a loan/ deposit ratio of 1:1. Currently, the company is participating out loans and gaining fees so that it does not have to rely on highly expensive funds. As a result the bank has made low cost deposit generation a main focus in the second half of the year. Overall, VNBC has been able to reach 5 year CAGR numbers in loan growth, deposit growth, and asset growth of 76%, 89%, and 86%, respectively. The firm has a 10 year goal of reaching assets of \$10 billion.
- Non-Interest Income for the company comprises 7.6% of the total operating revenue. This was a 19% climb from 1Q05. SBA loans and service fees improved 17.2% and 21.5%. Non-Interest expenses fell in the quarter 1.3% on a sequential basis. This number will not stay low in the future as costs associated with expansion will be realized. The efficiency ratio for VNBC stayed at a low 48.22% and management says that it will likely stay in that neighborhood citing their plans for growth.

### **Valuation, Risks, and Outlook**

- Future growth prospects for VNBC are very attractive. Participation of loans outward will continue into the future as deposits catch up with loans. Branch and staff additions should help with deposit generation and take some pressure off the NIM. VNBC is currently trading at a large discount to its peers who trade at 20x earnings. The reason for VNBC's trade discount is due to its perceived risk in the southern California marketplace and their unusual business model. Taking this into account an 18x earnings multiple would not be considered atypical for a stock that is growing earnings at a 5 year average of 50% and projected into the future to grow at 23%. The 12 month price target is \$40.
- Risks that VNBC will not perform as projected are a large decline in the California housing market, steep incline in interest rates, and/or a failure of the bank to attract low cost deposits to support loan growth.
- The outlook for VNBC is favorable and with a .83% dividend and a projected value of \$40 the stock is a buy recommendation.



## **Delta & Pine Land Company**

### **DLP**

Price: \$25.54 (\$24.30 – \$30.74)

Fiscal Year Ends: August 31

September 22, 2005

Michael Hepp

Russell 2000 Index: 650.28 (588.36 – 688.51)

*Delta and Pine Land Company is primarily engaged in the breeding, production, conditioning and marketing of proprietary varieties of cotton planting seed in the United States and other cotton producing nations. The company is also engaged in the breeding, production, conditioning and marketing of soybean planting seeds in the United States. The company holds several licensing agreements with Monsanto concerning the use of gene technology. Delta and Pine Land uses the Bollgard® gene in its cotton seeds, which produces a toxin to ward off pests, along with the Monsanto's premiere gene referred to as Roundup Ready®, which allows for the resistance of herbicides that go by the same name. The company's international presence comes mainly through joint ventures established by D&M International, a subsidiary of both D&PL and Monsanto created in 1995. In 2002, D&PL acquired Monsanto's stake in the joint venture, and since that time D&PL has wholly owned the subsidiary.*

### **Recommendation**

Delta and Pine Land Company is a great low-risk equity. The company's fundamentals prove to be very strong, and are good predictors of favorable future performance. The company should achieve 12% revenue growth for the year, which translates into an equal growth in EPS for F2005. Similar performance is expected in the following year, given current market conditions and expectations about next year's cotton planting. With a dividend yield of 1.81% and a projected value of \$31, DLP is a buy recommendation.

### **Key Statistics**

**Sept. '05**

Portfolio Weighting	2%
S&P Rating	N/A
Market Cap	\$926.68M
LT Debt/Total Cap.	9.36%
Dividend Yield	1.81%
ROE LTM	10.3%
P/E Fiscal '05E	22.05
P/E Fiscal '06E	19.32
Morningstar Sector	Ind. Materials

### **Investment Thesis**

- **Technology:** The acquisition of technology licenses for insect resistance in soybeans and cotton in August 2004 from Syngenta, will spur growth domestically and internationally. D&PL will receive a 70% share of the revenues received by these products. This could be a sign of D&PL making steps to reduce its reliance on Monsanto for technology and other technology licenses. New technology will also command a premium, and the potential of new seeds to be adopted by planters should be highly likely, given that cotton prices are at levels above previous years and demand remains strong. According to the United States Department of Agriculture, the price of upland cotton (Southeastern U.S.) was \$.4538 per pound, while historic averages were much lower.
- **International growth:** U.S. cotton production is expected to remain relatively flat next year. Total U.S. acreage planted in 2005 was 13.8 million acres. For every 500,000 increase/decrease in acres planted earnings per share should increase/decrease by \$.12. Growth in Brazil, India, and China are expected to drive up revenues internationally, as world cotton use is projected to grow from 108 million bales in 2004 to 112 million bales in 2005 and consumption remains strong.

- Stock repurchasing of \$50 million, plus a fourth quarter dividend that will be 25% higher than third quarter's dividend. All of which will put upward pressure on share value.
- Legal fees related to the Monsanto/Pharmacia lawsuit less than previously expected.

### **Valuation**

Based upon a dividend discount model, the intrinsic value of D&PL should be \$31.40 versus a current price of \$25.53. This is based on the assumption of a 9.5% cost of capital and a 7.5% terminal growth rate. Relative valuation measures support the intrinsic value determined by the dividend discount model. Based upon three relative valuation measures, D&PL should trade in the range of \$29 and \$40. These measures support a 56% upside and, obviously, a very little downside. DLP has a 1.81% dividend yield.

### **Risks**

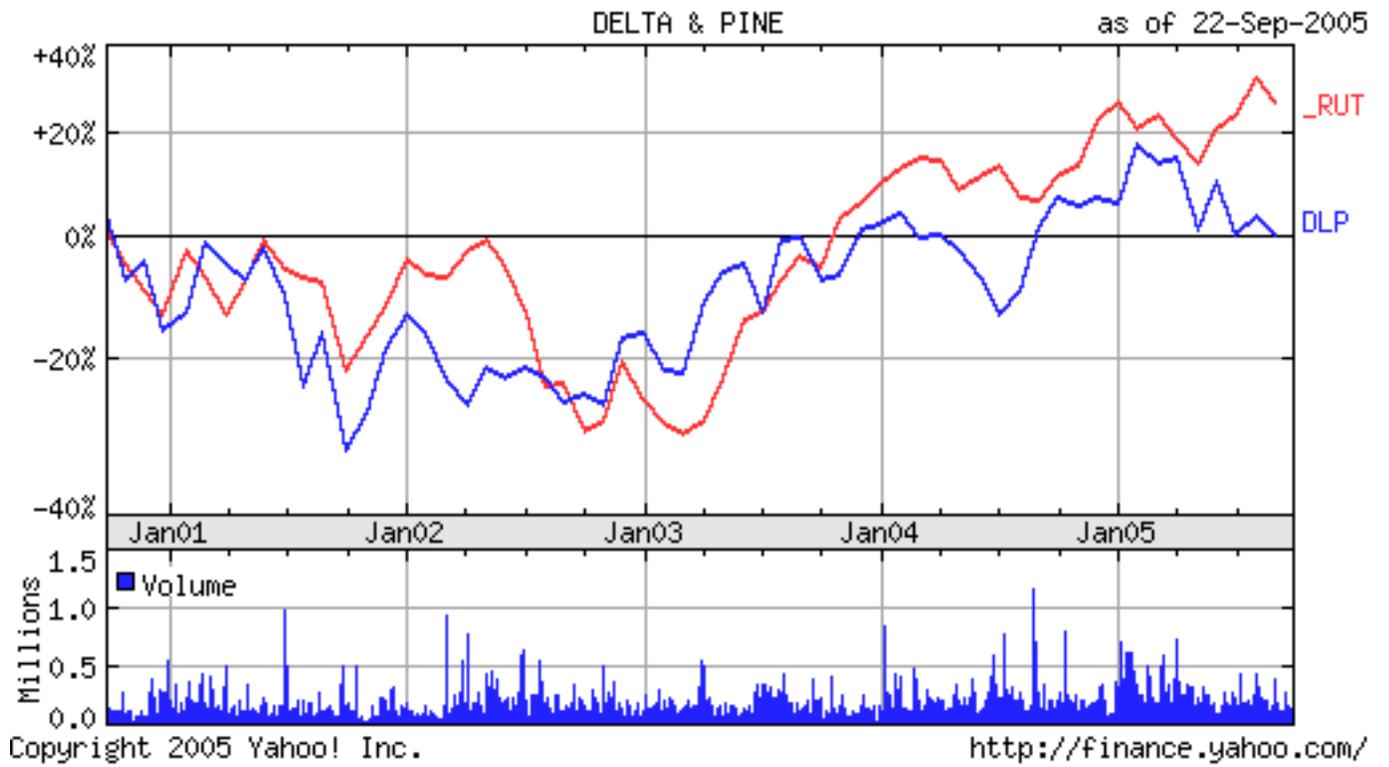
- Farm subsidies: Any changes in government subsidies to cotton planters may greatly affect the acreage planted. In 2002, the company's revenues were hit by the late passing of the U.S. Farm Bill. Total acreage of cotton planted in the U.S. fell by 8%, which translated into lower sales.
- Commodity prices: Cotton prices generally vary year-to-year, and affect the total planted acreage.
- Government regulation: Genetically modified plants have no history of causing environmental harm; however, there are still some fears among the general public.
- Legal issues related to Monsanto: Monsanto pulled out of a merger agreement in 1999. There is an ongoing suit against the Monsanto Company for damages related to their violation of the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Furthermore, DPL is in a dispute resolution and arbitration process with Monsanto. Monsanto wants to determine its rights if it chooses to pull out of the licensing agreement with DPL early.

### **Management**

CEO/President Thomas W. Jagodinski has been with Delta and Pine Land Company since 2002, when he replaced the retiring Murray Robinson. Jagodinski previously worked for Arthur Anderson in various positions. Jagodinski has a .3% stake in the company's common stock.

### **Outlook and Growth Assumptions**

- The total acreage planted has a large impact on revenues generated by D&PL. U.S. acreage growth is expected to be nearly flat, as cotton prices remain stable. Global supply has met demand. Demand is expected to grow in Asia.
- Revenue growth for 2005 is expected to be 12%. The same growth rate is expected for 2006. Most growth will come from higher margin seeds sold domestically and growth in international markets.
- Margins should stay in line with the previous year. The gross margin is expected to be around 36%, while SG&A expenses should be about 16% of total revenues.
- The stock has a projected value of \$31 and is a buy recommendation.



## LCA-Vision, Inc.

### LCAV

Price: \$37.66 (\$15.67 - \$51.32)

Fiscal Year Ends: December 31, 2005

September 19, 2005

Russell 2000 Index: 649.94 (558.36 – 688.51)

Jaelyn Jensen

Health Care Sector

*LCA-Vision, Inc. is a provider of laser vision correction services under the LasikPlus brand. The company owns and operates 49 closed-access fixed-site laser vision correction centers in the United States and a joint venture in Canada which employ laser technology to help and correct three of the most common vision impairments: nearsightedness, farsightedness, and astigmatism. LCAV is the only publicly traded US company that focuses exclusively on laser vision correction services. The company has performed over 400,000 of the estimated 4 million total procedures performed in the United States since 1995.*

### Recommendation

I believe that LCA-Vision will be able to attain at least 80% earnings growth in the 2005 fiscal year and will be able to maintain an annual growth rate of 35-40% over the next five years. The company has a strong and focused business model which has allowed it to excel in the laser eye surgery market, growing at a faster pace than the market. The current market is fragmented and under penetrated providing growth opportunities for LCAV as a specialized provider. LCAV is on target to open 10-12 locations in 2005, all of which are expected to be profitable within 3-6 months of opening. LCA-Vision has a negligible level of debt and over \$100 million in cash making it financially capable of achieving their growth intentions. I believe that the company's stock is currently undervalued and has the potential to appreciate to \$55-60 in the near term and \$80 in the long run. It also currently has a dividend yield of .85%.

### Investment Thesis

- **Significant growth opportunity.** Approximately 60 million people qualify for laser eye surgery and the number of people eligible for treatment is likely to grow at a faster rate than the number of people receiving treatment. LCAV has doubled their market share to 10% in the past two years and is continuing to pursuing an aggressive growth strategy by opening new vision centers; a center is currently within an hour drive of 35% of the US population. The company has already opened 5 locations this year, and is on target to open 5-7 additional locations by year end, bringing their market coverage to 40%. Same store growth was 39% in the past quarter and revenue growth was 53%, this is consistent with past performance and is likely indicative of future performance. Revenue estimates for 2005 range from \$184-195 million, indicating a 45-53% increase over 2004 revenues. Since last year's net income included a tax benefit, 2005 EPS is expected to decline 10% on an after tax basis. However, on a before tax basis, 2005 LCAV is on track to post at least an 85% gain in EPS.
- **Proven profitability.** The company has been profitable for over two years. LCAV has benchmarked their new stores to be profitable within six months of opening; most have been profitable within three. The 2004 pretax profit margin was 21.2% and earnings estimates project a 5% increase in profit margin for 2005.

<u>Key Statistics</u>	<u>Sept 2005</u>
Market Cap	\$773.620M
Enterprise Value	\$668.620M
Shares Outstanding	20.542M
Daily Volume	1.201M
Beta	1.79
EPS (TTM)	\$1.20
2005 Estimated EPS	\$1.38
P/E (TTM)	31.30
Dividend Yield	0.85%
Cash Flow/Share	\$1.48
FCF/share	\$1.12
Debt/Assets	0.90%
ROE	33.60%
Pretax Margin	21.20%
LT Growth Estimate	37.00%

\*Source: Bloomberg

- **Unique operating structure.** LCA-Vision converted to a closed-access facility in 1997 (meaning that they employ their own staff rather than rent out their facilities to local practitioners), which has helped to ensure consistency and quality of care. They are the only US company that focuses exclusively on laser-vision correction (TLC Vision Corporation in Canada follows a similar business model); their competitors are local providers, hospitals, and independent optometrists. LCA-Vision's specialization makes them more experienced in both marketing and treatment.

### Valuation

LCAV has experienced phenomenal growth rates over the past two years. While I do not believe that such growth is sustainable, I agree with the consensus that the company can continue to grow at an average of 37% over the next 5 years. Based on the dividend discount model, the theoretical price is \$82.84. I believe in the long run this is attainable, however in the near term I would set the target price in the range of \$55-\$59. On a relative value basis, LCAV is trading at a premium over its nearest competitor TLC Vision Corporation, with P/E ratios of 31.3 and 21.9 respectively. However LCA-Vision is in a much stronger financial condition and has demonstrated considerably higher growth rates, which I believe justifies the higher multiple.

### Risks

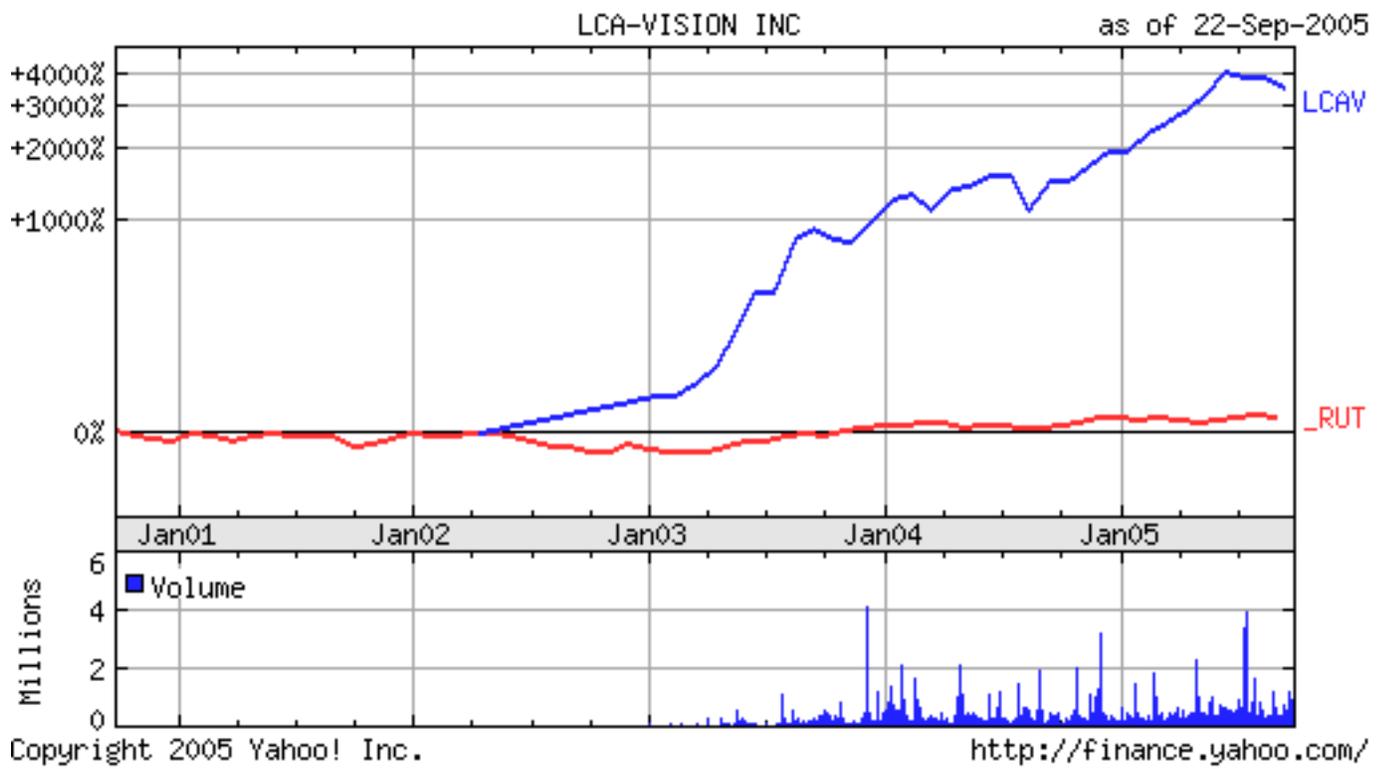
- **Revenues generated exclusively by laser vision.** Since laser eye surgery is an elective procedure it is not covered by most insurance providers, therefore demand (and revenues) may decrease in a weakening economy.
- **Deep-discounting practices of competitors.** Some of LCAV's competitors have deeply discounted prices in the past which has adversely affected revenues. Further, it is possible that a better-financed or lower-cost provider may cut into the company's market share.
- **Potential Negative Publicity.** The discovery of long-term adverse side-effects or a well publicized malpractice suit could significantly decrease procedure demand and revenue.
- **Regulatory and other legal issues.** Laser surgery procedures and equipment are subject to FDA regulation and the company could be negatively affected by changes in FDA requirements. LCAV could also become the defendant in lawsuits regarding professional liability, malpractice, or product liability. Currently, revenues are primarily private-pay, so the company is not affected by changes in Medicare and Medicaid.

### Management

LCA-Vision has a stable and competent management team. Dr. Stephen Joffe, the Chairman and CEO, founded the company in 1985, before which he held faculty positions at multiple universities and had a profitable hospital-based management business. Management compensation is reasonable and the board of directors appears to be independent.

### Other Notable Information

- LCAV has raised earnings expectations for each of the previous six quarters and then beat expectations by 20-74% each time. The positive earnings surprises have boosted the stock price in the past. It is reasonable to assume that this will continue in the near term.
- The Board of Directors authorized a share repurchase plan of 1 million shares, or 5% of shares outstanding, on May 17, 2005.
- Insider and Institutional traders have been net share purchasers in the past 45 days, although there was a significant sell off at the beginning of the year. Insiders and Institutions hold 90% of the shares outstanding.
- LCAV is actively followed by four analysts (employed at Oppenheimer, Raymond James, Taglich Brothers, and Maxim Group) all of which currently rate the stock as a buy or strong buy.



**Korn/Ferry International**  
**KFY**

Price: \$15.82(\$13.55-\$21.86)

Fiscal Year End: April

September 22, 2005

Tim Wojs

Russell 2000 Index: 651.16 (558.36-688.51)

*Korn/Ferry International is the global leader in executive search and placement services. KFY provides executive, professional, and middle-management recruitment services globally to both large and small companies. With 35 years of experience, KFY has expanded operations to 70 offices worldwide, including offices in Europe, Asia, and South America.*

**Recommendation**

I believe that KFY can continue to achieve consistent growth (12-15%) in the next couple of years, although, not at the rates that were seen in fiscal '05. Nevertheless, with its strong balance sheet, extensive global network, and high reputation in its industry, Korn/Ferry is a strong small-cap investment. Its leading position in the executive recruiting industry will drive its growth. Given that the stock price has fallen almost 15% since its earnings report on September 7, 2005 to \$15.74, but maintains its street fair value estimates of \$18-23 makes an investment even more attractive. I think that KFY is undervalued for a company of its stature in its industry and recommend a buy with a 2% portfolio weighting.

Key Statistics	Sept. 2005
S&P Rating	B-
Portfolio Weighting	2%
Market Cap	644.71 million
Debt/Capital	20%
Dividend Yield	0%
ROE LTM	17.2%
LT Growth Rate	15%
EPS '05	\$0.90
Est. EPS '06	\$1.11
Est. EPS '07	\$1.26
Average Volume	405,685
Shares Outstanding	39.1 million
Morningstar Category	Business Serv.

**Investment Thesis**

- **KFY has some of the strongest financials in the industry.** Compared to the industry and its closet competitor (HSII), Korn/Ferry has sound financials that look extremely attractive. Operating margins for fiscal '05 are 13.8%, compared to HSII's 8.58%, and the industry average of 3.98%. Gross margin has consistently been in mid-30s. KFY's quick ratio is 1.78, implying that current financial liabilities will be met. Free cash flow almost tripled this past year, going from \$29million to \$80.3million.
- **Experience counts.** Korn/Ferry has been in the executive recruiting business for over 35 years. There are currently 2.9 million executive profiles in KFY's database. Not only does KFY have a superb reputation for finding top quality talent, it also has an extensive global network, which attracts larger firms. According to Morningstar, 47% of KFY's clients are Fortune 500 companies. With a strong reputation and vast global infrastructure, Korn/Ferry can accommodate larger clients more effectively than the smaller players in the industry, making it more attractive to its customers. Most companies in the industry deal with client companies exclusively, so the emphasis on effective recruiting for repeat business is high. New computer software technology, that may not be available with smaller firms, has recently been implemented and makes searches much more efficient as well.
- **Ability to cross-market its products.** KFY has built a reputation of being the leader in executive recruiting services. With more attention being focused on its middle-management (Futurestep product) recruiting services, KFY can take full advantage of past customer relationships. With client companies relying exclusively on one recruiter to fill its positions, KFY's ability to provide

not only executive placement, but also middle-management services, makes it appealing to these firms.

- **Long-term industry trends are favorable.** In the next five to twenty years, the baby boomer population will be retiring, creating a void in the work force, especially in the executive and middle-management areas. Client companies will need to be able to fill these positions with experienced talent. Outsourcing this responsibility to more qualified companies like KFY is likely.

### Valuation

Due to the high cyclical nature of the recruiting industry, drawing on past revenue and earnings growth trends is uninformative for the most part. Because business tends to fall in-line with the overall economic cycle, looking at something like the employment cycle would be more beneficial. August '05's unemployment rate was the lowest in 4 years at 4.9%, showing that the market is still tightening. This translates into what I think will be constant growth for the next year or two. KFY is trading at \$15.74, which is a healthy discount from the Morningstar's fair value estimate of \$18, Baird's estimate of \$22, and S&P's estimate of \$23. The P/E is 16.24, which is below the industry average of 23.23. Street consensus estimates for estimated EPS in '06 and '07 are \$1.11 (23.33% yr/yr) and \$1.27 (14.4% yr/yr) respectively. A long-term growth rate of 15% is foreseeable.

### Risks

- **High cyclical nature of recruiting industry.** The recruiting industry is highly cyclical. According to Michael Carney, an employment analyst, "the fundamentals of the sector are relatively slow," but "the stocks move a lot faster." This fast movement is influenced by bad economic news and the release of monthly employment numbers.
- **Low barriers to entry.** There are virtually no barriers to entry if a company wanted to enter the recruiting business. The importance placed on relationships is extremely high, but the cost of entering this industry is relatively low.
- **Increased competition could lead to price pressure.** With increased competition, competing firms may cut prices in order to obtain market share. This could hurt KFY's profitability. But with their extensive global network and resources, KFY offers a superior service to its customers. Reassuring the client companies that better recruiting service will be realized at a slightly higher price is essential.

### Management

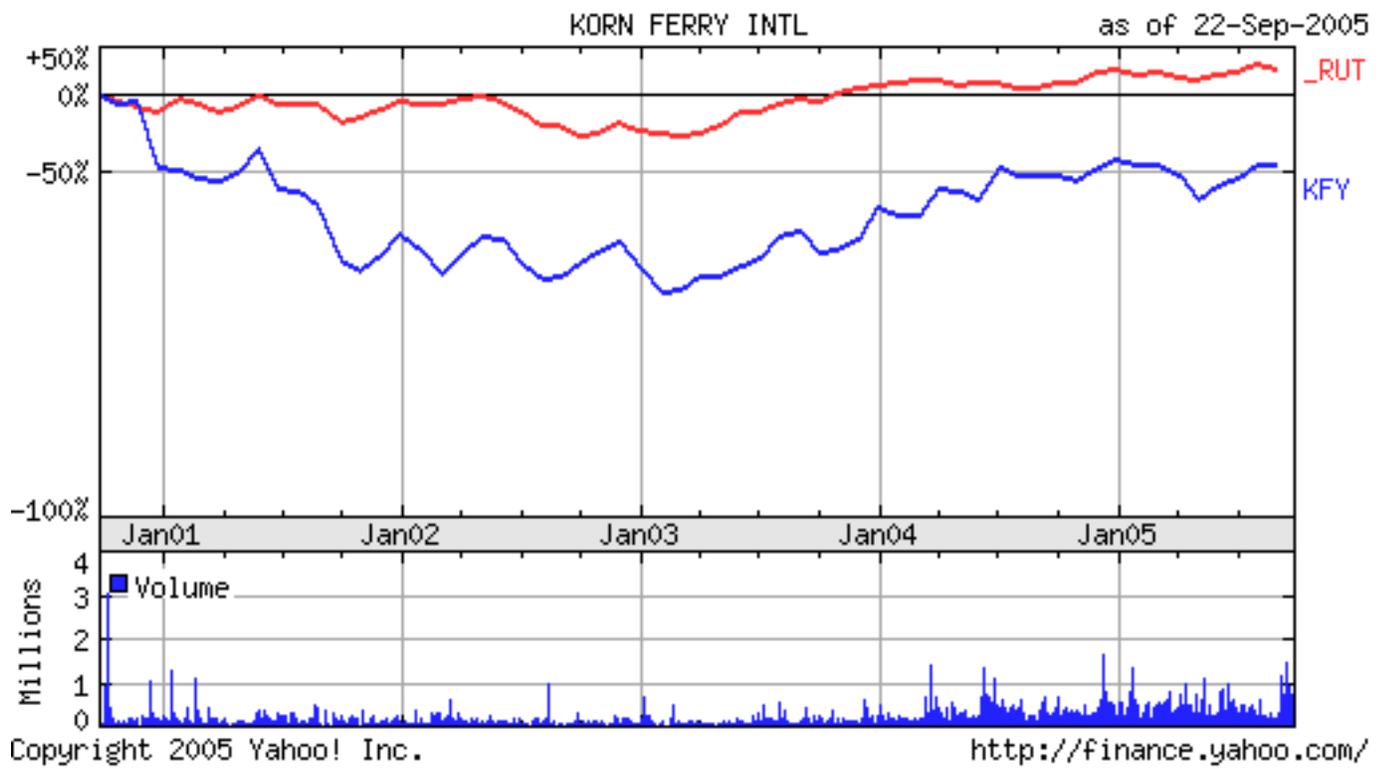
Paul Reilly, former CEO for KPMG International, has been the CEO of Korn/Ferry for a little over four years now. The current management is responsible for the KFY's recent growth and success. The company's executive compensation is one of the highest in the industry, with Reilly receiving a bonus of \$1.05 million in 2004.

### Outlook and Growth Assumptions

- For the first quarter of fiscal '06, KFY's earnings met consensus estimates of \$0.27 which translates into growth of 28.6% yr/yr. Revenues were up 19% yr/yr, rising to \$122.2 million.
- A softer than expected forecast for the second quarter of fiscal '06, which was due largely to the slower demand for KFY's services during the vacation season of late summer. Executives usually defer their recruiting services until the fall.

Long-term financial goals:

- Growth rate of new clients in the upper-single digit to lower double-digit range. Revenue growth of 15% long-term is expected.
- Margins should continue to rise above competitors' as KFY's new software and economies of scale boost efficiency. Continue to increase revenues from their Futurestep product.



## Edge Petroleum Corporation

### EPEX

Price: \$23.53 (\$12.46-\$24.75)

Fiscal Year Ends: December 31, 2005

September 22, 2005

Ryan Berg

Russell 2000: 650.67 (558.36 – 688.51)

*Edge Petroleum Corporation is a rapidly growing Houston based independent energy company engaged in the exploration, development, and production of crude oil and natural gas with operations focused onshore in the United States, primarily along the Gulf Coast and Permian Basin of Texas and New Mexico.*

### Recommendation

Edge Petroleum is a fundamentally strong growth story, and represents a good value trading in-line with peers' valuation multiples. EPEX is among the best in their peer group in almost every category of fundamental performance. Furthermore, they have demonstrated a great ability to pursue successful exploration projects, finding 30 of their last 31 drillings to be apparent successes. Finally, their conservative capital structure and successful risk management hedging techniques make them a relatively safe bet in a risky business. Combining these factors with the continued upward pressure on oil and gas prices, it appears Edge is poised to continue to outperform their peers for the next several years.

<u>Key Statistics</u>	<u>Sept 2005</u>
Market Cap	403.27M
Average Daily Volume	210,406
Beta	1.365
EPS(TTM)	1.33
2005 EPS estimate	1.85
P/E (current)	17.64
Forward P/E	12.72
Operating Cash Flow/Share	3.24
LT Debt/Total Capital	11.73
2004 ROIC	11.22
Operating Margin	36.93
LT Growth estimate	15%

### Investment Thesis

- **Successful Exploration Projects:** Through the end of August, they have drilled 31 total wells, of which 30 have been successful. This 97% success rate is unprecedented and should pay dividends down the road.
- **Additional Capacity for Growth:** Despite the fact that rig day rates have been climbing steadily with the price of energy products, Edge took the bold move of contracting four additional rigs in a tight market where additional rigs are very hard to find. This will be costly, but judging by the current oil price environment, it could prove to be a very positive long-term strategic move.
- **Beneficial Hedging Contracts:** Also, they have done a good job of hedging without completely negating the upside of such a bullish commodity price environment. They have successfully hedged about 45-50% of their 2006 production and locked in great prices by entering into the following collar contracts:
  - 10000 Mcfe per day with a floor of \$7.00 and a ceiling of \$10.50
  - 10000 Mcfe per day with a floor of \$7.00 and a ceiling of \$16.10
  - 400 Boe per day with a floor of \$55.00 and a ceiling of \$80.00

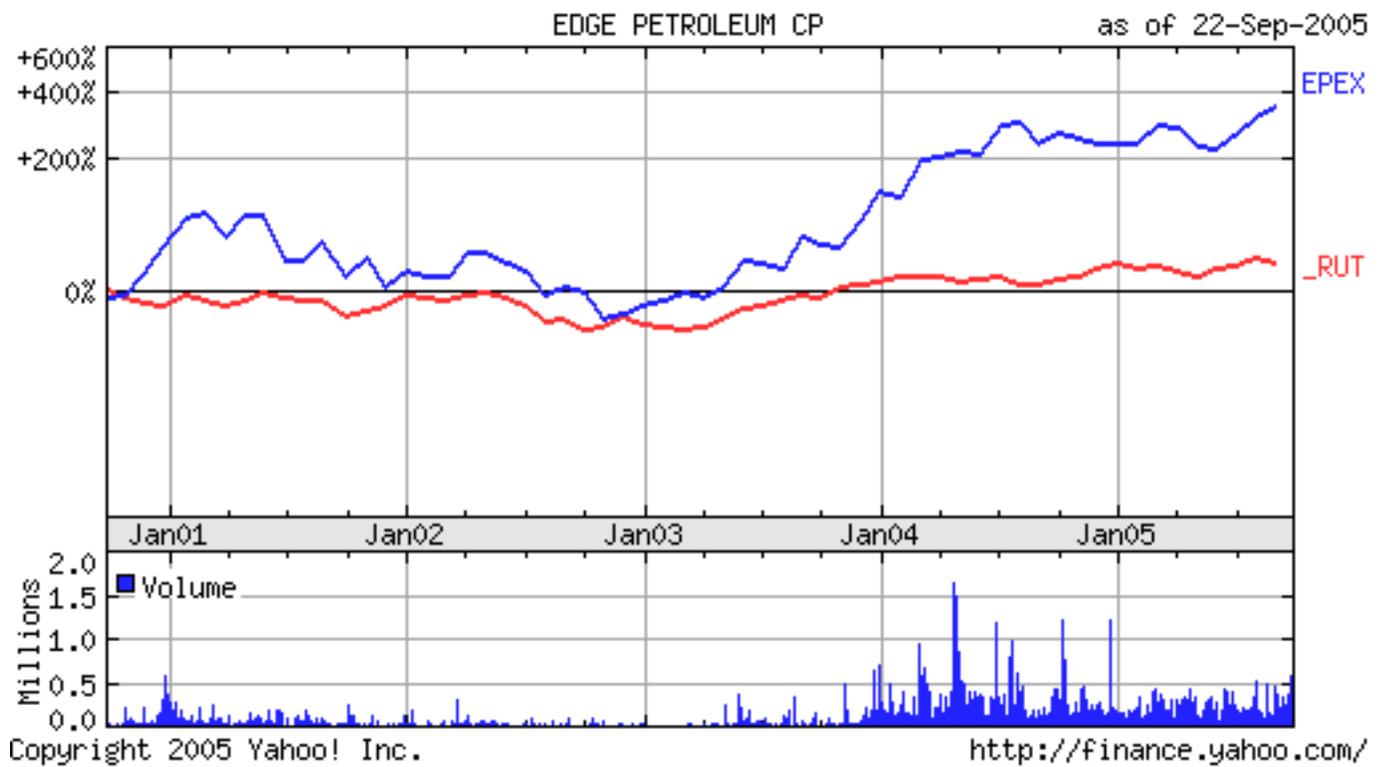
- **Production Growth Among Industry's Best:** They demonstrate a strong historical record of growing production, posting a compound annual growth rate of 19% from 2001 through 2004. For 2005, production growth is expected to be between 45-50%.
- **Growth Through Acquisition:** Recently, Edge made what appears to be a very synergistic acquisition in South Texas, an area they have been very successful in and know very well. Furthermore, the premium paid for this acquisition likely did not fully anticipate the extent of the rise in oil prices or the likelihood that \$50 oil could be here to stay.
- **Good Financial Condition:** They have a strong balance sheet, with less than only \$13 million in total debt. This represents only 7% of their total capital structure. They have been able to finance their growth internally, which is impressive at the rate they have been growing.
- **Impressive Relative E&P Metrics:** Edge performs very well relative to their peer group in three key E&P metrics: reserve replacement costs, finding and development costs, and reserve replacement ratio. Through 2003, within a group of nine peers, they ranked third in reserve replacement costs, third in finding and development costs, and fourth in reserve replacement ratio.

### **Valuation**

On an EV/TTM EBITDA basis, Edge is trading at a discount to its peers, at 6.85 compared to the average of 11.09. On a Price/Sales basis, Edge is trading relatively in-line, at 4.78 versus the average of 5.86. Finally, using a DCF analysis with a growth rate of 15% for 10 years and 6.25% thereafter, and using a cost of equity of 11%, Edge is valued at a price of \$26.87, which would yield a return of 14.2% from the current price of \$23.53. These estimates are conservative given Edge's recent strong growth. If oil prices are sustainable at or around their current levels, this DCF valuation offers significant upside potential. The recommendation is to buy Edge at anything below \$25 and a sell at \$32.

### **Risks**

- Hurricane Rita poses a very serious threat to this company. Their main operations lie along the Gulf of Mexico in Texas, Louisiana, and New Mexico.
- Another significant risk to this Edge Petroleum's stock price is the volatility of oil or natural gas prices, which are the main drivers of margins for oil and gas companies.
- There is also a significant amount of risk involved inherently in the process of exploration and drilling for hydrocarbons. A significant amount of costs are incurred in the process, and if no hydrocarbons are found, all of these costs are sunk.



## AudioCode

AUDC

Price \$10.54 (\$8.67 - \$17.00)

Fiscal Year End: December

September 20, 2005

Greg Rawls

Russell 2000: 651.16 (558.36-688.51)

*AudioCode has been working on network data transmission including VoIP technology since 1992. AudioCode develops both parts for original manufactures as well as systems that include media gateways and media servers. AudioCode products include media gateway systems, Voice over Internet Protocol (VoIP) communication boards, VoIP media gateway modules, VoIP chip processors, and analog media gateways for access and enterprise solutions.*

### Recommendation

AudioCode is considered an attractive buy at its current level due to the tremendous growth that is in store for the data transition especially the VoIP industry. As a result of continuing growth in VoIP communications, AUDC will be able to grow at around 40% over the next few years. VoIP will grow at a phenomenal rate as the technology becomes more available to consumers world wide through companies like Google and Yahoo who recently began to offer this service. AUDC has been poisoned in the industry and is prepared to establish themselves as the major supplier of data transmission hardware for several of telecoms original manufactures.

<u>Key Statistics</u>	September 2005
Portfolio weight	2%
Morningstar Rating	Four Stars
Market Cap	\$431 million
LT Debt/Total Cap.	49.7
Dividend Yield	0%
ROE	8.5%
Bloomberg Est. LTG Rate (5 yr)	37.25%
Thomson Consensus Rating	1.89
P/E Fiscal '05E	44.1
P/E Fiscal '06E	23.42
Morningstar Sector	Hardware
EPS 2005	\$.30
EPS 2006	\$.44
EPS 2007	\$.55

### Investment Thesis

- **Exceptional growth is anticipated to occur for VoIP in the upcoming years.** The VoIP market is preparing to grow at an exceptional rate in the upcoming years and AUDC is positioned to benefit greatly from this. VoIP is has a clear price advantage compared to traditional voice communications that will help to accelerate its growth and adoption by consumers. With the recent entry into the market by companies such as Google and Yahoo VoIP and its benefits will be introduced too much more of the world population. A survey commissioned by Level 3 indicated that 60% of people have heard of VoIP while only 4% have used the service. Going a step further they fully explained the benefits of VoIP and then 71% of the people stated that they would consider switching from conventional service. VoIP is also expected to do well in developing nations because of the wireless aspect of VOIP.
- **AUDC has experience working with VoIP.** AUDC has an advantage working with VoIP because they have been involved in the development of VoIP and data transfer since 1992. Over time, AUDC has established good relationships with several large telecom manufactures including Nortel, 3Com, Alcatel and Siemens.
- **Initial phase of growth has been spectacular and should continue to boom given that improved communications, especially VoIP, is in infant stages now.** The initial booming effect of the improved VoIP communication is already being reflected in the financial performance of the company over the past two years. Revenues have increased by 62%, 87% and 73% in 2003, 2004 and the TTM respectively.

## Valuation

AUDC has averaged around 70% revenue growth over the last two years. The trailing PE ratio for AUDC is 44.1 and the forward PE for AUDC is 23.42. The average 5 year growth rate for AUDC is 37.25% according to 10 analysts surveyed by Bloomberg. A twelve month target price for AUDC is \$15 a share based on a discount cash flow model that included a 37% growth rate over the next five years, 8% growth rate at maturity, EPS of \$.30 for this year and a discount rate of 10.89%. A lower level that would be considered for sale of the stock would be \$8 a share. The stock is a buy recommendation.

## Risks

- **Political risk.** With AUDC being headquartered in Israel there is an extremely high amount of political uncertainty that affects them. There is a chance that AUDC could be negatively affected by the continual instability of Israel.
- **Exchange rate risk.** AUDC has sales all over the world and could be affected by large changes in currency rates.
- **Increased competition.** AUDC will likely see the emergence of several other companies becoming involved in the VoIP market given its tremendous growth outlook. This will likely result in a decline in profit margin.
- **Customer concentration.** 19% of AUDC's 2004 revenue was with to Nortel. There is a trend of greater customer concentration at AUDC as well. Their top three customers accounted for 29%, 27% and 22% of all revenues in 2004, 2003 and 2002 respectively.

## Management

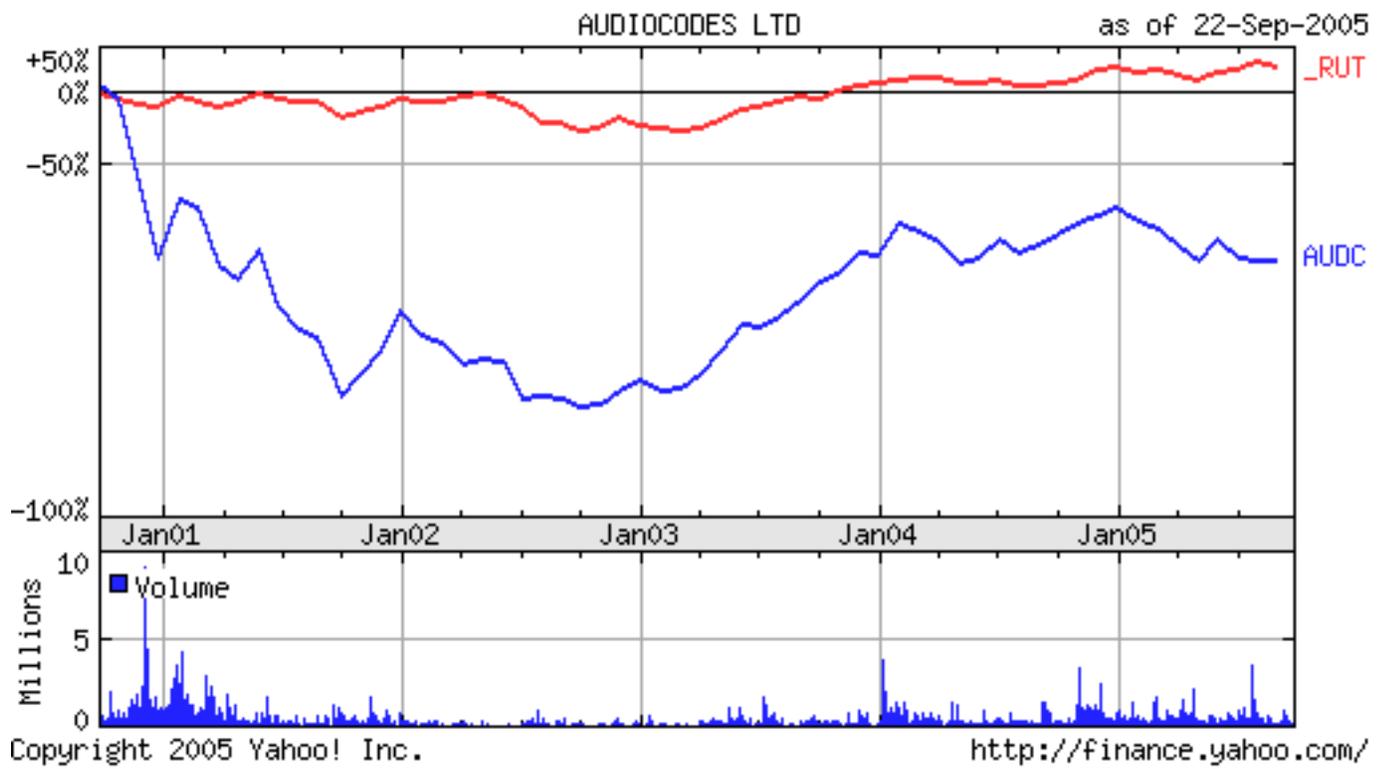
Management is a strong point for AUDC whose CEO is co-founder Shabtai Adlersberg who currently owns 13% of the company. AUDC also has stock option plans in place for not only the rest of management but all of their employees.

## Outlook and Growth Assumptions

- EPS for the second quarter where in line with the street's estimates of \$.07 a share. Revenues increased by \$9.4 in the 2<sup>nd</sup> quarter of 2005 that is up 49% compared to 2004 2<sup>nd</sup> quarter results.
- EPS guidance for the third quarter of 2005 is \$.08 a share and that would be a 50% increase compared to the 3<sup>rd</sup> quarter of 2004
- Average analyst estimates EPS for fiscal 2005 to be \$.30 and that would be an increase of 250% compared to 2004 EPS of \$.12.

Long-term financial goals:

- AUDC has a 5 year growth rate average of 37.25% and an 8.1% growth rate at maturity.
- AUDC's operating margins are currently at 10.4% and are expected to continue to increase over time as revenues increase.
- It is worth noting AUDC has in the last three years reported earnings that exceeded the streets estimates 83.3% of the time.



## Salem Communications

SALM

Price: \$17.78 (\$16.44 – 27.46)

Fiscal Year Ends: December

September 23, 2005

Paul Zandt

Russell 2000: 651.16 (558.36-688.51)

*Salem Communications is radio broadcasting company specializing in religious programming. The company currently owns and operates 105 radio stations around the country, with 68 stations serving the top 25 largest U.S. markets, including New York, Los Angeles and Chicago. Salem has also developed a radio network that offers talk, news and music content with Christian and family themes to listeners around the United States. Salem has been aggressively expanding in recent years, and continues to focus on acquisitions in the top 50 U.S. radio markets.*

### Recommendation

Salem Communications is poised for a 20% annual earnings growth rate over the next five years, which is well above the radio industry average. While the audience for many radio stations has been fragmented by music downloading and MP3 players such as iPods, talk radio seems to have been unaffected by this trend. In addition, the demand for religious programming has increased in recent years, and Salem appears to be serving a healthy niche of listeners with minimal competition on a national level. With music sales down and music downloading continuing to be a detriment to other musical formats, Salem should be one of the few radio companies that thrive in the next several years.

Key Statistics	Sept. 2005
Portfolio weighting	1%
Credit Rating	B+
Market Cap.	\$442.7 million
Cash flow margin	11%
Dividend yield	0%
ROE	4.89%
ROA	3.64%
LT Debt to Total Capital	55.60%
Price to book ratio	1.93
Trailing P/E	36.69
Forward P/E 12/06	25.25
Estimated 2006 EPS	0.67
Morningstar Sector	Media

### Investment Thesis

- **Stable and growing audience base.** While the audiences of many radio and television stations are being fragmented from music downloading and MP3 players, this is less of a threat to Salem's religious broadcasting content. The mixture of Christian-based news talk and music programming is far less accessible on the Internet and less available for downloading. Salem Communications caters to a faithful niche audience that is steadily growing. Religious radio listenership in the U.S. has grown 28% in the past five years.
- **Fairly wide economic moat as a religious broadcaster.** Though radio in general tends to have a very narrow economic moat, Salem Communications is an exception. With its nationwide network of 105 radio stations, Salem has very little competition – both on a local and national level. For four consecutive years, Salem's same station revenue growth has outperformed the industry.
- **Strong growth should continue well into the future.** Salem Communications' radio stations are well-positioned for continued growth, considering the nature of their programming and their audience, which both appear to be less susceptible to competition from the Internet or iPods. 44 of Salem's stations have a Christian Teaching and Talk Format and an additional 31 employ a news talk format. 15 other stations have a Contemporary Christian Music (known as the Fish® Format), which has little, if any, competition in the markets those stations serve.

## Valuation

Salem Communications has experienced steady revenue growth in the past five years, averaging 15.5% per year. Street estimates are for annual revenue growth rates of 10-15% and annual EPA growth rates of 20% over the next five years. My target price is \$28.57, based on an annual revenue growth rate of 10% and an annual free cash flow growth rate of 14%. The current market price is \$17.78 and SALM is a buy recommendation.

## Risks

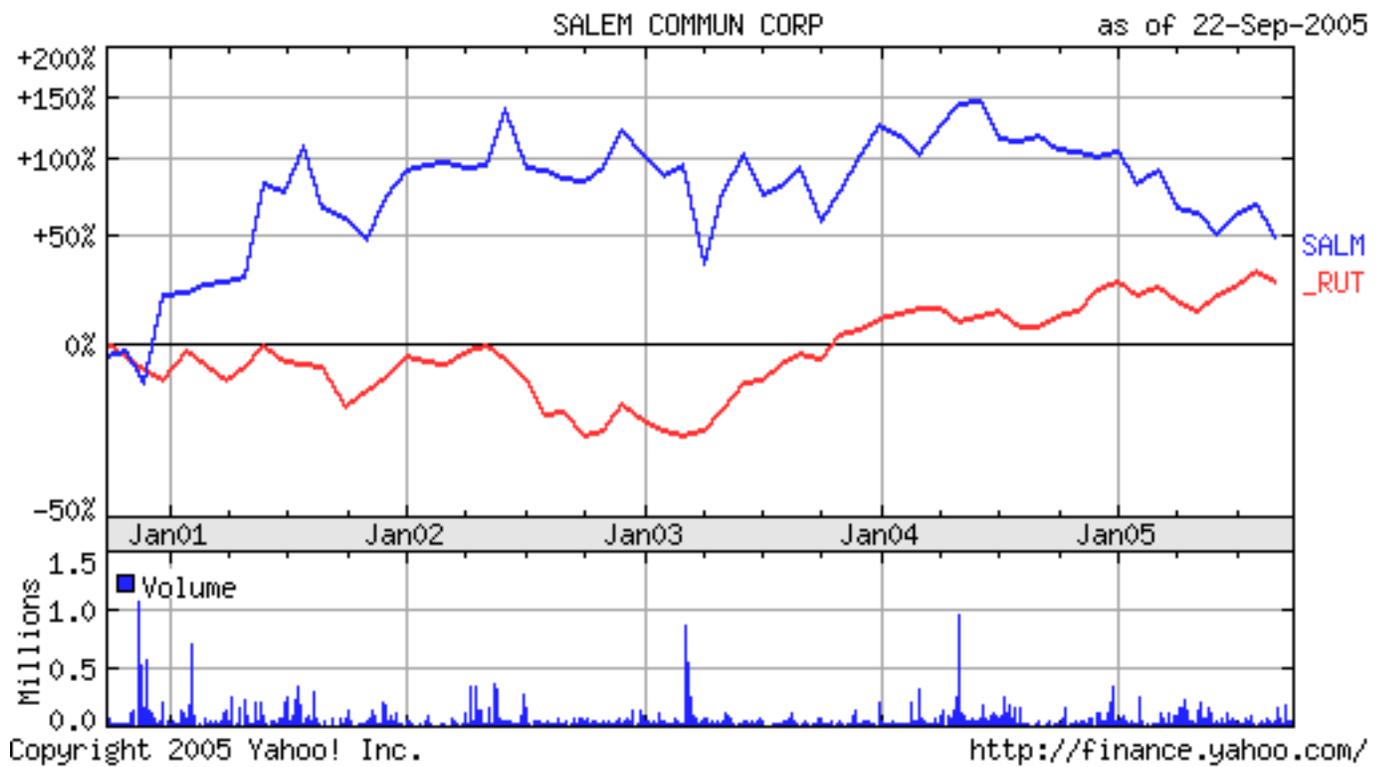
- **High relative valuation.** SALM's trailing P/E ratio of 36.69 is high compared to other media stocks. The company will have to continue its impressive revenue and earnings growth, well above the radio industry average, in order to grow its stock price.
- **Increased competition from potential entrants into Christian-base programming.** While Salem Communications currently enjoys a very dominant position in serving this niche, competition from other networks wishing to duplicate its success may eventually threaten Salem's growth potential.
- **Continued slump in the media sector.** Investors remain hesitant to invest in radio and other traditional media companies, which have generally experienced audience erosion in the past decade from the new media. Increasing competition from satellite radio also remains a concern. At the present time, there is no indication that investor sentiment will change in the near future, and this may continue to create a drag on Salem's stock price.
- **Restrictions by the FCC on ownership of multiple stations in each market.** In 2003, there was reason to believe the FCC restrictions would be relaxed, but changes to those restrictions have been put on hold. Current FCC rules limit the company's ability to acquire additional radio stations and fully develop its "cluster strategy," which results in operating efficiencies in markets where it owns more than one station.

## Management

The management team, led by President and CEO Edward Atsinger III, has been highly effective in growing the business and strategically expanding into key markets through the United States. In the past six years, the company has more than doubled the number of stations it owns and operates (from 46 to 105), while keeping its long-term debt at a manageable level.

## Outlook and Growth Assumptions

- On September 20, Salem raised its third quarter revenue outlook from \$50.3 million to \$50.8 million, based on growth at new stations.
- In the second quarter, the company beat analysts' EPS expectations by \$0.01, posting a profit of \$3.6 million, or 14 cents a share. Revenue in the second quarter grew by more than 8%.
- Estimates for earnings growth rates are 20% over the next five years. Many of Salem's radio stations are in the start-up and early development stage, and the company believes these stations represent a significant opportunity over the next several years. SALM is currently undervalued and is a buy recommendation.



## North Pittsburgh Systems Inc.

### NPSI

Price: \$19.51 (\$17.33-\$26.24)

Fiscal Year Ends: December.

September 22, 2005

Jason Toellner

Russell 2000: 647.35 (558.36 – 688.51)

*North Pittsburgh Systems, Inc. (NPS), through its subsidiaries, provides telecommunication services and equipment in western Pennsylvania and Pittsburgh. Its subsidiaries primarily include North Pittsburgh Telephone Company (NPTC); Penn Telecom, Inc.; and Pinnatech, Inc. NPTC operates as an incumbent local exchange carrier that provides various services to approximately 71,500 business and residential access lines in western Pennsylvania. Penn Telecom, through its optical fiber cable network, offers broadband services and long distance services, as well as provides traditional key and private branch exchange systems to business customers. Pinnatech principally provides Internet and broadband-related services. North Pittsburgh Systems provides directory advertising and billing, as well as sells telecommunications equipment. The company is based in Gibsonia, Pennsylvania.*

### Recommendation

North Pittsburgh Systems, Inc. should be able to achieve annual double digit earnings growth over the next several years. The company is a leader in adoption and innovation of new wireless technologies and features with in the western Pennsylvania area. With its planned launch of Voice over IP (VoIP) services by the end of 2005, NPSI will enhance its diversification of the telecommunication / wireless services that it offers. The business model generates solid ROE, OM, and dividend yields comparative to the industry as well as generates a solid free cash flow. NPSI pays a dividend yield of 3.7% and has an intrinsic value of \$24; it is a buy recommendation.

Key Statistics	Sept. 2005
Weighting	1%
Market Cap	\$307M
LT Debt/Capital	23.16%
ROE	24.04%
Dividend Yield	3.70%
Operating Margin	26.35%
Current P/E	14.52
EPS 05E	\$1.40
Rev 05E	\$110.7M
Free Cash Flow	\$26.33M
Morningstar	
Category	Telecommunications

### Investment Thesis

- **New technological advances in Telecommunications industry.** There is an evident trend towards wireless communication in the United States. The cell phone keeps evolving regularly into a more sophisticated device. Estimated handset growth through 2010 is to be roughly 10-15% annually. The U.S. market is well penetrated, but replacement technology and advanced wireless features will have numerous growth capabilities as the technology continues to become more sophisticated. For NPSI double-digit earnings growth should be achievable through its diversification and the adoption of new telecommunication services.
- **Strongest player in niche market combined with adoption of new services.** North Pittsburgh Systems, Inc. has a stable market within Pennsylvania with little competition other than from wireless giant companies such as Verizon and Sprint. However, NPSI currently has contracts with many of the larger telecommunications companies to provide some wireless services to their customers. Market growth is limited within the area, but there has been a steady increase in suburban growth in western Pennsylvania since the mid 1990's. With VoIP expected to be released by late 2005, NPSI should be in a favorable position with a large number of customers who could be updating their technology during the Holiday season.

- **Improving, profitable business model.** NPSI has had solid improvement in nearly every major financial measure since 2000. The operating margin has been steadily increasing every year and is currently at 26.35%. With NPSI's recent overhaul of their old software, 2005 should see more efficiency. North Pittsburgh Systems, Inc. boasts some of the best current and quick ratios within in the industry, in addition to their strong return on assets and return on investments ratios compared to the industry.

### **Valuation**

Using the discounted cash flow model an intrinsic value of \$24.76 was computed using a cost of equity of 12.44% and a growth rate of 9.37%. The stock may be currently undervalued by as much as 25%. With a 3.7% dividend, the stock is a buy recommendation.

### **Risks**

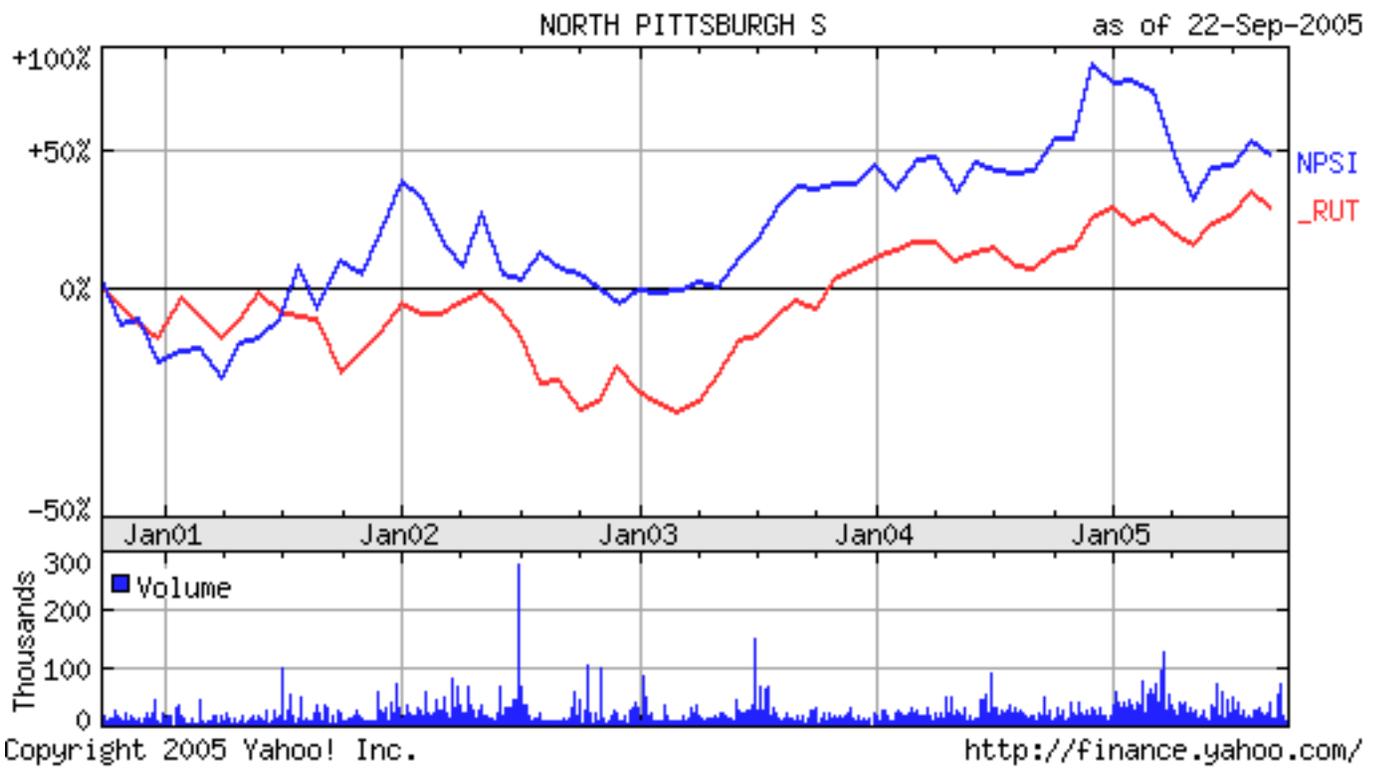
- **Regulatory Issues.** The entire telecommunications industry has been under numerous regulatory issues over the past decade and additional unexpected issues could arise at any time. However, NPSI receives subsidies as a rural carrier and is able to maintain a firm grip on competition as well as maintain solid operating margin numbers. Regardless, any negative development in industry regulations would have a negative impact on the industry as well as NPSI.
- **Competition and Pricing.** The communications industry has become increasingly competitive which has resulted in pricing pressures on service offerings within the industry. Also, many of NPSI's competitors, such as Sprint and Verizon, have many more resources and options to offer to their customers.

### **Management**

The management team at NPSI has been a solid team since the mid-1990s. The team is regarded as high quality and efficient. CEO Harry Brown has been in charge since 1998 and is currently 68 years old.

### **Outlook and Growth Assumptions**

Revenue is expected to grow between 6-8% and EPS is expected to fall within the range of 10-15% growth for the years to come. Current estimates for '05 include revenues of \$115M and an EPS of \$1.40. With a 3.7% dividend yield and an undervalued market price, NPSI is a buy recommendation.



**Quality Systems, Inc.**  
**QSII**

Price \$70.00 (\$62.00 – \$85.00)  
Fiscal Year Ends: March

September 20, 2005  
Russell 2000: 647.35 (558 – 688)

Christopher Cunningham

*Quality Systems, Inc. designs, develops, and markets its software for healthcare information systems designed to automate and improve the efficiency of certain administrative tasks to dental and other specific practice groups, as well as to hospital organizations, ambulatory care centers, and other medical and health centers. All of QSII's software packages operate on Windows-based systems. QSII is composed of the QSI Division and NextGen Healthcare Information Systems, Inc., a subsidiary. The QSI division focuses on the development and marketing of software packages to the dental and specialized groups, while NextGen develops and markets the company's products to the more general healthcare organizations. The company is headquartered in Irvine, California.*

**Recommendation**

I believe QSII can achieve 30% annual growth of earnings for at least the next five years, based on their present growth opportunities from the expanding and changing healthcare services market. In order to stay competitive, many healthcare groups are incorporating more technology in their daily business practices to cut costs and facilitate faster, more effective service. I am particularly impressed with the company's gross margin, currently over 64% TTM - which has been increasing over the past several years. Valuation of the company supports a \$68 - \$72 intrinsic value estimate. The stock has a current dividend yield of 3.4% and is a buy recommendation.

Key Statistics	Sept. 2005
Weighting	1%
Market Cap	\$847M
LT Debt/Capital	0%
ROE	26.24%
Dividend Yield	3.4%
P/E Fiscal '06E	41.94
P/E Fiscal '07E	32.82
Morningstar	
Category	Software

**Investment Thesis**

- **Impressive growth throughout the last few years.** The company's financials show very positive growth in earnings, revenues, gross margins, and operations for the past eight years. QSII has seen 15 concurrent quarters of revenue growth to date. Revenues this year are predicted to grow 34% and EPS over 50%.
- **Growing client group and need for their products.** The healthcare services sector has been expanding as an increased number of people utilize more complicated and specialized healthcare groups for their ailments and needs. Competition among these healthcare providers is fierce and one thing that differentiates one apart from another is speed and efficiency of service. Much of this can now be augmented by incorporating greater technology and automation into these providers' businesses, allowing increased growth for companies like QSII. Also, with the aging baby boomer generation, I expect to see an increase in demand for healthcare services as these aging healthcare consumers embrace and utilize the scientific advances recently discovered and developed. QSII has also diversified its customer base worldwide, which greatly increases the possible clientele group the company can service.

- **Strong management has increased customer confidence.** QSII's management focus is on strong customer service, which has helped them grow market share. Customers can obtain help 24 hours a day, 7 days a week through the company's customer service and support center. After signing a deal to implement a software package at a healthcare organization, the employees there receive a full tutorial of their purchase.

### **Valuation**

For the last three fiscal years, Quality Systems has reported over 26% average annual revenue growth, and over 42% average annual earnings growth. I feel that the fair value of QSII is \$70, and could increase from there as investors look ahead to even more positive earnings growth in upcoming years. The current P/E ratio is 48 which is well above the industry ratio of 29.

### **Risks**

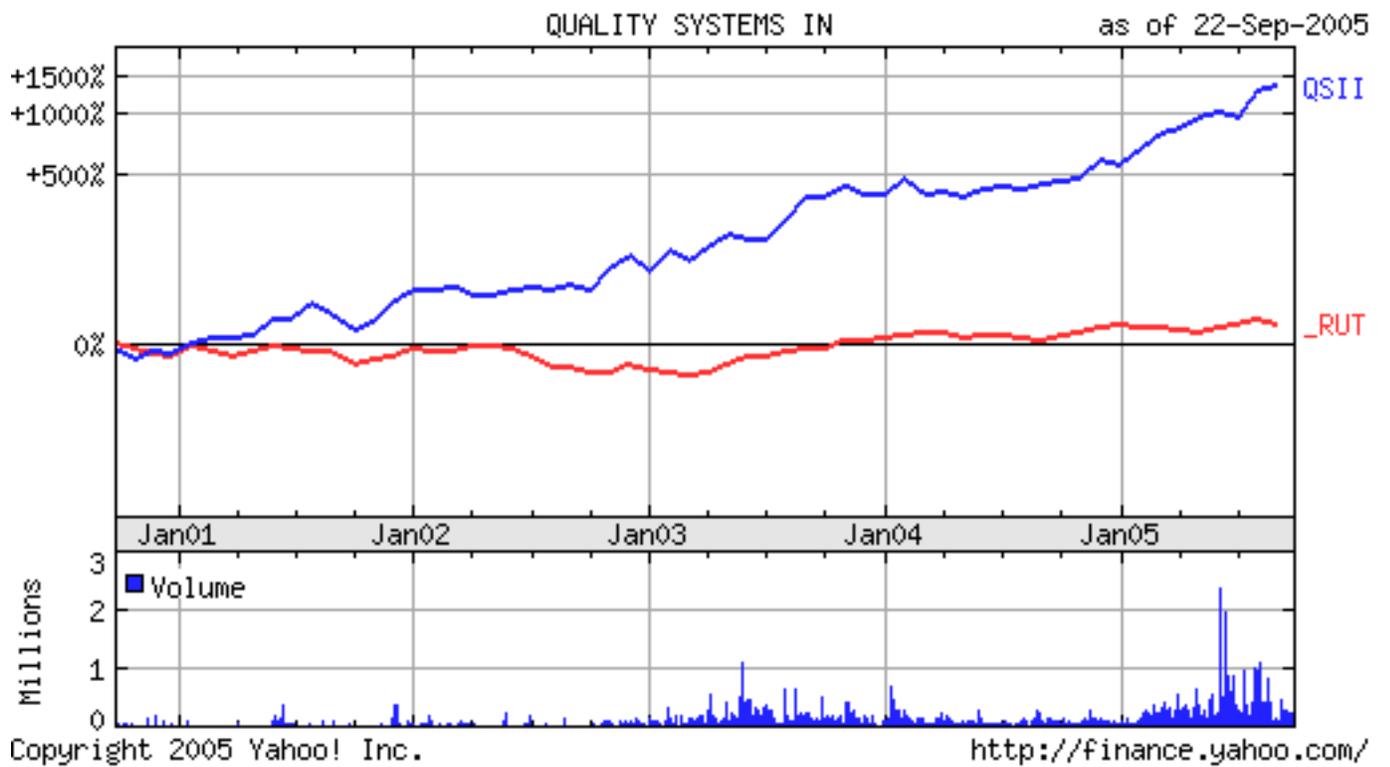
- **Last year NextGen operations constituted 82.7% of revenues.** While this division services the more general healthcare group, which is a larger group than the more specialized organizations, having that much revenue derived from a single company division is risky. Last year NextGen revenues grew by 45.8% and 35.2% in FY 2004 and 2005, respectively.
- **The QSI division has seen some declining revenues.** This division declined 5.3% and 6.8% in 2004 and 2005 respectively. This has not been felt in revenues and earnings because this division only constitutes 17.3% of revenues.
- **The healthcare information systems market is becoming increasingly competitive.** Management predicts the already competitive market to become even more competitive which will present new challenges to increase the current customer base.

### **Management**

The management team is very experienced and has brought this company to an excellent position in its market. Both the CEO and CFO have been active in the company since 2000.

### **Outlook and Growth Assumptions**

- Revenue grew over 25% last year.
- Earnings grew close to 52%.
- The company can sustain its own cash growth, though they gave up some of that cash in dividends last FY.



**Pike Electric Corporation**  
**PEC**

Price: \$17.65 (\$13.60 - \$18.44)  
Fiscal Year Ends: June

September 21, 2005  
Russell 2000: 649.94 (558.36 – 688.51)

Scott Kennedy

*Pike Holdings Inc. provides outsourced electric distribution and transmission services, focusing primarily on the maintenance, upgrade, and extension of overhead and underground sub-500 kV power lines. Its customer base is comprised of 150 electric utilities, cooperatives, and municipalities in 19 contiguous states from Pennsylvania to Florida to Texas. In addition, it is widely recognized as a leader in storm restoration services. The company has been in existence since 1945, and publicly traded starting on July 27, 2005.*

**Recommendation**

I believe Pike will be able to achieve 12% earnings growth in the next few years as they realize revenues from acquisitions and on increased need for their services. Being the largest provider of outsourced electric distribution and transmission services allows PEC to have a wide economic moat. The business model generates high profitability margins and it has the ability to expand through acquisitions and continued customer satisfaction. Valuation has increased following Hurricane Katrina, and the stock should move further to the \$20-21 estimate as I believe management storm restoration revenue guidance to be conservative for Katrina and it does not include a forecast for Hurricane Rita.

<u>Key Statistics</u>	<u>Sept. 2005</u>
Market Cap.	575.84M
Portfolio Weight	1%
Dividend Yield 0%	
ROA	...
ROE	...
P/E '05	15.73
EPS 4Q '05	(\$0.65)
FCF/Sales	(1.28%)
Sector Category	Utilities

**Investment Thesis**

- **Vital to electric utilities.** There has been an increase in outsourcing of electrical infrastructure maintenance and system improvements within the industry as utilities have returned to focusing on their core competencies. Pike has a 60-year track record of expertise in its field and has become a reliable partner to its contractors. Lastly, their work is done on a per hour basis, rather than per job, which is an important revenue provider as crews are operating 24/7 after storms.
- **Trends in electricity consumption and need for infrastructure investment.** Pike services the region of the country that has experienced the most population growth in the past decade. This has resulted in increased demand for electricity and a greater need on the part of utilities and municipalities to invest in electrical infrastructure.
- **Integration of similar companies.** The Red Simpson acquisition generated significant revenues that will overcompensate for the non-recurring charges involved within the transaction. Not only does it give them greater exposure to states vulnerable to storms (Texas and Louisiana), but it also increases their workforce and familiarity with the region. Furthermore, the fleet they have acquired is, on average, in its fifth year of its ten to twelve year life expectancy.

**Valuation**

Pike Electric has averaged 10% annual revenue growth over the last 10 years. Earnings growth is forecast to be 15% over the next 7 years. Estimates for the next fiscal year imply earnings per share of \$1.44,

followed by a deceleration toward the historical 10% average due to the uncertainty of storm restoration revenue. The discounted cash flow price is \$20 for PEC shares based on the Red Simpson acquisition, as well as increased storm revenue in the near term. Whereas Pike normally expects \$30 million in storm revenue, they have doubled that estimate in response to Hurricane Katrina, but I believe they have even greater earnings potential in that field. Currently, PEC does not pay a dividend.

### **Risks**

- **Cyclical**ity. Storm restoration services are volatile and uncertain due to the unpredictable nature of the weather. Demand for their infrastructure services is also dependent on economic factors. As a result, during economic downturns, municipalities may be less likely to invest in electrical infrastructure needs.
- **Integrating Acquisitions.** In July 2004, Pike acquired Red Simpson Inc. Prior to being acquired, Grant Thornton LLP reported a material weakness in their internal control over financial reporting that could affect their internal accounting controls. They are in the process of integrating Red's operations into their own and managing their new customers. The acquisition has greatly expanded their service territory, workforce, and demands that need to be taken into account.
- **Short Notice Contract Termination.** As a part of the outsourced services sector, Pike's customers are not obligated to continue offering contracts. In addition, many of their master agreements are open to competitive bidding.

### **Management**

The management team at Pike Electric is led by President and CEO J. Eric Pike, who has been working there since 1990 and is the grandson of the business' founder. He is surrounded by a management team averaging 19 years of experience with the company.

### **Outlook and Growth Assumptions**

- Revenue increased 65.5% in the fourth quarter and 90% for the year.
- Record storm revenue of \$149.3 million for fiscal year.
- Hurricane Katrina contracts will be reflected in September quarter.
- Proceeds from the IPO went towards paying off \$122 million in debt.
- Net loss of \$0.11 per share for fiscal year 2005; loss of \$0.65 in the fourth quarter.
- Non-recurring charges excluded, net income would have been \$1.44 (non-GAAP).
- Red Simpson contributed 59% of the revenue growth, storms added 31.1%.

Long-term financial goals:

- Market penetration and expanding the geographical footprint
- Working capital increase by 67%
- Property, plant, and equipment increase by 50%
- Free cash flow goes toward relieving debt
- Lower Debt/EBITDA to 2 times

PIKE ELECTRIC CORP.

as of 22-Sep-2005



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