Applied Investment Management (AIM)

AIM Equity Fund Presentations

Location: Driehaus, Chicago, IL

November 25, 2008

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Alison Bettonville	CPFL Energia S.A.	CPL	$42.74	2
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CPFL Energia S.A. (CPL)
Price: $42.74 ($34.99-$77.98)
Fiscal Year Ends: December 31

November 24, 2008 — Alison Bettonville
S&P ADR Index: 928.56 (936.96-2085.17) — International Utilities

CPFL Energia is a holding company for Brazilian electric utilities, operating mainly in the states of São Paulo and Rio Grande do Sul. CPFL operates in three segments: generation (23% of 3Q08 EBITDA), distribution (74%), and commercialization (12%). For its generation segment, the firm's 32 hydroelectric plants and 1 thermoelectric plant generate over 1,600MW of electricity. The distribution segment annually provides 35,234 GWh of electricity to 6.3 million customers in 568 municipalities. Via its commercialization segment, CPFL sells electricity to unregulated customers (9,128 GWh in 2007) and provides value-added electricity services to a range of clients. CPFL Energia is the largest non-government owned electric utility in Brazil, privatized in 1997 after 33 years of federal and state ownership, and is now majority owned by a consortium of domestic pension funds.

Recommendation:
CPFL's dominant position in the distribution market (13.8% of Brazilian electricity distribution) offers a stable revenue source, while expansion in the generation segment through the expected addition of 500MW of capacity brings an opportunity to expand margins. With Brazilian electricity demand projected to grow at 3-4% per year, CPFL will have many opportunities to further strengthen its position in the industry. CPFL can add "free" customers to its client base through the commercialization segment; management expects this unregulated segment to realize 5% growth over the next few years. With CPL currently trading near $42.75, I recommend adding the ADR shares to the AIM portfolio with a target price of $50, representing an approximate 17% upside potential.

Key Statistics	November 24, 2008
Market Cap	R$15726.68M
Shares Outstanding	479.911M
Shares per ADR:	3
% of ADR to shares outstanding	3.73%
3 mo. avg. volume (ADRs)	192,000
TTM EPS	R$2.735
EV/EBITDA	7.67
P/E (TTM)	11.88
Debt/EBITDA	2.40
ROE	33.5%
ROA	9.3%
Beta (5 yr wkly v. SPADR)	1.29
WACC	12.6%
Dividend yield	R$4.59 (9.15%)
Target Price	**$50.00**

Source: Bloomberg

Investment Thesis:

- **Stable Distribution Business.** CPFL earns a spread connecting generators to final customers via its 196,749 km of distribution lines and 222,240 transformers; this segment offers a stable, predictable cash flows (R$1B+ OCF, '05-'07). As the largest distributor, CPFL has achieved scale in the industry, creating to strong regional positions (distributes 24% and 31.9% of electricity in Sao Paulo and Rio Grande do Sul, respectively) and maintaining relationships with generators, politicians, and regulators.
- **Growth and Margin Expansion through Generation.** Through its subsidiaries, CPFL is developing three new hydroelectric plants, adding 500MW of capacity by 2010; this

electricity will be sold to the distribution segment, leading to expanded margins. Further, through its new Bioenergia subsidiary, CPFL is moving into alternative energy production. The company predicts renewable energy to grow from 3% to 15% of Brazil's total electricity sources by 2015, and CPFL wants to be force in the market. The segment signed its first project in 3Q08, a thermoelectric generation joint venture with a sugar cane producer, expected to provide 25MW of capacity.

- **Low Foreign Exchange Exposure.** Relative to its peers, CPFL has very low exposure to fluctuations in the value of the real. The company's debt is almost entirely denominated in real, and although about 20% of the electricity purchased by CPFL for distribution is priced in US dollars, these costs can be passed on to final customers.

Valuation:

An eight-year DCF model, assuming a WACC of 12.58% and a terminal growth rate of 3%, valued the ADR shares at $49.65. On a relative basis, CPL is currently trading at 11.88 times 2008 earnings, slightly rich based on current industry and historical company multiples. It was determined that a P/E of 10 to be a fair multiple for the company; based on 2010 estimated EPS of R$4.97, an estimated value of $48.93 was obtained. Combining the two methods, $50 was determined to be a fair target price for the ADR shares. CPL also has a 9% dividend yield.

		WACC				
		11.5%	**12.0%**	**12.5%**	**13.0%**	**13.5%**
terminal growth rate	**2.0%**	$55.08	$49.78	$45.01	$40.70	$36.80
	2.5%	$58.50	$52.76	$47.62	$43.01	$38.84
	3.0%	$62.32	$56.07	**$50.51**	$45.54	$41.07
	3.5%	$66.62	$59.77	$53.72	$48.34	$43.52
	4.0%	$71.49	$63.93	$57.30	$51.44	$46.23

Risks:

- **Debt profile.** CPFL has R$738.27M of debt maturing in 2009, and will need to access the capital markets to refinance. Further, the company has been acquisitive, and will consider debt as a funding vehicle for future acquisitions.
- **Tariff rates.** Rates at which electricity is bought and sold on the regulated market and contract timing, length, and size are strictly regulated by the government. Tariffs are adjusted annually to account for inflation; CPFL has little influence on the direction and magnitude of these changes in tariffs, which directly affect the company's revenues.
- **Contract law.** Contracts are very important to CPFL's business, especially within the framework of the heavily regulated Brazilian electricity industry; should the legal mechanisms of contract enforcement not support the company's contracts, CPFL could suffer severe losses if customers reneged on their obligations to purchase electricity.

Management

Company leadership has strong backgrounds within the Brazilian power sector. CEO Mr. Wilson Ferreira Junior's previous experience includes the Distribution Executive Officer at competitor CESP and CEO of CPFL's now fully-consolidated subsidiary Rio Grande Energia. The chairman of the board, Mr. Luiz Anibal de Lima Fernandes, hold degrees in both mechanical and electrical engineering, and had experience working for two of the largest government-owned electric utilities in Brazil, CEMIG and Eletrobras. At least one of the seven members of the board of directors must be elected by minority shareholders.

CPL 1 Year Price Chart

1 Year Price Chart vs MSCI Emerging Markets

Ownership

% of Shares Held by All Insider and 5% Owners:	86.86%*
% of Shares Held by Institutional & Mutual Fund Owners:	39.37%

*Source: Bloomberg, 10-K**

Top 5 ADR Shareholders

Holder Name	Shares Held	Percent of Shares Outstanding
Mondrian Investment Partners Ltd.	648,700	.41%
Invesco Ltd.	447,778	.28%
Barclays Global Investors UK	297,706	.19%
Ivy Management Inc.	275,00	.17%
Morgan Stanley & Co Inc.	236,550	.15%

Source:Bloomberg

Gildan Activewear Inc.
GIL
Price: $16.55 ($16.34 - $43.88)
Fiscal Year End: September 30th

Date: November 22nd, 2008 | Brian Finnie
MSCI Canada Index: 15.20 (14.21 – 36.22) | International Consumer Goods

Gildan Activewear is a vertically integrated manufacturer and marketer of high-volume, basic apparel for wholesalers and mass retailers. The company produces and markets active-wear (86% of 2007 revenue), such as t-shirts, fleece, sport shirts, and underwear, in addition to socks (14%). The cotton-based "blanks" are sold in the U.S. (88% of 2007 revenue), Canada (6%) and Europe (6%) after which they can be decorated with screen prints and logos before being purchased by consumers at retailers, events, and tourism destinations. The company utilizes 15,300 employees at manufacturing and distribution facilities in both the United States and the Caribbean to produce its products. Gildan was founded in 1984 and is headquartered in Montreal, Canada.

Recommendation

Although consumer spending is expected to weaken, Gildan Activewear will withstand the deteriorating macroeconomic environment as a result of the inexpensive nature of its basic apparel and its mass production model. The current low valuation provides an attractive entry point to a leading basic apparel provider that has increased its share of the $2.5 billion U.S. wholesale market from 39% to 52% over the past two years in addition to acquiring a 30% market share in the sock market. Gildan has been able to expand its market share over the last ten quarters by growing product sales 11% above the industry on average. Importantly, during and following the last recession, from 2001 to 2004, GIL's returns outperformed the apparel maker industry and the S&P 500. Gildan will be able to outperform going forward by increasing its 52% share of the U.S. wholesale market to 60%, expanding activewear production 33% to support sales in the $22.5 billion retail market, and leveraging its mass production manufacturing facilities for socks to increase company gross margins 1%. It is recommended that GIL be added to the International AIM Equity portfolio with a target price of $20, providing an upside of 21% from the current price. The company does not pay a dividend presently.

Key Statistics	Nov. 22nd, 2008
Market Cap	$2.0B
Shares Outstanding	120.5M
Avg. Volume	1.14M
3-Yr. Rev. CAGR	21.8%
F2007 Net Rev.	964.4M
F2007 EPS	$1.07
F2008E EPS	$1.47
Operating Margin	17.6%
P/E (NTM)	8.2
PEG	0.56
ROE	21.77%
Debt/Equity	8.17%
Beta	0.965
WACC	9.73%
Analyst Coverage	15
Target Price	$20

Source: Bloomberg, Company Filings

Investment Thesis

- **Wholesale Market Share Growth.** Gildan believes it can expand its 52% share of the $2.5 billion wholesale market to 60% over the next twelve months. The company will continue to grow its market share as it has in the past through leveraging its vertically integrated manufacturing and distribution processes to provide low prices and quality service.
- **Retail Channel Expansion.** Gildan entered the $22 billion retail market in 2006 through sock and underwear sales programs to regional retailers**.** Beginning in 2010, the company plans to expand its presence in the retail market by penetrating national mass-market retailers. Gildan is preparing for the retail market expansion through the construction of a new distribution facility in

Honduras along with a new retail-only Honduran textile manufacturing facility which is expected to increase activewear capacity by 33%.

- **Sock Production Efficiencies and Expansion.** Gildan is actively expanding its 30% market share in the retail sock market by enhancing production efficiency and capacity. In 4Q08 the company completed the ramp up of production in a new Honduran sock facility which is expected to expand company gross margins 1% in F2009 as production efficiencies are realized. Another sock facility is currently under construction in Honduras and is expected to increase sock production 33% after it is completed in 3Q09. Furthermore, the company could see greater margin improvement through product distribution synergies and the elimination of unprofitable product lines.

Valuation

The $20 price target is supported by a DCF valuation and P/E analysis. A 10-year DCF yielding $19.48 per share was computed using a 3% terminal growth rate, 9.7% WACC, average revenue growth of 9% and peak operating margins of 23%. Additionally, the $20 price target assumes a very conservative 10x F2009E consensus EPS multiple, below the low end of the historical range of 11-50x EPS. Although GIL is currently trading even with comparables at 8x F2009E consensus EPS, a 10x EPS multiple is justified because of GIL's leading market share position and vertically integrated manufacturing processes. The $20 price target offers a 21% upside on the stock.

		Terminal Growth Rate				
	$ 19.48	2.5%	3.0%	3.5%	4.0%	4.5%
WACC	12.5%	$ 12.31	$ 12.73	$ 13.21	$ 13.73	$ 14.32
	11.5%	$ 14.07	$ 14.64	$ 15.27	$ 15.99	$ 16.82
	10.5%	$ 16.30	$ 17.07	$ 17.96	$ 18.98	$ 20.17
	9.5%	$ 19.19	$ 20.29	$ 21.57	$ 23.09	$ 24.90
	8.5%	$ 23.09	$ 24.72	$ 26.67	$ 29.06	$ 32.05

Risks

- **Consumer Spending Slowdown.** October results for The Conference Board Consumer Confidence Survey illustrate that consumer confidence has dropped to its lowest point in the survey's 40-year history. As consumer spending slows, retailers and wholesalers may also tighten their spending and inventory levels which would harm GIL's sales and margins. Though GIL's low cost basic apparel should be in a better position than other consumer goods to weather the downturn, it is not entirely invulnerable to macroeconomic weakness.
- **Production Levels.** On April 29th, 2008, GIL lowered F2008 guidance $0.30 in response to activewear production difficulties at its Dominican Republic facility. While there have been no manufacturing delays since then, any additional interruptions in production may impact GIL's sales and drive away customers.
- **Trade Barriers.** Although in recent years free trade has expanded, the textile industry typically has high trade barriers. An increase in negative public sentiment toward free trade may encourage President-elect Obama and the Democratic congress to implement protective trade barriers. The company estimates that an annual 5% tariff on sock sales into the United States from Honduras would result in a $0.04 decrease in EPS.
- **Class Action Lawsuit.** In June of this year a class action lawsuit was filed by investors against Gildan alleging that Gildan mislead and withheld material information from investors regarding the company's lowering of F2008 guidance on April 29th, 2008. This incident may decrease confidence in management's character or attentiveness.

Management
Mr. Glenn J. Chamandy is the current CEO of the company and co-founded the company in 1984. Mr. Laurence G. Sellyn was named the CFO of Gildan in April 1999 following various corporate finance positions at other large, public Canadian firms.

Ownership

% of Shares Held by Insiders:	8.6%
% of Shares Held by Institutional & Mutual Fund Owners:	91.4%

Source: Bloomberg

Top 5 Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
Burgundy Asset Management	11,483,278	9.53%
Fidelity Management	9,940,440	8.25%
Fidelity Management-Pyramis Global	6,121,300	5.08%
Alger Management	5,207,829	4.32%
Bank of New York Mellon	5,101,771	4.23%

Source: Bloomberg

Bank of Ireland (ADR)
NYSE: IRE
Price: $5.81 ($4.61-$65.74)
Fiscal Year Ends: March 31

November 21, 2008 Chris Cebula
S&P ADR Index: 928.56 (869.29 – 2,079.49) International Financial Services

The Governor and Company of the Bank of Ireland provides a broad range of financial services in Ireland and the UK. The Group operates primarily in four segments: Retail Republic of Ireland, Bank of Ireland Life, Capital Markets, and UK Financial Services. Bank of Ireland is the largest banking institution in Ireland by assets and operates one of the largest retail branch networks in the country. The company is a leader in both commercial and consumer lending. The Group generates about 73% of its operating profit in Ireland, 25% in the UK, and 2% from the rest of the world (primarily the US). The company was founded in 1783 and is headquartered in Dublin, Ireland.

Recommendation

Bank of Ireland has the unfortunate distinction of being the leading mortgage underwriter in Ireland. As housing prices tumbled (-14% since February of '07) and Ireland became the first Euro nation to officially enter economic recession, the Irish financial system came under significant pressure in the marketplace. The deterioration in asset quality and increasing impairment charges certainly pose risks to Bank of Ireland in the short term. However, there seems to be an unbelievable disconnect between the market value of the stock and the long term value of the business. In evaluating Bank of Ireland's capital position and the makeup of their loan portfolio, it seems as though the destruction in the stock price dramatically overstates the actual destruction of business value. A market that has been trading increasingly on short term expectations has created an incredible opportunity for investors with a long term time horizon. As we have the ability to withstand the short term volatility, I am recommending that Bank of Ireland be added to the IAIM Fund with a target price of $48.

Key Statistics	11/21/08
Market Cap	$1.46B
Shares Outstanding	251.05M
Avg. Volume	240,544
EPS (ttm)	€6.96
Est EPS (FY09)	€2.30
P/B	0.20
P/FCF	0.59
ROA	0.69%
ROE	20.05%
Financial Leverage	29.1
NIM	1.71%
Tier 1 Ratio	8.70%
Target Price	$48.00

Sources: Yahoo! Finance, Bloomberg

Investment Thesis

- **Adequate Fundamental Capital Position.** Bank of Ireland has a Tier 1 Ratio of 8.7% and a core Tier 1 ratio of 6.3%. While these ratios have increased over the past year and are at the high end of the bank's target range, Irish banks look undercapitalized relative to their UK peers after the government recapitalization in mid October. However, Bank of Ireland has no investment banking division and very limited exposure to the structured products that have caused significant write downs at UK financial institutions.

- **Well Funded Balance Sheet.** The Group has continued to reduce their exposure to the wholesale funding markets that have been particularly sensitive in the current environment. Short term wholesale funding now makes up less than 30% of their total funding. Incremental loan growth has been funded through customer deposits, which have increased 5% since March 31st. Customer deposits in the UK have increased 19% over the same time period as their joint venture with the UK Post Office has gained traction.
- **Favorable Asset Mix Relative to Irish Peers.** There are concerns over the fact that 44% of Bank of Ireland's loan portfolio is tied to residential mortgages in Ireland and the UK. However, strong underwriting standards (typically ~60% LTV) have led to minimal losses on these assets. Property and Construction development loans along with consumer loans have seen the greatest deterioration in quality in this environment. These loans combine to make up 20% of the Group's loan portfolio, whereas these loans make up 44% of loans at Allied Irish Banks and 89% of loans at Anglo Irish Bank.
- **Attractive Valuation.** The stock is trading at .20x book value, a TTM P/E of .88, and a FY09 P/E of 2.3. Bank of Ireland has no doubt been affected by the global credit crisis and will be negatively impacted by economic recession across Western Europe. However, it appears to have been oversold based on unfounded concerns over their asset quality and capital position. Bank of Ireland has been penalized in the marketplace for their geographic exposure despite the fundamental differences in their business relative to peers.

Valuation

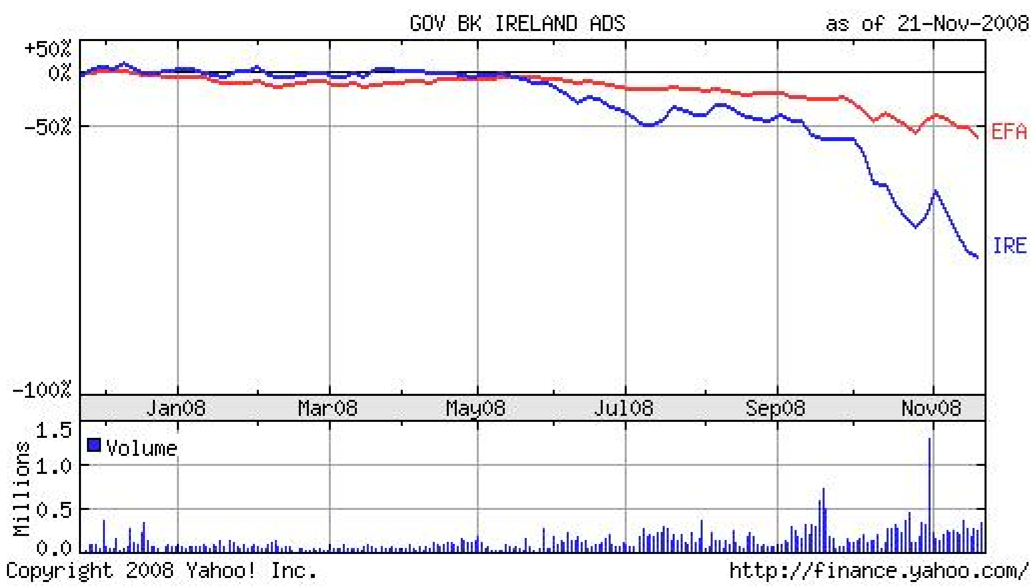
A 5-year DCF model with a WACC of 12.00% was performed along with a P/B multiple in order to estimate the intrinsic value of the business. Assuming the economic environment returns to normality in FY12 and taking both metrics into account, a price target of $48 is established.

Risks

- **Dilutive Capital Infusion.** There is pressure from the market for Irish banks to shore up their capital bases in a manner similar to that of the UK banks. While the Irish Financial Regulator has resisted up to this point, any significant capital infusion would be dilutive to existing shareholders. This could actually be a catalyst for the stock in the short term, however, it would be detrimental to our stake in the long term profits of Bank of Ireland.
- **Uncertainty Regarding the Short Term Environment.** A consortium of investment firms has reportedly made an unsolicited offer for the Bank of Ireland. Couple that with the uncertainty regarding the likelihood and structure of a potential capital infusion from the government and the stock could be particularly volatile in the short term. Also, projecting the long term prospects of the business is difficult when the make-up of the company could be materially different in the future.
- **Dramatic Deterioration in Mortgage Assets.** The last six months have provided insight into the quality of many of the assets on the Group's balance sheet. However, the negative performance in their mortgage book is going to lag the general economic downturn. The transparency on the strength of these assets hasn't been there to the point where it seems to be the most uncertain projection management can make at this time. Loan losses materially exceeding management guidance on these assets would be detrimental to the stock. Management expects impairment charges of 20 bps in FY10 and FY11 from 8 bps in FY09.

Management

Brian J. Goggin is the Group Chief Executive Officer. He joined Bank of Ireland in 1969 and has held a variety of senior management positions within Bank of Ireland Group in the US, UK and Ireland. Mr. Goggin was appointed Group CEO in June 2004. John O'Donovan has been the Group Chief Financial Officer since joining Bank of Ireland in 2001. Prior to that he was the Finance Director at Aer Lingus plc.



Top 5 Shareholders (Underlying Shares)

Holder Name	Shares Held	Percent of Share Outstanding
Harris Associates LP	57,588,378	5.73%
Bank of Ireland Asset Management	31,619,982	3.15%
Capital Research and Management	24,959,690	2.49%
DWS Investment GMBH	5,500,000	0.55%
UBS Strategy Fund Management Co.	4,715,043	0.47%

Source: Bloomberg

Open Text Corporation
OTEX
Price: $27.75 ($22.01 - $39.09)
Fiscal Year Ends: June 30

Date: November 12, 2008 — William Lunkes
NASDAQ Composite Index: $1499.21 ($1493.79-$2734.82) — International Software

Open Text specializes in the production of enterprise content management (ECM) software. The ECM suite that OTEX sells, allows its customers to effectively access and manage business content without having to switch programs. Its primary ECM solution, Livelink, enables corporations to manage traditional forms of content, such as images, office documents, graphics and drawings, as well as to manage electronic content, including web pages, email and video. In addition to this, OTEX produces a wide variety of smaller ECM solutions that focus on managing nontraditional content like wikis, as well as solutions that are complementary to business software produced by key partners. Open Text is headquartered in Waterloo, Ontario and employs 3,000 people.

Recommendation

Open Text occupies a position as a leader in the business software market, and is the largest independent vendor in the ECM market. OTEX's products increase its customer's productivity by allowing seamless management of traditional content like emails and nontraditional content like wikis. The company also maintains different code integrations to ensure that their ECM suite can work effectively with other software. This "neutrality" is very important, as the company relies on key partnerships with major business software providers to help expand their customer base. Open Text does this by creating software to complement its partner's product offering. This competency makes OTEX a very attractive acquisition target for the larger business software companies. Currently, the market is undervaluing OTEX and based on a target price of $36, a 29.7% upside is realizable using reasonable drivers. With this, a recommendation to buy has been made to take advantage of potential growth through partnerships as well as the value discrepancy affecting the company. OTEX does not pay a dividend.

Key Statistics	Nov. 12, 2008
Market Cap	$1.44B
Shares Outstanding	51.87M
Average Volume	1,124,283
Beta	1.39
Diluted EPS (TTM)	$1.01
P/E (TTM)	12.61
P/S (TTM)	1.90
Price/Book	2.31
WACC	12.88%
ROE	9.14%
ROA	3.84%
Gross Margin	68%
Operating Margin	14%
Target Price	$36

Source: Bloomberg*

Investment Thesis

- **Partnerships.** Open Text has an important network of strategic partnerships. OTEX has partnered with SAP AB, Microsoft, Oracle, and Global Systems Integrators to produce ECM packages that complement these firm's products. This has allowed the company to greatly expand their customer base. Management views this as a major business component and has reaffirmed its commitment to this strategy in guidance.

- **Consistent Earnings.** OTEX has a very steady revenue stream with 50% of FYE 2008 revenues derived from normal recurring maintenance fees. This has allowed the company to be very reliable during earnings calls. The company has not had a negative earnings surprise since Q1 2006.
- **Acquisition.** OTEX has very consistent earnings and is the largest independent vendor of ECM software in the market. Additionally, the company's product can be easily tailored to complement other business software programs. As a result, the company is a very attractive acquisition target for a larger firm looking to gain market share or increase the scope of their business software suite.

Valuation

Using a discounted cash flow evaluation of OTEX and assuming a perpetuity growth between 2.5% and 4% results in an intrinsic value between $27.16-$48.84. Assuming a WACC of 12.88% and a perpetuity growth rate of 3.5% yields a price target of $35.64. Using an EV/EBITDA valuation yields a range between $33.78-$40.49; therefore, a price target of $36 is reasonable.

Present Value of Equity Per Share At Perpetuity

		2.5%	3.0%	3.3%	3.5%	4.0%
	10.9%	$41.62	$43.72	$44.88	$46.11	$48.84
	11.9%	36.84	38.44	39.32	40.24	42.27
WACC	12.9%	32.98	34.24	34.92	35.64	37.19
	13.9%	29.81	30.82	31.36	31.92	33.14
	14.9%	27.16	27.98	28.41	28.87	29.84

Risks

- **Partnerships.** Management's current strategy relies on the use of OTEX's strategic partnerships to grow the company's customer base. Loss of a major partnership could hurt revenues. Additionally, if one of OTEX's partners begins to expand into ECM software, the company could suffer.
- **Sales Cycle.** Due to the complex nature of the company's product, a lengthy installation process is required to ensure proper integration into a customer's system. Should this process be delayed for any reason, delayed revenue recognition could cause OTEX to miss earnings.
- **Product Defect.** Software is a complex product and defects can be very costly. Defects in the development stage could become costly by causing product delays. Additionally, defects discovered post installation could be very costly depending on the severity of the problem.
- **Intellectual Property.** The company needs to protect its intellectual property to prevent competitors from stealing trade secrets. Additionally, since OTEX's product is software, there are piracy concerns.

Management

John Shackleton has served as the CEO of Open Text since 2005. Prior to this position, Mr. Shackleton served as the president of the company from 1998. Prior to working for OTEX, he held various presidential and vice presidential positions at Platinum Technology, Sybase Inc, and View Star Corp.

Ownership

% of Shares Held by Insiders and 5% Owners:	2.93%
% of Shares Held by Institutional & Mutual Fund Owners:	77%

Source: MSN Money

Top 5 Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
Fidelity Management & Research	6,278,530	12.1%
Pyramis Global Advisors, LLC	2,932,107	5.7%
Barclays Global Investors Canada Limited	2,510,074	4.8%
Calamos Advisors LLC	2,070,735	4%
GWL Investment Management Ltd.	1,780,651	3.4%

Source: MSN Money

Source: Yahoo! Finance

Websense Inc.
WBSN
Price: $16.43 (15.43-24.60)
Fiscal Year Ends: December 31

Date: November 14, 2008 Andy Verchota
Russell 2000 Index: 456.52 (441.92-799.57) Software Sector

Participating in the internet solution industry, Websense offers a dominant web security product while working to expand their offerings in messaging security and data loss prevention (DLP). Websense sells their solutions to governmental, educational, and corporate institutions. Their products offer functions seeking to protect companies against malware, spyware, phishing, and database infiltration. Websense competes in markets including the United States, Europe, Latin America, Middle East, Africa, and Asia Pacific. Competitors include niche players such as Secure Computing and Blue Coat as well as larger organizations Symantec and McAfee. Headquartered in San Diego, California, Websense was founded in 1994 and currently employs 1,180 people.

Recommendation

In conjunction with an increasingly global workplace the threat and cost of malicious viral attacks has grown substantially. WBSN's recent acquisition of SurfControl expanded market share and improved their footprint in the SMB market. A subscription based revenue model provides transparent cash flows, allowing investors to accurately predict the present and future business environment. Continued penetration of existing customers and conversion of the acquired customer base will drive organic growth. Their dominant position in the web filtering vertical (64%) supported by expansion into messaging security and DLP provides growth potential for WBSN. At current valuation, WBSN offers an attractive entry point for addition to the AIM portfolio.

Key Statistics	Nov. 14, 2008
Market Cap	$803M
Shares Outstanding	45.0M
Average Volume	.695M
Beta	0.76
EPS (TTM)	$1.34
F2009 Estimated EPS	$1.43
P/E (forward)	12.48
P/B	4.09
P/S (TTM)	2.72
WACC	9.1623%
ROE	33.8%
Gross Margin	89.7%
Operating Margin	30.3%
Analysts Coverage	14
Target Price	$22.00

Source: FactSet

Investment Thesis

- **SurfControl Integration.** In 2007, WBSN acquired their second largest competitor in the web filtering vertical. Purchased for $400M ($200M cash / $200M debt) at 4X EV/S, SurfControl increased WBSN market share from 49% to 64%. In addition, conversion of the existing SurfControl customer base provides increased ASP's of 10-30%, focused in the low-end SMB market. In 3Q08, one-third of SurfControl customers up for renewal renewed contracts with WBSN. The acquisition added significantly to company expenses, resulting in GAAP net losses expected through 2008. Thus far, only 5-6% have upgraded to WBSN products. Q4 will present a significant opportunity to increase conversion of SurfControl's 10M users.

- **Product Offering Expansion**. Introduction of the upgraded Web Security Gateway (WSG) product integrates WBSN into growth regions of the web security industry. The WSG offering saw immediate traction, providing $2 million of billings in late Q3. This web filtering solution offers more comprehensive coverage of messaging security. WSG drives 30% upside to average selling price per seat due to premium pricing charged for added capabilities. An estimated 43 million seats under subscription would be natural upgrades to this solution for its added protection from next-generation web threats.
- **100% Subscription Model.** The WBSN revenue model provides strong visibility to investors. Around 90% of quarterly revenues come straight from deferred revenue on the balance sheet. Historical renewal rates have ranged from 85-90%, suggesting the necessity of these products in an increasingly web-based workplace. This steady cash flow characteristics has provided strong visibility leading to 31 consecutive quarters of meeting or beating EPS expectations..
- **Data Loss Prevention.** The January 2007 acquisition of PortAuthority provided WBSN a footprint in the DLP business. An increasing regulatory environment has provided sustained need for software capable of protecting sensitive customer information. DLP sector stands to grow at an 82% CAGR through 2012, becoming a $2.4B business. In 2Q08 DLP comprised ~3% of WBSN total billings.

Valuation

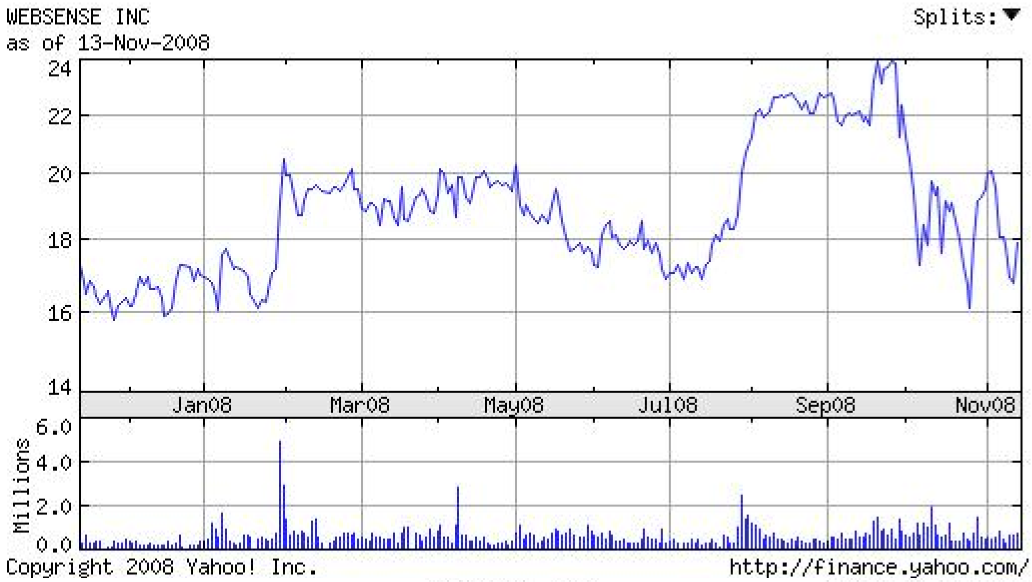
A DCF model offered a range of $16-25 using different earning growth assumptions. Shares currently trade at 12.3X 2009 earnings. Based on their disruptive business model resulting in underlying billings growth, a valuation of 15X was applied to result in a $22 price target. Consistent valuation expectations can be derived from the regularity of cash flows resulting from their subscription model.

Risks

- **Decreased Contract Length**. A decrease in yoy average contract length reflects negative macro trends. At 22.1 month in 3Q08, the average contract has decreased from 23.1 in 3Q07. WBSN products are offered on contract lengths of 12, 24, and 36 months. Twelve month contracts comprise 55% of the total number outstanding. A trend towards shorter duration contracts threatens historical renewal rates between 85-90% and increases the opportunity for larger players (Symantec) to steal market share.
- **Negative FX Effect**. In their Q3 conference call WBSN tightened their billings forecast for 2008 to $345-$350 from $345-$355. This reflects a $4-5M of negative FX effect in relation to the USD. Since September 23rd the Pound (-16%) and Euro (-15%) have seen significant weakening. The United Kingdom provides the second largest source of revenue, at 11% in 3Q. Non-USD denominated countries comprise 41% of the company's annual revenues. In 3Q08 WBSN saw an adverse effect of $1.8M resulting from currency fluctuation.

Management

CEO of WBSN, Gene Hodges, joined the company in January 2006, after serving as President of McAfee from 2001-2006. Hodges's experience with large competitor stands as an advantage for WBSN to establish a footprint in security software. Douglas Wride (President) and Dudley Mendenhall (CFO) both joined the firm since Hodges's arrival, having served previously at in accounting and other executive roles.



Ownership

% of Shares Held by Insiders:	10%
% of Shares Held by Institutional & Mutual Fund Owners:	90%

Source: Yahoo! Finance

Top 5 Institutional Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
Osterweis Capital Management	4,363,843	9.69%
AXA	3,079,110	6.83%
Barclays Global Investors UK Holdings	3,079,110	5.04%
Lord Abbett & Co	2,203,096	4.89%
T. Rowe Price Associates	1,899,500	4.22%

Source: Yahoo! Finance