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Monthly Update



An investment publication with a focus on Telecommunications, Technology, Industrial and Small Cap stocks.

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Welcome!

Since our newsletter issued last month, the equity markets have remained volatile, although to a lesser extent than that seen in late summer. In our view, equity market dynamics have changed quite a bit over the previous months, with a market dispensing greater dichotomy between winners and losers than seen in the more general uptrend of the previous several years.

Questions still remain over how far-reaching the credit issues will reach, although many financial holdings have been hit hard already. Residential housing, which seems destined for continued declines on a slurry of additional mortgage resets, appears to be performing below already dampened expectations. Fed rate cuts have been and will be a major concern going forward, but are necessary to help out the consumer. As we have stated before, international growth appears to remain quite strong despite the domestic weakness and falling dollar, with globally diversified companies continuing to benefit. We continue to see both hard and soft commodity costs rise, which is resulting in higher food prices and materials inputs.

Included in this month's analysis are notes from recent earnings announcements and management conference calls. Specifically, we highlight some companies that have been able to continue to perform well in the current environment.

We are also including updates on The Cardinal Group's Investor Relations Clients:

- TESSCO (TESS)
- PCTEL (PCTI)

Agco Corporation (AG) - South American Sales Drive Q3 Results

Agco Corporation (AG), as the name implies, is a manufacturer and distributor of agricultural equipment and replacement parts. For background, the company expects sales to the EMEA region to constitute over 60% of total sales this year, with North America in the low 20% range, South America around 15% and the remainder APAC. Recent results were well above expectations and were driven by favorable product mix and explosive y/y strength in South America. On the negative side, supply constraints across the board remain a challenge and appear to be an issue going forward, which is being factored into management's Q4 guidance.

For the first time in recent memory, AGCO management stated that they are seeing healthy activity in nearly every agricultural market in the world, except for Australia, which is operating under severe drought conditions. Agricultural related businesses can be lumpy and seasonal as one would expect, which should leave investors cautious in extrapolating strength in results. Drought can cause severe downturns in various crop yields, but when conditions are right and grain prices are high, as they are now, farmers tend to buy more equipment and require more aftermarket parts.

Contributing to the recent strong results, South America is coming off of drought conditions in 2005 and subsequent weak harvests for soybeans. Specifically, Brazil is enjoying a strong

sugar cane sector for the past 2 years which remains strong again this year. Although appreciation of the Brazilian Real has hurt profitability of the local Soybean farmers (it is a large export item), prices now remain high enough to positively impact profitability.

Broadly speaking, secular trends relating to a growing world population and general improvement in worldwide income levels are driving increased demand for energy and food supplies. Regardless of the use, the world's farmable land will remain under increasing levels of stress and improved farming productivity will remain of paramount focus. These trends are contributing to forecasted year-end grain levels at record lows and related commodity prices at record highs. One of the most practical improvements in productivity is the migration towards more advanced farming equipment produced by companies such as Deere (DE), AGCO (AG) and CNH Global (CNH). As an example, China's economic growth has been no secret, but an important deduction from this growth is the country's changing diet characteristics as it migrates towards higher protein foods vs. grain. Ironically, this phenomenon actually requires more grains for the country than in the past. Additionally, China doesn't currently meet its grains demand and a significant portion of that is imported from other countries.

Casey's General Stores (CASY) - Stable Operator with an Acquisition Based Growth Opportunity

We recently participated in a conference call with the management of Casey's General Stores (CASY), a mid-west regional convenience store operator. The company's store base is concentrated in 9 states that reside within 500 miles of its Iowa based corporate headquarters / recently expanded distribution center. Most stores reside in very rural locations with over half of these in areas with populations below 3,500. In its niche rural markets, CASY offers a recognizable brand that serves multiple needs for local residents by providing gasoline, grocery and prepared foods.

- CASY owns delivery trucks and the real estate under its store base vs. the "sale and lease back" model. 70% of gasoline is handled on their own tankers.
- CASY management believes the company's self-distribution model is a relatively unique concept within the fragmented convenience store industry.
- The company purchases about 10m pounds of cheese a year for its prepared foods segment. Management has needed to pass through cost increases for items like cheese and even coffee due to recent rising inputs.

Gasoline Sales (F2007: 72% of revenue and 21% of gross profit):

Similar to competing convenience stores, gasoline pricing literally drives consumer traffic, but it also shapes consumer expectations and more importantly determines whether much higher margin products within the store will be consumed. Given that retail gas prices tend to exude upward and downward stickiness, wholesale price fluctuations lead to periods of expanding and contracting margins. Gasoline margins are presented in cents per gallon, with management providing a \$0.108 goal for the year. Margins typically vary from \$0.09 – \$0.12 per gallon from one quarter to the next.

Acquisition Consolidation: The Main Growth Driver

While primarily building stores in the late 1990s and early 2000 (building 80 or so per year), management has since realized higher returns more quickly by consolidating smaller competitors. Acquisitions tend to come in fits and starts and may consist of a single mom and pop shop to a much larger regional operator. In F2006, management acquired Gas 'N Shop, which included 51 stores in Nebraska (10 were closed immediately due to competition with existing stores). Also a recent acquisition, Handimart included 33 stores in Cedar Rapids and Iowa City. Management is in the process of putting a kitchen in each of these stores as they believe prepared foods and the self-distribution model offer the greatest acquisition synergies. Management sees literally thousands of stores within its distribution area that could be considered for further acquisition based growth.

Ciena Corporation (CIEN) - Well Positioned for Communications Infrastructure Growth

Ciena (CIEN) was founded in 1992 and went public in 1997. The company is primarily a provider of optical transport and optical switching platforms for global service providers. Although Ciena was one of the many high fliers during the late 1990's Telecom bubble, it fell on hard times during the downturn of 2001-2003. However, bolstered by a healthy cash balance, the company continued to invest heavily in its business, despite losing money quarter after quarter. Management's aggressive spending aimed to strategically position the company for the perceived inevitability of resurged network spending. This strategy has recently begun paying dividends for the company as market share gains have contributed to growth along with a solid position in higher growth markets. Ciena recognized its first profit in a number of years in fiscal 3Q06 and has improved on that one year later, reaching close to a 14% operating profit margin.

The company focuses on products enhanced with Ethernet technologies (software and hardware), where the majority of the market growth is occurring in the telecom equipment market. These Ethernet based products benefit from the migration away from cornerstone legacy architectures, which Ciena has little exposure to. Ciena's products are intended to deliver more services faster, with an improved end-user experience at reduced network costs. Ciena is benefiting from industry demand drivers, such as increased bandwidth consumption, as part of a significant infrastructure build cycle. By targeting high-growth segments in core optical and access and especially metro optical and carrier Ethernet switching, Ciena anticipates faster than market growth.

- Most revenue comes from North America (U.S. contributed 71% of MRQ revenue) and Europe. Ciena typically has three 10% customers in any given quarter, although customer names rotate a bit.
- Ciena acquired multiple companies over the past few years, so focus has been on integration. A large acquisition appears unlikely, although niche technologies may be considered such as a recent asset acquisition for Ethernet switching technology. Therefore, product development will largely be initiated through R&D. Partnerships are an option as well for new products, which have been utilized within the access product line.
- Ciena's normalized operating model expects R&D between 12.5% - 15.5% of sales, S&M between 12.5% - 15.5%, and G&A between 4.5% - 5.0% of sales. The as-adjusted operating profit margin target is 15%.
- Driven by product mix, Ciena increased its F4Q07 (October quarter) gross margin target at its recent Analyst day from the mid-40% range to 47% - 49%. Over time, gross margin will continue to benefit from Ciena's transition from a transport focused provider to a multiservice (switching, monitoring, and aggregating traffic, etc...) vendor. Relative to the industry, Ciena believes it can sustain faster growth and higher margins as it does not have as much legacy technology to protect as many of its competitors.



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Biography

Theodore J. Moreau, CFA-Principal

Ted Moreau was previously Robert W. Baird's Senior Analyst covering Network Technology (1985-2005). Ted has been nationally recognized by the Wall Street Journal and Institutional Investor Magazine. Ted was named to the Wall Street Journal "All-Star Analysts Team" in 1994, 1996, and 1997. He was honored by Institutional Investor Magazine as a "Home Run Hitter" in 1994. Ted was also named to the Institutional Investor's regional "All-American Team" in 1997. He received a BBA and an MBA from the University of Wisconsin-Madison.

Charles R. Moreau, Associate

Charles has over four years experience in the securities industry. He started his career at Robert W. Baird & Co. as part of the Equity Capital Markets Group and maintains a degree in Finance from the W.P. Carey School of Business at Arizona State University. Charles is a candidate in the CFA program, has passed the Level 1 exam, and plans to take the CFA Level 2 exam in June 2008.

Ted J. Moreau, Jr., Associate

Ted Moreau joined The Cardinal Group in 2007 and has over seven years experience in the telecom and securities industries. He started his career at Artesyn Technologies, later acquired by Emerson, as a telecom equipment market analyst. Ted has a degree in Finance from the University of Wisconsin-Madison.

Disclosure

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