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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 regained a progression upward, clearly aided by Federal Reserve rate cuts. Volatility in September appears to have taken a back seat relative to the roller coaster month of August, which impacted most, if not all markets rather wildly due to credit catastrophe concerns. Questions over how far-reaching the credit issues will reach appear to be somewhat constrained to the residential housing market at this point, which has yet to recover even remotely. As we stated in our previous newsletter, we believe markets saw an even greater share of volatility and selling pressure as tumbling financial holdings likely forced many hedge funds to sell unrelated positions to meet margin calls. In the short-term and despite drastic rate cuts, we remain somewhat concerned that lackluster consumer spending lies ahead due in part to further declines in home prices, potential for further volatility in the equity markets, and more financial related layoffs which all will likely drag on domestic economic conditions. Broadly speaking, international growth appears to remain quite strong despite domestic weakness and a falling dollar, with globally diversified companies continuing to benefit.

In recent news, we visited 9 companies in the Minneapolis area on September 25th and 26th as part of an investor field trip. Our meetings included strategic discussions with management teams and/or investor relations representatives.

Included in this month's analysis are notes from our Minneapolis trip on:

- **Day 1:** Toro (TTC), Donaldson (DCI), Patterson (PDCO), Pentair (PNR), Stratasys (SSYS),
- **Day 2:** Ecolab (ECL), St. Jude (STJ), ADC Telecom (ADCT), MTS Systems (MTSC).

Toro Company (TTC) - \$59.89

Overall revenue growth is expected to reside in the 8% area going forward driven by 5% core aided by 3% acquisitions.

Margin Improvement Opportunity:

Toro primarily operates by serving the lower margin and more volatile, although very well-known, residential (individual consumer) (about 1/3 of sales) business and the much higher margin and more predictable professional (landscape contractor or golf course grounds crew) (about 2/3 of sales) segment. Toro plans to continue its push towards a greater sales contribution from the professional leg and believes it can attain closer to an 80/20 split in the future. The professional clientele provides much more predictable spending patterns and a greater appreciation for product innovation, thus resulting in the higher margins.

Macro Trends:

Investors have expressed concerns over Toro's clear dependency on golf course maintenance (about 1/3 of revs) as the U.S new course construction market has slowed significantly, as of late, with more course closings last year than openings. There are about 17,000 courses in the U.S. and 13,000 in the rest of the world, which is mostly concentrated in Europe and Canada and increasingly the APAC region. Int'l revenue contributions continue to represent a larger share of total sales and are steadily approaching 30% of total.

Representing a small portion of sales, the micro irrigation market (4% or so of sales) appears to provide a high growth opportunity for TTC as water users become more conscientious over water regulations, price and availability. TTC's irrigation products help to maximize water usage by providing technology that avoids waste and promotes uniform application. Higher ethanol demand has also provided necessary economics to purchase TTC's higher cost irrigation products.

Donaldson (DCI) - \$42.28

Originally operating as primarily a diesel filtration company, DCI has since diversified its businesses to focus on value-add filtration products and avoids lower margin commodity markets (such as auto). End markets are inherently cyclical, but the company's broad diversification off-sets much of these cyclical fluctuations.

Consistent Growth:

Revenue has grown at approximately 9% CAGR since 1990 (16% earnings CAGR) and has been steadily growing at about 1% from acquisitions + 6% or so from general filtration market growth and the remainder in market share gains. Since 1990, the company has grown dividends at about 15% CAGR and achieved about a 2% CAGR in share-count reductions.

Growth is expected to continue from a diversified approach, driving towards 50% exposure to the replacement market (about 43% now) and towards 50% exposure to international markets (Int'l was 53% in FQ4 2007). Acquisitions are expected to generate between 2% - 4% of sales growth going forward.

Diesel Emissions Represent Significant Opportunity:

Regarding diesel emission truck standards, management expects the changes to offer a collective \$100m growth opportunity for DCI by 2012. Opportunities require improved engine filtration technology with more stringent standards changes in the U.S. in 2007 (occurred on Jan. 1, 2007), Euro 5 emissions standards in 2009, U.S. again in 2010 and Euro 6 in 2012.

Patterson Companies, Inc. (PDCO) - \$39.46

PDCO operates in 3 very fragmented businesses (Dental, Medical and Vet), which all fit nicely into the company's distribution model. PDCO is pressed with the dilemma of how to spend its cash and is likely being pressured by investors for clarity. The company is sitting on over \$100m of net cash (as of the recent quarter) following debt repayments and the expectation of more to come. PDCO generated \$244m of cash from operations last fiscal year and likely higher levels are expected this year while only expecting to spend \$25m - \$30m on capital expenditures. If cash isn't deployed in a meaningful way, PDCO could have over \$1.5 billion in cash on the balance sheet over the next 5 years.

Acquisitions:

Acquisitions represent a meaningful and likely use of cash and will be a significant issue for the company going forward. The fragmented markets present lots of opportunities, but the company would rather focus on market share gains than buying a host of very small operations. The \$10m opportunities take as many resources as the harder to come by \$100m acquisitions and likely will drag on company returns. Management has expressed interest in adding a 4th business segment if the right characteristics presented themselves. The added segment would also need to reside in a fragmented market with similar characteristics to that of the dental, medical and veterinary businesses and is not necessarily limited to healthcare.

Pentair (PNR) - \$33.20

PNR's CEO, a significant holder of the company's stock, has implemented several management changes in 2007 including a new CFO, VP of IR and VP of Water Technology. In 2006, he downsized his management team and created a COO position.

The company has recently been active on the acquisitions front acting as a consolidator, particularly in the water market, and is now likely in a period of digesting and integration. Organic growth will receive greater attention going forward and is included in management compensation targets. PNR operates as a holding company and is accustomed to entering and exiting businesses, including the sale of its power tools segment several years back (largest business segment at the time). Interestingly, at inception in 1966, PNR was originally in the paper mill business and only later moved into the pump and pool markets.

PNR receives about 70% of revenues from its Water segment, serving the pool, pump and filtration markets. Products manufactured are included in some of GE's and Culligan's products and even filters for Brita. Although Wall Street has been paying greater attention to companies with water exposure, PNR has been dragged down by its 16% - 17% exposure to the housing industry, which began to dip in 2H06. Any reduced availability or higher interest rates on home equity loans could negatively impact pool demand as well.

Stratasys (SSYS) - \$28.66

SSYS is the market leader in the Rapid Prototyping (RP) industry and its technology is completely changing the industry by cutting manufacturing and design costs and processing time, thereby improving time to market. Stratasys is broken down among 3D Printing (also known as low end systems), High End Systems (\$50,000+), and Paid Parts Services (orders are web-based).

The markets Stratasys targets historically have had high costs, limiting industry growth. However, the industry has now reached \$1 billion and is experiencing mid-20% market growth according to market research firms, although measuring the growth rates remains difficult. Stratasys leads the market in terms of units shipped (41% share) and has been very successful at the low end of the market, where prices have been falling.

In 2006, total industry shipments (low end and high end systems) reached about 4,200 units. Stratasys believes the industry can reach 10,000 unit shipments if the price point of the low end systems continues to fall. The industry is moving into the next phase of its growth as rapid manufacturing, which is a much larger market, is where Stratasys is expected to be a market leader. SSYS has a diverse customer mix and does not have a 10% customer. Industries served include: aerospace, automotive, consumer, education, medical, tool & die manufacturing, heavy machinery and architecture.

Ecolab (ECL) - \$47.85

ECL, a provider of sanitation products and systems to the top 100 restaurant and lodging companies and over 400,000 customers, has consistently produced sales and earnings growth, with 13% CAGR for EPS over the past 10 years and 16% CAGR over the past 5 years.

ECL maintains a #1 market share (about 11%) in a very fragmented \$47 billion market, which provides ample opportunity for organic growth through additional market share gains and inorganic growth as a consolidator. End markets in the U.S. restaurant, food industry, lodging, and healthcare industries all provide very stable growth markets. As an example, a bad year for the domestic lodging industry would be down 1% y/y and a good year up around 4% growth. At 48% of 2006 sales, ECL's international business contributes a significant portion of the company's consolidated base.

Revenue growth going forward is expected in the 10% - 11% area and driven by 8% organic and 2% - 3% through acquisitions.

ECL is highly dependent on its sales and service support staff, which consistently maintain low turnover through 90% retention levels. Sales incentives are about 75% incentive based vs. 25% base salary with commissions and bonus structure. Sales execution is of paramount

importance and is evaluated monthly. Most revenue is recurring and is often time critical for the end user, meaning downtime or sanitation issues at any of these industries is crucial.

Interestingly, the company believes the food industry has much higher sanitation levels than seen in healthcare, which could likely see enhanced scrutiny in the coming years. Additionally, hospitals are now likely more economically sensitive to infections occurring in patients, and the related costs, as Medicare will no longer pay for hospital based infection treatment. Increasing scrutiny on Medicare spending could require a greater attention to sanitation and safety measures by hospitals in the years to come.

St. Jude Medical (STJ) - \$44.60

The U.S. ICD (about 1/4 of STJ sales) market experienced a dramatic drop in 2006, leading many analysts to conclude that growth may continue on at a lackluster pace due to market saturation, the possibility that the market is not as large as previously expected and industry product recalls / bad press. However, STJ believes there is ample opportunity for further market penetration with about 350,000 deaths per year that could have been prevented with better screening and identification measures. Investors may be cautious as to the extent and timing of the rebound, which could constrain revenue growth for STJ until a new round of products emerge. STJ expects the global ICD market to grow 3% - 9% in 2007 and closer to 10 - 15% on an average annual basis by 2008.

In 2004, STJ had 10% ICD market share and has grown to 22% share in the most recent quarter. Gains have occurred from increasing R&D spend and associated expansion in its product line, marketing programs and education programs, and sales force. Management believes it continues to take market share and expects to reach closer to 33% through continued lower single digit market share increases each year, although a distinct timeline to reach those levels wasn't clear. Notably, management has already increased its sales force to a capacity level that would be more consistent with a firm controlling 33% market share.

STJ appears to be pushing to increase its sales force to hire sales representatives from competing firms such as Boston Scientific (likely an attempt to take advantage of recent competitor's woes). As of Q107, STJ stated that 450 people were recently hired in sales support, with approximately 40% of those with previous experience and a likely associated (common for the industry) 1-year non-compete clause. The majority of those reps were hired in Q306, Q406, and Q107, meaning these reps will come off contract to service local territories again in the late 2007 and early 2008 timeframe.

ADC Telecommunications (ADCT) - \$20.34

ADC's largest growth area is in residential broadband where carriers are building out FTTH architectures to offer Triple Play services (voice, video and data). For this opportunity, ADC's primary customers include Verizon, AT&T, and Deutsche Telekom. Note that the Verizon opportunity is for a FTTP architecture which results in a greater revenue opportunity due to the sale of cabinets and connectivity. Conversely, AT&T and Deutsche Telekom are deploying a FTTN architecture, which while it generates fewer revenues for ADC, those revenues come with higher gross margins.

In F2007, revenue from Verizon has been more stable than in F2006. The stability was likely the result of gradual subscriber uptake of Verizon's FiOS offering. When Verizon passes a home with FTTP, that equipment is typically 25% filled with components. As subscribers grow, ADC benefits by selling additional components into previously installed equipment. Verizon is approaching the halfway point of its plan to pass 18 million homes by 2010.

AT&T is building out a FTTN architecture for its Project Lightspeed. Recent industry speculation has raised an inventory buildup concern over this buildout. However, ADC notes most of the growth in sales from AT&T has been in long distance networks in support of enterprise data applications (IP data and video). Spending in the BellSouth and Cingular networks re-

mains depressed and below year ago levels, but is improving. Visibility into the timing of a spending resumption at BellSouth and Cingular remains unclear.

We note that a few telecom equipment suppliers that are largely dependent upon North American carrier spending have negatively pre-announced their September quarter results. ADC's somewhat cautious October quarter guidance limits this risk, in our view. In the most recent quarter, revenue from the U.S. was 62% of total.

ADC remains optimistic over its international FTTX opportunities. Unfortunately, the Deutsche Telekom project remains marred by regulatory issues that don't appear to resolve themselves anytime soon and ADC does not expect improvement out of Deutsche Telekom in F2008. Positively, FTTX opportunities in APAC are starting to gain traction with APAC up 20% y/y in the July quarter. With the exception of Australia, the APAC region is not as regulated as Europe.

MTS Systems (MTSC) - \$43.25

MTSC, a company with reasonable sales and backlog visibility, is a manufacturer of mechanical testing solutions and position sensing equipment. We had the privilege and opportunity to meet with company management and take a brief tour of their Minneapolis facility (HQ) on our trip. Generally, manufactured products tend require a high level of customization and engineering expertise and include a wide array of uses from an omni-directional treadmill (demonstration available on you tube) to earthquake simulation devices to off-road simulators.

Investors have expressed some concerns over sluggish top line revenue growth for the company, which based on the mid-point of 2007's revenue guidance, represents about 6.7% CAGR since 2004 and 3% over last year. The company's sales force consists primarily of sales engineers selling project based contracts, which can result in lumpy sales and margin figures. As an example, the most recent quarter produced several projects that appeared to miss cost estimates, which lowered gross margins, but are mostly worked through at this point. Gross margin erosion hasn't dipped to these levels (39% area) since 2002. Management doesn't expect it to repeat these levels going forward.

The recently changed operating legal structure in China could contribute to sales growth in that region as it allows for opportunity to provide more local value add. Specifically by segment, the test market is expected to grow at about 3% - 5% per year on the belief that market share gains can continue to be realized. Upside in the test market is driven by product development and innovation, but can be restricted by capital spending constraints in some industries such as auto. However, the ground vehicle market represents 55% of test and may be driven by such important and potentially costly items as product reliability and warranties.

MTSC has a diverse set of customers, with no account representing 10% or more of consolidated sales. Sales mix by geography is about 1/3 North America, 1/3 Europe and 1/3 APAC, with the expectation for that split to remain relatively constant going forward. The company's fragmented industry offers plenty of opportunity for consolidation, but many of the competing shops are small engineering firms that may not provide appropriate scale. The company has been active in looking at acquisitions with a focus on core businesses and geographic expansion.



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Biography

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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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