

September 5, 2007



Monthly Update

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

By *Ted J. Moreau, CFA*
Charles R. Moreau
Ted J. Moreau, Jr.

Welcome!

Since our newsletter issued last month, the equity markets have seemingly thrived and collapsed, leaving us and the rest of the investment community wondering if a bottom has finally been reached. Continued volatility is clearly stemming out of credit concerns and speculation as to how far-reaching its nasty tentacles will extend, combined with questions as to how the Fed will respond. One thing is certain, however, financial holdings have contributed to a far greater share of the malaise and have likely forced many hedge funds to sell unrelated holdings to meet margin calls. What's left, we believe, are opportunities for patient investors seeking favorable pricing in globally diversified companies. In the short-term, we are somewhat concerned that lackluster consumer spending lies ahead due to declining home prices, volatile equity markets, and financial related layoffs which all will likely drag on domestic equities.

Included in this month's analysis are notes on the following companies:

- **Joy Global (JOYG):** Domestic Coal Restrains Earnings and Valuation. International Markets Remain Robust.
- **Ciena's (CIEN):** Growth Opportunity Remains Exciting. Valuation Steep. Not Rated
- **Cisco (CSCO):** Raises Long Term Revenue Growth Outlook to 12% - 17% growth from 10% - 15%.
- **Tekelec (TKLC):** Orders Lighter than Previously Anticipated.

Joy Global (JOYG): Domestic Coal Restrains Earnings and Valuation. International Markets Remain Robust. (Favorable Entry-Point)

Following the most recent earnings release on 8/29 and the negative pre-release in late July, Joy Global's stock has sold off dramatically from its highs earlier this year. Certainly overall market weakness, stemming from credit fears and extreme volatility, are serving as partial catalysts, but the real culprit lies within short-term weakness in the U.S. coal markets. We believe Joy's stock will continue its long-term march upward, driven by an extensive \$1 billion share repurchase plan (440,000 shares repurchased in the quarter) and much more so from worldwide energy and infrastructure demand. In the short-term, however, supply constraints and fluctuations in capital spending patterns amongst coal producers can leave impatient investors frustrated.

For the most recent quarter, total revenue of \$622m was up 4% y/y and down 1% sequentially. Offsetting the weak U.S. coal conditions was an 8% y/y increase in international related revenue, the major growth driver in Joy's story. Gross margin of 31.7% was slightly below the previous quarter on the lower revenue figures and SG&A at 14.3% of sales remains reasonably well contained. Operating margin of 17.7% and EPS of \$0.66 were below expectations leading to a mild disappointment on the "Street".

Sluggish U.S. Coal Demand:

Interestingly, U.S. coal demand has been sluggish due to a weakening in electricity consumption. Demand has been running at levels below those seen last year, which was only the 4th year out of the past 50 years that domestic power demand didn't grow y/y. While

management's guidance expects little to no recovery in U.S. coal, we believe it appears likely that the most recent quarter will represent a bottom, with much of 2008 coal stockpiles at producers currently not priced. This suggests pricing increases are on the way and a likely improvement in equipment spending. Longer term, US coal is supported by additional capacity expected to come online in the next 10 years, with plants currently under construction and several more in the permitting stages. Additionally, providing a reliable, secure and environmentally friendlier energy solution, clean-coal technologies will continue to gather steam in the wake of any potential changes in political landscape.

Capacity Constraints:

In an effort to reduce the negative drag from U.S. coal, management has focused on domestic headcount and overhead cost reduction initiatives, which will likely remain permanent as markets recover. Production capacity is being reallocated to China, with a \$50m investment in a new facility in Tianjin, which will break ground later this fall and begin production in spring 2008 with full production in 2009. Contributing to the production constraints, Joy shovel demand is already sold out through 2008. The full capacity measure translates to annual production of 22 shovels (shovels typically sell for \$17m - \$20m a piece), although the company is currently building at a 26 shovel run rate. The new facility in Tianjin will offer increased flexibility and help to alleviate the capacity constraints currently experienced. Capex in the quarter tapped \$19.3m or 3% of sales and is consistent with guidance figures going forward of 3-4% of sales.

International Demand Remains Robust:

As discussed in previous reports, emerging markets in China and India continue to drive worldwide demand for coal and other commodities. China, the leading consumer of all metals worldwide and the largest market opportunity for equipment companies, will soon exceed metals demand of all G-7 industrialized economies combined. While China coal production remains robust and attempts to satisfy the country's immense hunger for energy, it remains at inadequate levels to meet the exploding demand, resulting in a recent move to become a net importer of coal. International coal demand continues to progress favorably, with pricing improvements over the past 6-8 months due to steadily growing appetite levels and contributions from supply constraints in several large coal exporting countries. Notably, the UK and Germany continue to build coal power plants as well, which appear to attract less attention.

Copper markets remain robust despite a weak U.S. housing market (historically representing about 5% of global Copper consumption). Copper pricing is expected to remain in disequilibrium for several more years and will likely support current levels. Another primary growth market, the Canadian oil sands region, is also breeding life into the shovel market with 5 new oil sands projects approved earlier this year. Projects in this region remain economically justifiable at \$35 - \$45 per barrel, providing strong economics for expansion projects. Joy Global expects shovel demand in the region to approximate 6-8 shovels per year and sees that rate continue for the next 10 years. Shovel competition will be supplied by both Joy Global (JOYG) and Bucyrus International (BUCY).

Ciena's (CIEN) Growth Opportunity Remains Exciting. Valuation Steep. - Neutral

Ciena's market opportunity is most certainly compelling, but many sell side analysts rate the equipment vendor as a hold due to valuation. From our perspective, Ciena (CIEN) continues to impress and remains a compelling growth story with their converged Ethernet strategy, which is benefiting from increasing demand for network capacity and the general industry transition of carrier networks towards an Ethernet/IP-based network infrastructure. It's this strategy enabling Ciena's targeted market to grow anywhere from 10% - 15% annually, versus 3% - 5% annually for the overall telecom industry.

For the July quarter, Ciena reported revenue of \$205m vs. the \$203m consensus and EPS of

\$0.37 (excluding stock option expense) vs. consensus of \$0.31. EPS largely benefited from a positive product mix shift towards the CoreDirector Multiservice Switch, positively impacting gross margin, which at 48% surprised to the upside and came in at the high end of Ciena's mid-40% guidance range.

Of concern is Ciena's significant dependence on a few North American based customers, which typically include AT&T, Qwest, Sprint, and/or Verizon. Ciena's customer concentration is clearly evident with three 10% customers in the quarter representing 48.5% of sales. International sales were 29% of total, with the most exciting opportunity anticipated in BT's (British Telecom) 21st Century Network. Notably, concerns over the high customer concentration risk and lofty valuation relative to a UBS analyst's F2009 EPS estimate of \$1.82, caused the analyst to rate CIEN a sell recently.

Still, Ciena noted that the consensus 2008 revenue estimates of approximately 20% growth "seems reasonable." The vendor is targeting a sustained 15% operating profit margin target through revenue growth and cost control initiatives.

Cisco (CSCO): Raises Long Term Revenue Growth Outlook to 12% - 17% growth from 10% - 15%. - Not Rated

Revenue for the July 2007 quarter of \$9.4 billion was well ahead of analyst estimates of \$9.29 billion and well ahead of guidance of 15% - 16% y/y growth. In the July quarter, order growth of high end routers was near 30% y/y, which compares with 20% order growth for each of the remaining quarters of fiscal 2007. Cisco highlighted the 2nd phase of the Internet enabled by Web 2.0 technology as the most exciting technology in the market. The technology is being driven by telepresence, which will enable innovation and major productivity improvements globally. Telepresence is a new technology that combines rich audio, high-definition video, and interactive elements to deliver a unique in-person experience over the network. This allows users, living worlds apart, to conduct face-to-face meetings like never before. Of the traffic routes Cisco has utilized for the telepresence application, approximately 2/3 have needed network upgrades to support the video offering. Cisco believes telepresence can go all the way to the home, although video applications go way beyond telepresence.

With the combination of a strong product backlog at \$3.9 billion (17 product lines have order growth rates of at least 15%) and healthy market trends, Cisco is increasing long term revenue guidance from 10% - 15% to 12% - 17% per year. Fiscal 2008 revenue growth is guided in the range of 13% - 16% y/y, translating to revenue of \$39.5 - \$40.5 billion. Revenue guidance for the October quarter (fiscal 1Q08) is \$9.45 - \$9.55 billion, or y/y revenue growth of approximately 16%. Cisco's stock has been in a nice uptrend over the past 6 months and reacted favorably to the most recent earnings call.

Tekelec (TKLC): Orders Lighter than Previously Anticipated - Neutral

During the June quarter earnings call, Tekelec lowered its 2007 orders target to \$370 - \$400 million. The company did not, however, change its 2007 revenue target of \$425 - \$440 million, which compares to \$443 million in 2006. With approximately 15% of their business quick turns, we view the lower 2007 orders target indicates 2008 could also be a year of light revenue growth. Therefore, we maintain our view that Tekelec is a margin improvement story in the near to medium term.

We are pleased that Tekelec is making strides in reducing its North American dependence. For the June quarter, international revenue was 71% versus 46% in the March quarter and by comparison, revenue from North America was at 61% in the June 2006 quarter. Tekelec expects international revenue to be more than 50% of total revenue over the long term.

Gross margins in the first half of 2007 included three out of the four low margin or no margin contracts that Tekelec has previously disclosed. Revenue from these contracts totaled \$17.1 million in 1H07 and contributed \$5.2 million to gross profit margins. There is one remaining contract totaling \$1.9 million that should be recorded late in 2007 or early 2008. R&D increased due to support for new customer wins, development of new transitional products. SG&A was lower due to recent reductions in personnel.

With its sizable cash balance, Tekelec is still looking at acquisitions in the \$25 - \$50 million range, but also looking to repurchase shares. After reporting earnings, Tekelec announced a stock repurchase authorization up to \$50 million of common stock. Tekelec shares gradually weakened in the weeks leading up to their June quarter earnings call and continued to fall afterwards.



758 N. Broadway • Suite 1224
Milwaukee, WI 53202

Phone: (414) 228-4630

Email:

tmoreau@cardinalresearchllc.com
cmoreau@cardinalresearchllc.com
tm@cardinalresearchllc.com

Please visit our website:

www.cardinalresearchllc.com

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

Cardinal Research LLC is an equity research and institutional investment consulting company specializing in several key industries and focusing primarily on medium, small and micro capitalization companies. Additionally, Cardinal Research provides industry research and consulting, primarily for corporate entities in the telecommunications industry.

The senior research analyst certifies that the views expressed in this research report and/or financial model accurately reflect such senior analyst's views about the subject securities or issuers and that no part of his compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the research report. Cardinal Research LLC may be compensated for its research by individual companies mentioned and in some cases recommended in this report. Cardinal Research LLC may have a position in and/or may act as an investment banker or advisor to such. This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

This material and any information from its use is provided for informational purposes only and should not be regarded as a solicitation of an offer to buy the securities mentioned in it. No representation is made that any returns will be achieved. Past performance is not necessarily indicative of future results. This information is subject to change without notice. The securities mentioned may not be eligible for sale in some states or countries, nor suitable for all types of investors. Cardinal Research LLC does not warrant the accuracy, completeness, reliability, fitness for a particular purpose or merchantability of this information. Cardinal Research LLC shall have no liability for the use, misuse, or distribution of this information to unauthorized recipients. This material is strictly for specified recipients only and may not be reproduced, distributed or forwarded in any manner without the permission of Cardinal Research, LLC.

©2007 Cardinal Research LLC. All rights reserved.