MARQUETTE UNIVERSITY
College of Business Administration
Applied Investment Management

AIM
APPLIED INVESTMENT MANAGEMENT

# Applied Investment Management (AIM) Program

## AIM Class of 2013 Equity Fund Reports
## Fall 2012

***Date: October 30, 2012 Time: 4:30 pm – 5:30 pm***
***Road Show Location: Marquette Chicago CIRCLES***
***The Union League Club***
***65 West Jackson Boulevard, Chicago***

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| Nicholas Hartnell | C & J Energy Services, Inc. | CJES | $19.40 | 2 |
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| Stavros Demogerontas | CVB Financial Corporation | CVBF | $11.11 | 11 |
| David Maio | Chemical Financial Corporation | CHFC | $22.99 | 14 |
| Daniel Tallarico | Coherent | COHR | $44.69 | 17 |
| Brandon Byrne | LSB Industries | LXU | $40.66 | 20 |

We appreciate the opportunity to take an AIM 'road show' to the Marquette Chicago CIRCLES event. These student presentations are an important element of the applied learning experience in the AIM program. The students conduct fundamental equity research and present their recommendations in written and oral format – with the goal of adding their stock to the AIM Equity Fund. Your comments and advice add considerably to their educational experience and is greatly appreciated. Each student will spend about 5-7 minutes presenting their formal recommendation, which is then followed by about 8-10 minutes of Q & A. Again, thank you for allowing us the opportunity to present at the Marquette Chicago CIRCLES event.

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**C&J Energy Services, Inc. (CJES)**
October 30, 2012

Nick Hartnell Energy

*C&J Energy Services, Inc. (NYSE: CJES) is an independent provider of premium hydraulic fracturing, coiled tubing and pressure pumping, wireline, and equipment manufacturing services with a focus on complex, technically demanding well completions. As an oilfield service company, C&J's clientele primarily consists of exploration and production (E&P) companies such as Anadarko Petroleum, EOG Resources, and Exco Resources. C&J provides its services in some of the most geologically challenging areas of South Texas, East Texas/North Louisiana, West Oklahoma, and West Texas/East New Mexico. The company was headquartered in Houston, TX in 2006 but converted to a Delaware corporation in December 2010 and employs 1,127 employees, 223 of which are full-time and salaried.*

| Price ($): (10/23/12) | 19.40 | Beta: | 1.42 | FY: Dec. 31 | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|
| Price Target ($): | 26.03 | WACC | 14.02% | Revenue ($Mil) | 758.45 | 1170.00 | 1400.00 |
| 52 WK L-H ($): | 15.61-23.32 | Premium | 2.00% | % Growth | 210.64% | 54.26% | 19.66% |
| Market Cap ($Mil): | 1039.80 | L-Term Rev. Gr Rate Est: | 5.00% | Gross Margin | 41.52% | 38.03% | 35.71% |
| Float ($Mil): | 35.66 | L-Term EPS Gr Rate Est: | 6.40% | Operating Margin | 34.56% | 28.52% | 26.20% |
| Short Interest (%): | 24.83 | Total Debt/EBITDA | 0.66x | EPS | 3.19 | 3.39 | 3.63 |
| Avg Daily Vol ($Mil): | 1.03 | Total Debt/Equity | 0.45x | FCF/Share | -1.93 | 2.48 | 2.37 |
| Dividend ($): | n/a | ROA: | 29.84% | EV/EBITDA | 3.65 | 3.53 | 3.69 |
| Yield (%): | n/a | ROE: | 59.48% | P/E | 6.37 | 5.46 | 6.23 |

**Recommendation**

With an expanded geographic presence in many of the most attractive areas for oil and gas E&P activity in the U.S., CJES is well positioned for sustainable long-term growth. Through vertically integrated acquisitions of Casedhole Solutions in June 2012 ($15MM in revenue and $5MM of EBITDA in Q2) and Total E&S in April 2011 ($18MM in cost savings and $4MM of EBITDA post-purchase), C&J has diversified its asset base to be a full-service, technologically-advanced oilfield services company with new product lines in new markets such as the Bakken and Appalachian shale basins. Through supply chain synergies, these two acquisitions have already been adding value and are expected to be significantly accretive. Though E&Ps have shifted focus to the oily formations (oil rigs up 31% yoy) due to the significant disparity between oil and natural gas prices on a Btu basis (oil is priced at 4.3x natural gas energy equivalence, down from 8x in April), C&J is encouraged by this trend due to the growth in unconventional drilling that is more service-intensive. C&J's value proposition of servicing the most demanding wells has enabled the firm capitalize on horizontal drilling trends and compete with the larger industry players. Because of these reasons and a favorable valuation, it is recommended that CJES be added to the AIM Equity Fund with a price target of $26, which offers a potential upside of 34%. The firm currently does not pay a dividend.

- **Synergistic Acquisitions.** C&J commenced its wireline business with the June 2012 acquisition of Casedhole Solutions, which allowed entry into three new geographic areas and opportunities to expand current and new customer relationships. The April 2011 acquisition of Total E&S added an equipment manufacturing business, allowing C&J to provide equipment repair services, sell oilfield parts and supplies to third-party customers as well as to meet internal needs. There have not been any supply-chain disruptions and the company has added new warehouses.
- **Industry-leading Efficiency.** Technology plays an important role in discovering new oil and natural gas reserves. As E&Ps focus on shale resources, exploration capital will likely increase and drive front-end service revenue. According to Bloomberg research, unconventional drilling requires six to seven times the horsepower of a conventional well and the vast majority of new rigs are horizontal (up 56% compared to vertical and directional down 26% each over the last 5

years). C&J's differentiation strategy of servicing the most complex, technically demanding well completion positions them well to compete with larger market participants.

- **Natural Gas to the Rescue.** Given the natural gas rig count collapse of the past year (-54% yoy), natural gas prices have trended back upward (up 96% from the April lows). Even if gas rigs do not reemerge until prices near $4/MMBtu, higher E&P cash flow will be deployed. If we have truly seen the bottom in the natural gas market, investors will look for names with the most upside on a recovery, especially those who benefit from a natural gas ramp-up like C&J. Look for a continued trend in natural gas prices this winter, as futures market expectations suggest.

**Valuation**

To find the intrinsic value of CJES, a ten-year DCF using a half-year convention discount rate was conducted. Total revenue is expected to grow 54% yoy in 2012 and 20% yoy in 2013 due to two new fracking fleets deployed this year and further development in new product lines and markets. Mid-term revenue growth is expected to average 10% annually, long-term growth is 5%, and terminal growth is 2.5%. A WACC of 14.02% was used after adding a 200bps small-cap premium and yielded an intrinsic value of $25.85. Sensitivity analysis accounted for variations in WACC and the terminal growth rate, which resulted in a price target range of $20-35. An EV/EBITDA multiple approach was also used. Blending a historic regression, historic average, and peer average, 4.60x was generated, yielding a $26.43 target. Finally, a P/E multiple approach was used, employing the same methodology as the EV/EBITDA valuation, and it produced a 7.06x multiple, garnering an intrinsic value of $25.89. Triangulating the three valuation methods and weighing the DCF 40%, EV/EBITDA 30%, and P/E 30% resulted in an overall price target of $26.03, which offers a 34% upside.

**Risks**

- **Cyclicality of U.S. Oil and Natural Gas Industry.** As exemplified during the unprecedented decline in drilling activity in 2009 as total rig counts dropped by 57% from 2008 highs, C&J is susceptible to significant operating result fluctuations as customers react to changing oil and natural gas prices. Expectations of these commodity prices falling will result in decreasing spot prices for new well service contracts. C&J derived 69% of revenues from term contracts in 2011 and only 21% of fracking revenue was from spot contracts in Q2 2012. CJES is 33% and 9% correlated to daily changes in WTI and Henry Hub prices over the past year, respectively.
- **High Customer Concentration.** C&J's customers are largely in the fracking space and are very concentrated, with the top five customers accounting for 81% of revenues and the top ten representing 93% in FY 2011. If one or more of these customers fails to pay or decides not to renew contracts, cash flows and financial condition will deteriorate. C&J has a portfolio of stable customers and is diversifying its revenue base into equipment manufacturing through its April 2011 vertically-integrated acquisition of Total and coiled tubing and wireline services with its June 2012 acquisition of Casedhole Solutions.
- **Hydraulic Fracturing Regulation.** There are a number of government reviews of the risk of water contamination from hydraulic fracturing. Due to the uncertainty surrounding future regulations as well as a lengthier permitting process on federal lands, E&P companies are cautious when drilling new wells. 80% of C&J's LTM revenue came from hydraulic fracturing.

**Management**

Joshua Comstock has served as the CEO since 1997 and was one of the founders, given the title of President in December 2010, and became Chairman of the Board in February 2011. Mr. Comstock began his career as a foreman on several natural gas pipeline construction projects, then transitioning into natural gas production working for J4 Oilfield Service as a service contractor for Exxon. He currently owns 5.5% of the company's outstanding stock. Randy McMullen is the CFO, Treasurer and Director since joining C&J in 2005. He has extensive investment banking experience working at Credit Suisse, the Gulfstar Group, and Growth Capital Partners.

**Ownership**

| | |
|---|---|
| % of Shares Held by All Insiders: | 7.38% |
| % of Shares Held by Institutional Owners: | >90% |

Source: Bloomberg

**Top 5 Shareholders**

| Holder | Shares | % Out |
|---|---|---|
| General Atlantic LLC | 5,248,508 | 9.95 |
| Energy Spectrum Partners IV, LP | 3,296,549 | 6.25 |
| Royce and Associates | 3,173,070 | 6.01 |
| Joshua E. Comstock | 2,892,287 | 5.48 |
| Stepstone Group LLC | 2,865,240 | 5.43 |

Source: Bloomberg

**Customers and Competitors**

| Top 5 Customers | Top 5 Competitors |
|---|---|
| Anadarko Petroleum | Superior Energy Services |
| EOG Resources | Key Energy Services |
| Exco Resources | Baker Hughes, Inc. |
| Penn Virginia | Exterran Partners, LP |
| Plains Exploration | Halliburton Co. |

Source: Bloomberg

**Domtar Corp. (UFS)**

October 30, 2012

Eric Gomach | International Basic Materials

*Domtar Corporation (NYSE: UFS) is a Canadian based paper producer engaged in manufacturing and distributing fiber-based products through its pulp and paper (80% of sales), distribution (13%) and adult incontinence (8%) segments. Through its operations, UFS produces hard and softwood fluff pulp used internally to manufacture its paper and consumer products. UFS is the leader in North American uncoated freesheet paper market (~1/3 market share) with annual production capacity of 3.5m tons, spread across its U.S. and Canadian based mills. The company recently entered the U.S. and European adult incontinence market through its acquisitions of Attends Healthcare Inc., Attends Healthcare Limited and EAM Corp, strategically shifting the company's sales mix into the growing $8Bn personal care market. UFS is a global industry leader in the paper specialty business with 2011 revenue of $5.6Bn derived from the U.S. (75%), Canada (13%), China (4%) and other countries (8%).*

| Price ($): (10/25/12) | 79.81 | Beta vs SPX: | 1.60 |
|---|---|---|---|
| PriceTarget ($): | 108.39 | WACC | 12.32% |
| 52 WK H-L ($): | 100.82-69.60 | M-Term Rev. Gr Rate Est: | -0.21% |
| Market Cap (mil): | 2,799 | M-Term EPS Gr Rate Est: | -0.49% |
| Float (mil): | 35 | Debt/Equity: | 28.50% |
| Short Interest (%): | 2.01% | ROA: | 4.40% |
| Avg. Daily Vol (mil): | 0.414 | ROE: | 8.60% |
| Dividend ($): | 0.45 | | |
| Yield (%): | 2.26% | | |

| FY: December | 2011A | 2012E | 2013E |
|---|---|---|---|
| Revenue (Mil) | 5,612 | 5,538 | 5,525 |
| % Year Growth | -4.07% | -1.32% | -0.24% |
| Gross Margin | 18.98% | 16.12% | 15.25% |
| Operating Margin | 12.99% | 7.88% | 8.10% |
| EPS (Cal) | $9.15 | $6.15 | $7.08 |
| FCF/Share | $18.52 | $13.35 | $12.99 |
| P/E (Cal) | 7.11 | 17.62 | 15.30 |
| EV/EBITDA | 3.44 | 5.48 | 5.40 |

## Recommendation

Despite the decreasing growth in the overall paper product industry (2-4%/year), Domtar has been able to maintain profitable through product specialization and a shift in revenue mix. Through repurposing assets, UFS is shifting its production capability out of the declining uncoated freesheet communication paper market into the softwood and fluff pulp industry. The majority of the asset shift is to provide softwood and fluff pulp for usage in internal production in the incontinence and specialty paper product segments. Since 2007, UFS has successfully shifted its end use pulp from the declining printing and writing market from 52% of usage, down to 21% usage in 2011. The move out of the declining hardwood pulp market has shifted UFS' pulp portfolio into the growing specialty softwood and the absorbent incontinence segments, which are expected to grow annually at GDP and 5%, respectively. In early 2012, UFS reached a supply agreement with Appleton Paper to provide uncoated freesheet paper to the company. The fifteen year agreement with Appleton is valued at $3Bn, providing a dependable purchaser of UFS' product. In regards to the company's distribution segment, the business has begun rolling out its enterprise resource planning system to improve operating efficiency and allow the segment to remain cash positive. Much of UFS' future growth potential relies on its ability to penetrate the growing $8Bn adult care market. After acquiring the U.S. and European Attends brands, UFS, has established a 9% market share in the adult care market. Furthermore, the acquisition of EAM provides an additional revenue stream and R&D arm to drive the company's personal care segment, as the firm attempts to double EBITDA from new segments in the next five years. Through a strategic revenue mix transformation, UFS is establishing its market position vs. competitors and is recommended as an addition to the AIM International Equity Portfolio with a price target of $108.39, offering a 36% upside from its current trading price. Additionally, the company offers a 2.26% dividend yield.

## Investment Thesis

- **Personal Care Segment:** The U.S. and world demographics are shifting into an elderly population. The U.S. South Atlantic region's elderly population, where the primary distribution

of the Attends brand occurs, is expected to increase 2.5x from 2010 to 2030. Additionally, UFS' products will benefit from the 6.3% expected increase in healthcare spending from 2010 to 2018, as the Attends products primary payer is Medicaid and Medicare. UFS' changing product mix into soft and fluff pulp allows the company to supply its new and growing personal care segment.

- **Returning Shareholder Value:** Despite stagnant revenue growth due to shifting of the company's sales mix, UFS has returned shareholder value through dividend increases and share buyback programs. UFS has increased its quarterly dividend on two occasions over the past three years, to its current level of $0.45/share, offering a yield of 2.30%. Management has repurchased a total 891,902 shares 2012 YTD, leaving an additional $386m available under the current repurchase program. Yield hungry investors will find UFS' appreciating dividend attractive in a market of overvalued dividend yielding equities.
- **Valuation Disconnect:** Despite UFS' lower leverage risk of 0.74x Net-Debt/EBITDA compared to its competitor average 2.49x, the company currently trades at a discount vs. its peer group. On a P/E and EV/EBITDA basis, the firm currently trades at a 43% and 50% discount, respectively. With a defined revenue expansion plan and healthy balance sheet, UFS appears to be at a valuation disconnect from its trading peers.

**Valuation**

To derive an intrinsic value for UFS, a five-year DCF was prepared. Using a computed WACC of 12.32% and a terminal value growth rate of 1.50%, an intrinsic value of $130.60 was obtained. Additionally, blended peer average, historic average and historic regression EV/EBITDA and P/E multiples of 5.05x and 13.28x were applied to forward 2013 EPS, yielding values of $100.52 and $94.06, respectively. Applying an equal weight of 1/3 to each valuation method, an intrinsic value of $108.39 was obtained, yielding a potential return of 35.81% over UFS' current share price. A sensitivity analysis was conducted on the computed WACC, terminal growth rate and peer multiples.

**Risks**

- **Product Mix:** Operating in a negative growth environment provides substantial risk to future firm profitability. If the company is unable to successfully repurpose its machinery to produce the needed soft and fluff pulp product, the majority of the firm's sales mix will remain exposed to the declining commercial grade paper market. Additionally, UFS' bull growth scenario relies on the firm's ability to expand in the personal care industry. An inability to generate internal soft fluff for incontinence product inputs or failure to uncover attractive M&A targets in the adult care segment could drastically affect UFS' much needed sales portfolio mix transformation.
- **Product Demand:** While the growth of the business' paper arm continues to decrease at 3%/year, any significant decrease in world economic growth could additionally hurt demand. Furthermore, the technological revolution of the tablet and smart phone market has contributed to the paper market decline. Any greater technological advancement in e-reading could accelerate the decline in demand.
- **Currency Risk:** UFS generates a majority of its costs through its Canadian operations, while realizes a majority of revenue through its U.S. operations. From 2007 to 2011, the Canadian dollar appreciated 15% relative to the U.S. dollar, creating a material adverse cost outside the company's control. Further appreciation vs. the U.S. dollar could continue to increase costs.

**Management**

Since taking over as Domtar's CEO and President in early 2009, John D. Williams has proactively transformed the company's capital structure and product mix to react to a changing business environment. Prior to joining the company, Mr. Williams held various finance, operating and board roles for SCA Packaging domestically and in Europe, providing valuable experience for an expanding global company.

**Ownership**

| | |
|---|---|
| % of Shares Held by All Insider & 5% Owners: | 5.40% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 92.98% |

Source: Bloomberg

**Top 5 Shareholders**

| Holder | Shares | %Out |
|---|---|---|
| Vanguard Group Inc | 1,819,229 | 5.19% |
| Blackrock Institutioanl Trust | 1,652,285 | 4.71% |
| Dodge & Cox | 1,329,621 | 3.79% |
| Franklin Resources Incorporated | 1,266,470 | 3.61% |
| APG All Pensions Group | 1,250,144 | 3.56% |

Source: Bloomberg

**Granite Construction (GVA)**
October 30, 2012

Jeff Johnson — Industrials

*Granite Construction (NYSE: GVA) is one of the largest diversified heavy civil contractors and construction material producers in the U.S, operating in both the public and private sectors. GVA operates in three primary business segments: Construction (45% of Q2 2012 revenues), Large Project Construction (42%), and Construction Materials (11%). The company's Construction division is focused on new construction and improvements to street, roads, highways, bridges, and other infrastructure projects. The typical projects are to be completed within two years and have a contract value of less than $75M. The Large Project Construction division focuses on large, complex infrastructure projects of longer duration and deals valued in excess of $75M. The Construction Materials division mines, processes, and produces construction materials for internal use and sells to third parties. Revenues for the company were derived solely from the U.S. and reached $2B in 2011. GVA has diversified sales with 37% of its sales coming from California, 34% from the Northwest, and 29% from the East. GVA was founded in 1992 and their headquarters are located in Watsonville, CA.*

| Market Price | $28.14 | Beta: | 1.56 | FY: Dec | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|
| Price Target ($): | $36.00 | WACC | 11.10% | Revenue (Mil) | $2,010 | $2,323 | $2,885 |
| 52WK H-L ($): | $30.88-$20.78 | M-Term Rev. Gr Rate Est: | 1.17% | % Growth | 13.99% | 15.61% | 24.18% |
| Market Cap (mil): | $1,008.00 | M-Term EPS Gr Rate Est: | 1.30% | Gross Margin | 12.34% | 14.55% | 14.00% |
| Float (mil): | 38.47 | Debt/Equity: | 28.89% | Operating Margin | 4.26% | 3.98% | 4.25% |
| Short Interest (%): | 4.90% | ROA: | 3.43% | EPS (Cal) | $1.31 | $1.52 | $2.07 |
| Avg. Daily Vol (mil): | 0.232 | ROE: | 7.69% | FCF/Share | 1.12 | 1.86 | 2.38 |
| Dividend ($): | $0.52 | | | P/E (Cal) | 18.1 | 24.8 | 18.3 |
| Yield (%): | 1.80% | | | EV/EBITDA | 5.5 | 6.3 | 6.1 |

## Recommendation

According to the American Society of Civil Engineers' *2009 Report Card for America's Infrastructure*, an estimated $2.2T is needed to bring the infrastructure to a good condition from its current poor rating. Federal and local spending will continue to play a major role in the development and improvement of the country's infrastructure. Federal spending on construction only accounts for ~3% of total construction or ~$25B at current run rates. Fiscal cliff concerns and proposed spending reductions could cut as much as $3.2B (13% from current levels) on infrastructure spending at a federal level. A more important factor is the impact of state and local governments, which represent a larger portion of construction spending. State and local spending represent 33% of total construction, up from 23% ten years ago. While spending has been impacted down 12% in 2011from its peak levels of 2009, highway funding is the largest portion of the state and local budget, consistently accounting for 28-30% of the budget over the past ten years. From its peak in 2008, GVA has seen an almost 10% YoY drop in revenues, while industry competitors have dropped an average of 13.5%. Their vertical integration and ability to operate at a low cost allowed them to win bids during the economic downturn. The American Recovery and Reinvestment Act of 2009 put in place an almost $83B stimulus over the next decade to set aside $101B for infrastructure spending, of which $42B will be used for highway development. With the continuing need to repair and develop our nation's infrastructure and favorable long-term prospects, it is recommended that GVA be added to the AIM Domestic Equity Fund at a price target of $36, providing a 28% upside and a 1.85% dividend yield.

## Investment Thesis

- **Pipeline picking up.** The company has a current backlog of $1.95B, from the 2009 low of $1.5B after the financial crisis. The company only books backlog orders when a contract has been won and funding has been put in place. This number is likely to improve in the next 6 months as the GVA makes the final round of bidding on 6 major projects. Their share in these projects would add an excess of $3B to the company's backlog. There is an additional $1.2B of other projects

GVA has been short-listed on that are likely to bid in 2013.While there is a degree of uncertainty as to the future government spending, GVA's near term outlook remains very favorable with strong pipeline and project opportunities that exist for the company.

- **Tax receipt improvement.** In a correlation done be Macquarie Equities Research tax receipts were found to lead state and local construction spending put in place by approximately 2 years. Tax receipts have improved from 2009 3.8% YoY, while construction spending at a local and state level has decreased 7%. This increase in tax receipts bears favorably on the ability of governments to increase spending on infrastructures as they will have more money to do so.
- **Sustainability.** GVA has a strong focus on having a sustainable impact to help fuel profitability. They use 2000 recycled tires in each lane mile of rubberized asphalt concrete allowing it to cut cost and reduce waste. The company has been recognized three consecutive years by *Ethisphere* as one of the "World's Most Ethical Companies" for its focus on sustainability and compliance. Green building products are forecasted to grow 7.2% annually reaching $80 B by 2013. Many existing buildings have applied for LEED certification by means of this growing trend. GVA can capitalize by selling more of its green building products to this growing market.

**Valuation**

To find the intrinsic value of GVA, a seven-year DCF, an EV/EBITDA, and a P/S multiple approach were used. Based on a calculated WACC of 11.2% and 2% terminal growth rate, the DCF analysis produced an intrinsic value of $35. A sensitivity analysis was performed on the DCF by altering the terminal growth rate and WACC which produced a range of $43.22-$30.11. Using a P/S multiple of 0.76 based on a historical P/S of a blended peer group, and 2012 projected sales of $2.3M, a price target of $46.14 was achieved. A peer EV/EBITDA multiple of 6.2 was on projected EBITDA of $165M, yielding a $33 price target. Weighting the DCF 70% and the P/S and EV/EBITDA multiples 15% each respectively, a final price target of $36 was obtained, representing a 28% upside. The firm pays a dividend that yields 1.85%.

**Risks**

- **Government Contracts.** Approximately 84% of 2011 revenues were derived from contracts funded by government agencies or authorities. Low tax revenues, budget deficits, and financing restraints may result in cutbacks to new infrastructure projects in the public sector and adversely impact the collectability of current receivables from government agency contracts. Sustainable future funding for highway construction is facing strong political headwinds, in large part due to the ever-increasing federal deficit.
- **Estimates for Revenues and Costs.** The process that the company accounts for contract related revenues and costs requires management to make a variety of significant estimates and assumptions. In Q2, the company had a $3M write-down to gross profit resulting from the poor execution of two projects to be completed in Q3. While management states that they are able to formulate appropriate assumptions that produce dependable estimates, the assumptions and estimates may change significantly. This could result in the reversal of previously recognized revenue and profit.
- **Bidding Environment.** With a lower number of private projects, focus has shifted to the public sector. This places pressure on construction firms to lower the bid price on the contract in an effort to win these limited projects. Tighter margins to win bids will have a negative effect on the profitability and the loss of a few major projects to competition could have a material impact on the cash flows of the company.

**Management**

James H. Roberts has a substantial history with the company, having joined in 1981 and now is the current CEO. Many of the other officers have been with the company for extended periods and have a deep knowledge of the industry, with an average executive tenure of more than 15 years. The incentive-

based compensation plan aligns management's interests with shareholders. Executives are rewarded when return on capital exceeds the cost of capital, and payments are reduced when returns fall below this hurdle rate. There are nine board members seven of whom are non-executive and independent representatives. The company has a staggered board, which provides a hurdle for takeovers.

**Ownership**

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 9% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 84% |

Source: Yahoo! Finance

**Top 5 Shareholders**

| Holder | Shares | % Out |
|---|---|---|
| Mercer Trust Company | 3,014,541 | 7.79 |
| Franklin Advisory Services | 2,782,500 | 7.19 |
| BlackRock Institutional Trust Company | 2,278,136 | 5.89 |
| The Boston Company Asset Management | 2,213,682 | 5.52 |
| Artisan Partners Limited Partnership | 1,992,162 | 5.15 |

Source: Thompson Reuters

**CVB Financial Corp. (CVBF)**
October 30, 2012

Stavros Demogerontas — Financial Services

*CVB Financial Corp. (NASDAQ: CVBF) is the holding company for Citizens Business Bank and is the largest financial institution headquartered in the Inland Empire region of Southern California. The company provides a full complement of lending products including commercial, agribusiness, consumer, real estate loans, equipment and vehicle leasing, The deposit instruments include checking savings, money market and time certificates of deposit. CVBF serves 40 cities with 42 business financial centers and 5 commercial banking centers in the Inland Empire, Los Angeles County, Orange County, and Central Valleys of California. At December 31, 2011, the firm's total assets were $6.47 billion, total loans were $3.38 billion, deposits were $4.6 billion, and total equity was $714.81 million.*

| Price ($): (10/30/12) | 10.98 | Beta: | 1.35 | FY:Dec | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|
| Price Target ($): | 13.72 | Discount Rate: | 7.10% | Revenue (mil): | 268 | 287 | 319 |
| 52WK H-L ($): | 12.95-9.02 | M-Term Rev. Gr Rate Est: | 6.00% | % Growth: | 2.00% | 7.10% | 10.00% |
| Market Cap (mil): | 1,014.10 | M-Term EPS Gr Rate Est: | 6.20% | Operating Margin: | 53.23% | 50.49% | 51.39% |
| Float (mil): | 88.5 | Financial Leverage: | 8.81 | Net Interest Margin: | 3.75% | 3.78% | 3.80% |
| Short Interest (%): | 6.83 | ROA: | 1.30% | EPS ($): | 0.73 | 0.81 | 0.87 |
| Avg. Daily Vol (mil): | 0.512 | ROE: | 12.00% | P/E ($): | 13.81 | 13.72 | 13.68 |
| Annual Dividend ($): | 0.36 | Tier 1 Capital Ratio: | 17.80% | BVPS ($): | 12.71 | 12.92 | 12.95 |
| Yield (%): | 3.1 | Debt/Equity | 150% | P/B: | 1.57 | 1.51 | 1.49 |

**Recommendation:**

CVB Financial Corp. has experienced an increase in loan demand and deposit base in the Southern California communities that it serves. In the third quarter of 2012, the company experienced an increase in total loans and leases of $3.4 BN on CVB's balance sheet. This was an increase of approximately $476.8MM, or 1.41% (YoY). The firm's total deposit and customer repurchase agreements totaled $5.23BN at the end of the third quarter, which represented an increase of 2.27% from the third quarter of last year. Along with CVB's solid growth in loans and deposits, they have strong capital structure and have shown profitability for 141 consecutive quarters. CVB continues to remain profitable, and generates strong ROE of 12%, along with a Tier 1 Capital Ratio of 17.80%. The competitors' ROE and Tier 1 Capital Ratio are 7.85% and 17.65%, respectively. CVB's ability to remain profitable and maintain a strong capital structure will allow the company to continue its growth strategy of acquiring banks and trust companies in California. Also, the California housing and real estate market continues to show improvement, which is a positive economic indicator for CVB, considering the company's loan portfolio is made up of 61.8% in real estate loans. In addition to these positive metrics for CVB, the company has managed to keep a solid dividend yield for its shareholders of 3.04%. CVB is expected to increase its dividend in 2013, and continue to do so in the future along with CVB's growth strategy. With CVB's position to take advantage of these drivers, along with management's attitude to generate growth for the company's shareholders, it is recommended that CVB be added to AIM Equity Portfolio with a price target of $13.44. The firm pays a 3.04% dividend.

**Investment Thesis:**

- **CVB's Growth Strategy.** CVB's mindset is to keep expanding around California utilizing excess capital. This, along with their ability to remain profitable gives the company an advantage over its competitors. The firm looks to acquire assets between $200MM-$2BN, and wants their future acquisitions to remain in California. CVB already has strong capital levels with a total common equity of 11.1%, which is an improvement from 10.7% from the previous year. In addition to improving profitability, CVB has been deleveraging which has helped free up capital to support

acquisitions. Lastly, the company remains flush with liquidity with nearly $300MM in cash and cash equivalents.

- **California Economic Growth.** Southern California's strong improvement in the housing and real estate market over the past two years is a key driver for CVB. The company's loan portfolio is made up of 61.8% in various real estate loans, and depends greatly on the housing and real estate market in California. The multifamily sector has led the pickup in residential construction; however, single-family home prices are rising and development activity is beginning to improve. The Inland Empire's incipient recovery may face headwinds from a slowdown in trade activity, but stabilization in the housing market will lend some support to the region's economy. The housing market has clearly turned the corner, and the improvement in the labor market should fuel demand for both sale housing and rental.
- **Superior Credit Quality.** CVB does an excellent job of attracting low-core deposits. With a loan-to-deposit ratio of 75% and costs of deposits running at 17 bps in the 3Q12. The company has one of the strongest deposit bases in its rated peer group. NPAs have decreased 33% since 3Q10, net charge offs were only 51 bps in the first nine months of 2012, compared with 148 bps two years ago, and NPL inflows were $5.8MM in 3Q12 versus $83.7MM in the 3Q10. The bank has not made a provision in either of the past two quarters, and if the trend continues, it likely will not have to for several quarters.

**Valuation**

To find the intrinsic value of CVB, an equity excess return analysis was conducted. Revenue growth rates were based on historical growth and management guidance. The equity excess return model helped yield an intrinsic value of $9.80. Another model used in the analysis was a dividend discount model, which also was based on historical values and management guidance, with a mid-term growth rate of 6% that helped yield an intrinsic value of $15.40. Lastly, a P/B multiple of 1.64x was used, which produced an intrinsic value of $12.60 .With the equity excess return model weighted 20%, the dividend discount model weighted at 50%, and P/B multiple weighted at 30%, a price target of $13.44 was established, providing a potential upside of 22%. The firm pays a 3.04% dividend.

**Risks**

- **Volatility in Commodity Prices.** Approximately 10.5% of CVB's loan portfolio was compromised of dairy, livestock and agribusiness loans. Recent volatility in certain commodity prices, including milk prices, could adversely impact the ability of the customers the company has made dairy and livestock loans to perform under the terms of the customers borrowing arrangements with CVB.
- **Interest Rate Risk.** If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, SBSI's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

**Management**

Christopher D. Myers assumed the position of President and CEO of the company on August 1, 2006. Prior to that, Christopher Myers served as Chairman and CEO of Mellon First Business Bank from 2004 to 2006. Richard C. Thomas has been the company's CFO and Vice President since 2011. Previously, Richard Thomas served as the Chief Risk Officer of Community Bank from 1987 to 2009.

**Ownership**

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 20% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 52% |

**Source: Bloomberg**

**Top 5 Shareholders**

| Holder | Shares | %Out |
|---|---|---|
| Vanguard Group, Inc. (THE) | 6,102,852 | 5.82 |
| Lord Abbet & Co | 5,290,773 | 5.05 |
| BlackRock Fund Advisors | 3,751,557 | 3.58 |
| State Street Corporation | 3,525,061 | 3.36 |
| Columbia Wagner Asset Management, L.P. | 3,397,000 | 3.24 |

**Source: Bloomberg**

**Chemical Financial Corporation (CHFC)**
October 30, 2012

David Maio | Financials

*Chemical Financial Corporation (NASDAQ:CHFC) operates as the financial holding company of Chemical Bank and offers banking, fiduciary products and services to residents and business consumers in Michigan. Its wide range of products and services include are typical of those offered by traditional community banks ranging from personal checking accounts to corporate and personal wealth management services. The majority of loans on the bank's balance sheet are made up of commercial real estate and commercial business loans, respectively making up 53% and 43% of the portfolio. As of September 30, total assets were $5.6B, total loans were $4.0B, and total deposits were $4.6B. CHFC operates through 142 banking offices located in 32 counties in the lower peninsula of Michigan. The company was founded in 1973 and is headquartered in Midland, Michigan with 1,716 employees.*

| Price ($): (10/23/12) | $22.99 | Beta: | 1.07 | FY: Jan | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|
| Price Target ($): | $27.15 | WACC: | 8.10% | Revenue (mil): | 228.25 | 237.50 | 250.96 |
| 52WK H-L ($): | 24.96-17.56 | M-Term Rev. Gr Rate Est: | 8.13% | % Growth | 4.30% | 4.05% | 5.67% |
| Market Cap (mil): | 640.4 | M-Term EPS Gr Rate Est: | 7.14% | ROE | 8.50% | 9.09% | 10.09% |
| Float (mil): | 26.8 | Debt/Equity: | 60.67% | EPS (Cal) | $1.57 | $2.00 | $2.33 |
| Short Interest (%): | 2.69% | ROA: | 0.90% | BVPS | $20.82 | $22.03 | $23.50 |
| Avg. Daily Vol: | 43,342 | ROE: | 8.50% | P/B | 1.02x | 1.13x | 1.2x |
| Dividend ($): | $0.80 | Tier 1 Capital Ratio: | 12.10% | | | | |
| Yield (%): | 3.60% | NIM: | 3.83% | | | | |

## Recommendation

CHFC has established itself as a stable bank by effortlessly navigating through the recession, especially considering its location in Michigan. The bank has an extremely strong loan portfolio that continues to get stronger as NPL's dropped 28% in 2011 to $106.26M, yielding a ratio of 2.77%. The decrease in NPL's and the allowance for NPL's moving forward shows the improved asset quality in the company and should enhance the company's profitability. In addition, NPA's fell 25% in 2011 to $131.75M, yielding a ratio of 2.47% which is well below the peer average of 5.37%. This balance sheet stability should also lead to expansion into other small communities of Michigan, driving earnings through increasing the loan balance. CHFC already completed an M&A deal in 2010 and recently purchased branches of another bank. The financial stability of the bank should translate into an increased market reach when the expected small bank consolidation does occur. In addition, all the profitability measures have been trending upwards. Net income increased 86% last year, leading to ROE, ROA, and net profit margin ratios doubling. Finally, management has placed importance on returning value to shareholders in the form of a dividend, which has yielded above 3% of the stock price in every year since 2005. For such reasons, it is recommended to add CHFC to the AIM Equity Fund with a price target of $27.15, representing an 18% upside.

## Investment Thesis

- **Reliable High Dividend Yield**: CHFC was one of a select few banks to continue to pay a strong dividend yield throughout the financial crisis. They have maintained a dividend yield above 3% since 2005. In addition, they announced in August that they would be increasing their dividend 5% to $0.21 per quarter. The company has had a solid capital structure and CHFC has shown the ability and willingness to increase their dividend moving forward.
- **Beneficiary of Small Bank Consolidation:** CHFC has been selective with their M&A opportunities and has stated they are actively looking for bank targets in both Michigan and Indiana. They purchased O.A.K. Financial Corp. in 2010 and announced this May that they had acquired 21 branches from Independent Bank (IBCP), which has already been approved by regulators and will close in the fourth quarter. That being said, they made a sound and consistent

decision throughout their history to stay out of troubled southeastern Michigan (Detroit) which paid dividends for the company during the crisis. CHFC is currently the second largest bank in Michigan and there are about 100 community banks in the state that would be easily absorbable (less than 10% of their balance sheet). Management has stated they believe their model is best suited for small communities and has room to expand its footprint, particularly in western Michigan which has shown some nice increased economic activity.

- **Loan Growth in Michigan:** CHFC has organically grown its loan portfolio in every quarter since Quarter 2 of 2010. Consumer loan demand has risen recently in the areas of Michigan outside of Detroit. CHFC has posted a 5-year annualized loan growth of 8.8% and an 8.5% annualized loan growth since the beginning of 2011.This loan growth can be expected to continue both through the channels they currently have as well as expanding into more communities of Michigan. Due to their bank's strategic locations, their loan portfolio and balance sheet has strengthened as the smaller communities of Michigan are showing increased signs of life, which should translate into continued, reliable loan growth.

**Valuation**

To value CHFC, two different valuation techniques were utilized. An equity excess returns analysis was performed with an assumed cost of equity of 10.13%, implying an intrinsic value of $26.09. A price-to-book multiple was also employed. A blend of a 5 year historical average and peer average of CHFC's 5 closest competitors yielded 1.2x, which was applied to the expected 2013 BVPS of $23.50 to find an intrinsic value of $28.20. Taking each valuation method into account and weighting them 50% each, a target price of $27.15 has been established, which makes an 18% return. CHFC paid a $0.20 dividend last year, representing a 3.6% yield.

**Risks**

- **Pressure to Repurchase Residential Mortgage Loans:** CHFC sells fixed rate long-term residential mortgage loans it originates in the secondary market. The sentiment is that the purchasers of these loans, mainly government sponsored entities, are increasing their efforts to seek to require sellers of the loans to either repurchase loans or reimburse purchasers for losses due to alleged failure to strictly conform to the purchaser's purchase criteria. As a result, the company may have to repurchase or reimburse the loans or may face increasing expenses to defend against such claims.
- **Interest Rate Environment:** The current interest rate environment has been a strain on banks as it has pushed loan pricing lower and in turn tightened banks' net interest margin. The FED has stated interest rates will stay low for the foreseeable future which will strain the bank if they do not have strong loan growth to combat the falling margin.
- **Increasing Regulatory Costs:** With the increased regulation and requirements being placed on banks after the financial crisis, expenses for banks are on the rise. These added expenses are from hiring more employees for compliance or completing work necessary for compliance. The increased expense of hiring extra employees would create a slight drag on earnings.

**Management**

David B. Ramaker, 56 years old, has served as the Chairman, President, and CEO of CHFC since 2006. He joined Chemical Bank as the vice president in 1989. Lori A. Gwizdala, 53 years old, has served as CFO since 1991. Management has had a long tenure with the firm and all executives are under the age of 60 so there does not appear to be a change in the coming future.

**Ownership**

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 3% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 51% |

Source: Bloomberg

**Top 5 Shareholders**

| Holder | Shares | % Out |
|---|---|---|
| Dimensional Fund Advisors LP | 1,853,353 | 6.74 |
| Vanguard Group, Inc. | 1,502,526 | 5.46 |
| Chemical Bank and Trust Company | 1,466,395 | 5.33 |
| Franklin Resources, Inc. | 1,278,567 | 4.65 |
| BlackRock Institutional Trust Company | 864,460 | 3.14 |

Source: Bloomberg

Coherent (COHR)
October 30, 2012

Dan Tallarico — Information Technology

*Coherent, Inc (NASDAQ:COHR) designs, manufactures and sells a variety of photonics based products. Coherent's products include general lasers, lasers for measurements and control, laser machining tools, and laser process tools. Services around these products are also provided by the firm. Coherent serves a variety of end markets which include microelectronics (48% of revenue), scientific research and government (19%), OEM components (19%) and instrumentation and materials processing (14%). Coherent's lasers are used for the cutting of a wide variety of materials including metal, plastic fabrication, and wood. Other Coherent products assist in activities that range from implementing LASIK surgery to helping create smartphones, tablets, and televisions. Additionally 76% of COHR's revenue comes from outside the United States with about 48% of total revenue coming from Asia-Pacific. The company currently holds 387 patents. Coherent was founded in 1966, has 2,328 employees and is headquartered in Santa Clara, California.*

| Price($) | 46.00 | Beta | 1.2 | | FY:September | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|---|
| Price Target($) | 56.96 | WACC | 11.8% | | Revenue(mil) | 802.84 | $ 775.45 | $ 884.01 |
| 52 WK H-L($) | 59.70-39.76 | M-Term Rev. Gr Rate Est: | 12.0% | | % Growth | 3.56% | -3.4% | 14.0% |
| Market Cap(mil) | 1,102.5M | M-Term EPS. Gr Rate Est | 5.5% | | Gross Margin | 43.70% | 41.3% | 43.0% |
| Float(mil) | 22.3M | Debt/Equity | 0 | | Operating Margin | 13.95% | 12.3% | 15.0% |
| Short Interest | 2.07% | ROA | 11.33% | | EPS($) | $ 3.66 | $ 2.79 | $ 3.52 |
| Avg. Daily Vol | 69,520 | ROE | 15.42% | | FCF/Share | $ 1.95 | $ 2.42 | $ 3.17 |
| Dividend($) | - | | | | P/E | 12.27 | 16.01 | 12.12 |
| Yield(%) | - | | | | EV/EBITDA | 5.68 | 5.31 | 6.03 |

**Recommendation**

Coherent holds the largest market share in three of the four end markets it competes in and is second in the remaining one, the material processing industry. This coupled with Coherent's increase in efficiency metrics and its plethora of patents puts Coherent atop multiple industries and well above its competitors. Gross margin, Operating Margin, ROE, and ROA have all increased since bottoming out in 2009. This increased efficiency has translated itself into an increase in cash flow. With a TTM FCF of $35.85 million COHR has been able to put this money to use by acquiring smaller firms and by buying back just under $396 million of stock since 2008. Coherent should be able to maintain their competitive advantage and efficiency through their 387 patents along with their 114 pending patents which have expiration dates between 2013 to 2029. They are in a great position to take advantage of positive macro trends going forward in a very cyclical industry after rebounding from one of the worst years in the history of the firm in 2009. Coherent has ramped up R&D expenditures over $70 million a year during the past 3 years. This is well above the $50 million that its competitor Newport spent on R&D this past year, and also well above the $25 million IPG Photonics spent during this same time period. These investments have positioned Coherent to not only hold their current market share, but to also increase their market share in each industry in which they operate. Coherent is recommended to be added to the AIM Domestic Equity portfolio at target price of $57 representing a 24% upside.

**Investment Thesis**

- **Investment in R&D and LEDs**. Capital spending has risen over the past few quarters because of significant manufacturing investments in OLED manufacturers in Korea and Göttingen, Germany to support the flat panel display business. LED lighting will become a greater source of lighting for the world as Japan, South Korea and China have set targets of 50%, 30% and 20% respectively for LED lighting as a percentage of general lighting by 2015. This transition, as well as opportunities in the television and flat panel display markets, will increase with continued

growth in high-definition LCDs and OLEDs, and the first shipments of OLED TVs. The OLED TV industry has the potential to be a $1 billion or more market opportunity for COHR.

- **Smart Phone and Tablet Positioning.** As companies transition to new devices such as boosting phones from lower generation tech to 3G and/or 4G technology the companies will likely need more powerful lasers to cut the boards used in the mechanisms. These smartphone and tablet trends will also be key in the advanced packaging markets. As smart phone market penetration grows into the mid-40s this year and tablet sales increase, API sales are likely to go up. Smartphone shipments increased nearly 40% in 2011 and this trend is expected to continue. Any significant change in technology in this industry would also be a major boost to the sales of COHR as new tech would likely require the use of new generation or more powerful lasers.
- **Increased Focus on Materials Processing.** Coherent has historically been under represented in the materials processing market. The material processing sector as a percentage of the global laser market is about 50%. Coherent had initially felt the need to stay away from this industry because competition was solely based on cost. Coherent has begun to make investments in this industry and see their market share increasing over the next few years. COHR plans on bringing a fiber laser, a direct diode system and a very efficient CO2 laser to the market. Management predicts revenue in this space will increase at a 10-15% CAGR over the next 5 years.

**Valuation**

To find the intrinsic value of COHR, a five-year DCF was conducted. Sales growth rates were varied year-to-year to account for both commercial laser revenue growth and specialty laser revenue growth. A sensitivity analysis also was used to account for variations in WACC and the terminal growth rate. A WACC of 11.3% was calculated and a premium of 50 basis points was added. This process yielded an intrinsic value of $51.29 Blended peer average EV/EBITDA and P/CF multiples approaches were used. With an EV/EBITDA multiple of 10x, this method yields an intrinsic value of $58.70 and a P/CF multiple of 17.5x yielding an intrinsic value of $60.90. Taking these into account and equally weighting the DCF and each multiple, a price target of $56.96 was established representing a 24% upside.

**Risks**.

- **Changing Technology.** As with any hardware company, changing technology is always a risk. As new and enhanced products generally continue to be smaller in size and have lower ASPs, the company has to sell more units to maintain revenue levels. They must continue to invest in research and development in order to develop competitive products.
- **Patent Protection.** COHR relies on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect their intellectual property rights. There is no assurance future patent applications will be approved, that any patents that may be issued will protect our intellectual property or that any issued patents will not be challenged by third parties.

**Management**

Dr. John R. Ambroseo has been the President and Chief Executive Officer of Coherent Inc. since October 2002. Ambroseo is also the Chairman of the board at Lambda Physik AG. Other key members of Coherent include Helene Simonet, CFO who has been with the company since 1999. Mark Sobey is the Executive VP and has been with COHR since 2007 and the final officer is Paul Sechrist, Executive VP of Worldwide Sales. This officer's average tenure at COHR is 10.8 years which has given the group a great depth of knowledge in each industry.

Ownership

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 11% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 82% |

Source: Bloomberg

Top 5 Shareholders

| Holder | Shares | % Out |
|---|---|---|
| Eagle Asset Management | 2,414,572 | 10.20 |
| Wellington Management Co LLP | 1,593,664 | 6.73 |
| Royce and Associates | 1,445,350 | 6.10 |
| Dimensional Fund Advisors | 1,258,277 | 6.08 |
| Vanguard Group Inc. | 1,258,277 | 5.31 |

Source: Bloomberg

***LSB Industries (LXU)***

*October 30, 2012*

*Brandon Byrne* — *Domestic Industrial Materials*

*LSB Industries (NYSE: LXU) is a manufacturing and engineering company that operates in two core businesses, climate control and chemicals. The company sells its products worldwide, however approximately 95% of sales come from the United States. The climate control business, which makes up around 35% of total revenues, manufactures and sells a broad range of heating, ventilation and air conditioning products, such as geothermal and water source heat pumps. The remaining 65% of LSB Industries's revenue comes from the sale of chemical-based products primarily used by the agricultural and mining markets. The chemical business products include high purity and commercial grade ammonia, fertilizer grade ammonium nitrate, sulfuric acids, nitric acids, diesel exhaust fluid, and various other chemicals. LSB's major customers include Bayer, Du Pont, Koch Industries, Yara, and Georgia-Pacific. The company was formed in 1968 and has offices based in Oklahoma City, Oklahoma.*

| Price ($) (10/23/12): | 40.66 | Beta: | 1.83 | FY: December | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|
| Price Target ($): | 52.80 | WACC | 14.3% | Revenue ($mil) | 805.26 | 764.5 | 865.5 |
| 52WK H-L ($): | 45.00-24.85 | Debt/Equity: | 29.3% | % Growth | 32.03% | -5.1% | 13.2% |
| Market Cap (mil): | 909.10 | ROA: | 18.8% | Gross Margin | 27.70% | 27.00% | 31.00% |
| Float (mil): | 18.5 | ROE: | 35.8% | Operating Margin | 16.94% | 15.17% | 19.64% |
| Short Interest (%): | 3.1 | ROIC: | 26.21% | EPS ($Cal) | 3.59 | 3.20 | 4.50 |
| Avg. Dailey Vol.: | 143,652 | EV/EBITDA | 6.18 | FCF/Share | 2.08 | 1.93 | 2.45 |
| Dividend: | N/A | P/B | 2.16 | P/E (Cal) | 11.65 | 12.70 | 9.03 |

**Recommendation**

Since 2000, LSB has seen a 9.71% CAGR in total revenues and a 26.71% CAGR in net income. Over the past several years, LSB Industries has been able to keep production costs low and spread risk across its two core businesses - each with highly diversified end markets. Instead of competing with the major multi-billion players, the company has engaged in supplier contracts and partnerships with some of the top names in the industry including Yara International, Koch Industries, and United Technologies Corp. With significant future growth potential in both of LSB's businesses, they are increasing capacity at three of their facilities to accommodate and capture the increased demand, and have recently introduced a patented, heating and cooling chiller modules to be used in either conventional or geothermal applications. In addition, LSB announced the launch of the Trilogy™ 40 geothermal series heat pumps that far surpass any other heating or air conditioning product commercially available today. LSB has a strong balance sheet with around $150 million in cash for further product and capacity upgrades. The company is well poised to benefit from the eventual economic recovery, the long-term trend toward "green" construction, and the growth of their emerging products. Furthermore, natural gas prices (the main input for the chemical business) are expected to stay low as Tudor, Pickering, Holt & Co. cut long-term forecast to $5/Mcf for 2016. It is important to note the May 15, 2012 explosion which destroyed a large portion of the Arkansas Facility. While the stock price has since regained its pre-crisis level, it is highly likely that this issue still has a depressing pressure on the stock. This is a crucial time to capture the low stock price and it is recommended that LXU be added to the AIM Equity Fund with a target price of $52.80, providing an upside of 30%.

**Investment Thesis**

- **Growth of Climate Control Business.** The Geothermal Heat Pump (GHP) market has seen a CAGR of 15.26% from 2004 to 2011. During the same period, non-GHP unit sales decreased 26%. By 2013, the market for GHP is projected to be in excess of $10 billion and is expected to continue growing as tax credits remain in place until 2016, the "green" trend remains strong, construction and housing industries recover, and as energy costs continue to climb. LSB Industries is the leader in geothermal technology and the dominate GHP player with a market share of 41%. McGraw-Hill Construction's "Green Outlook 2011" forecasts total non-residential green building market size to be around $130 billion in 2015 compared to the current $70 billion

in 2012. In addition, bull case proponents forecast residential starts to climb to the 20-year average of around 1 million by 2015 (approx. 685,000 in 2011). LSB is well positioned to capture large portions of these markets with its dominant market share, the introduction of new products, and the expansion of its air coil manufacturing and test lab facilities.

- **Growth of Diesel Exhaust Fluid (DEF).** In 2010, the U.S. EPA adopted more stringent standards for medium and heavy-duty trucks and requires nitrogen oxide (NOx) emissions to be reduced to almost zero. To meet the strict engine emission regulations, the trucking industry has begun to use Diesel Exhaust Fluid which converts over 99% of NOx into harmless nitrogen and water. In 2011, U.S. and Canada DEF consumption was around 70 million gallons with the number expecting to increase to 725 million gallons by 2019 according to Integer Research Report. LSB's Cherokee plant produces DEF (along with numerous other chemicals) and would easily be able to accommodate this increased demand with its flexible production. LSB is in an exclusive supply agreement with Yara North America, the largest DEF supplier in the world.
- **Repairs, Capacity Upgrades, and Crop Prices.** Fertilizer use has historically risen following bad crop production years. The U.S. drought this year has driven corn conditions to historic lows, and the USDA recently cut projected production by 12%. Even with near-term pressures on farm income, LSB expects higher crop prices to incentivize added use of fertilizers and other inputs in 2013. LSB's Pryor facility, which produces most of the fertilizer chemicals for the company, operated 50% below the target rate (income was $14 million lower) in the third quarter due to six outdated convertors. The company has recently received the permit to replace all six converters with one Kellogg converter. Once the replacement is concluded at the end of the fourth quarter, LSB should achieve optimal production rates. With this repair/update and the planned capacity increase in 2013, LSB will be in a position to regain lost income and capture market share.

**Valuation**

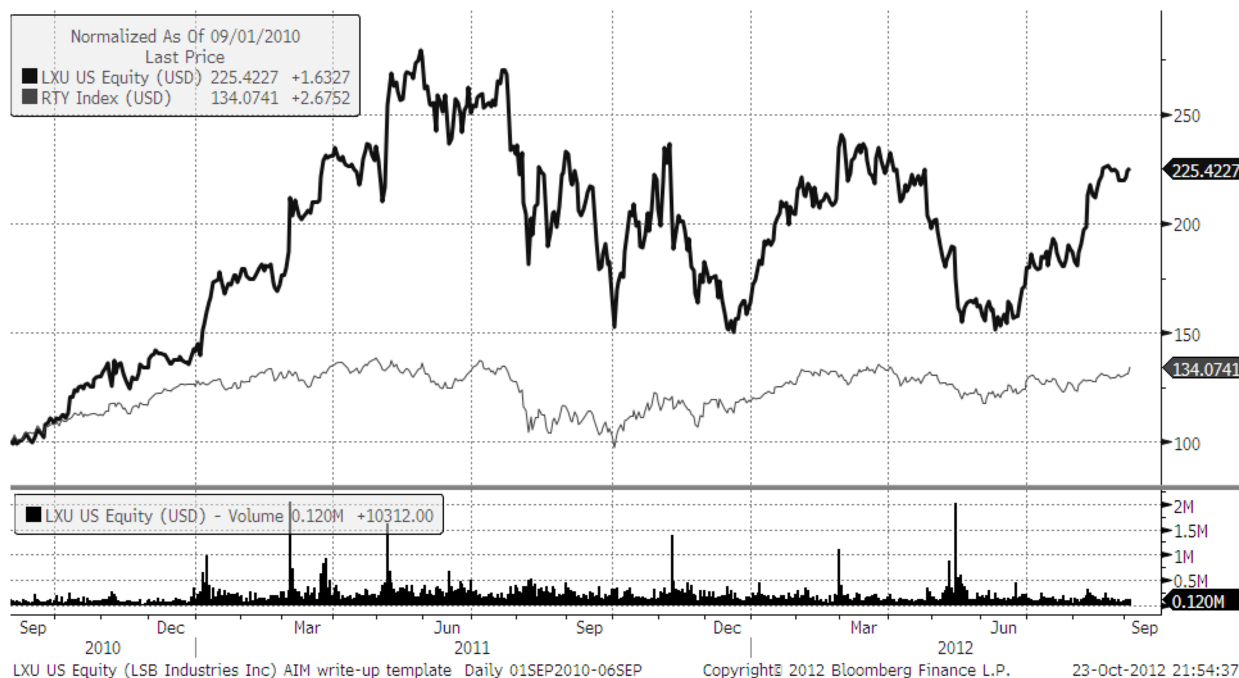
A seven year DCF was conducted using a terminal growth rate of 3% and a WACC of 14.3% which resulted in an intrinsic value of $53.27. Sensitivity analysis on both the terminal growth rate and WACC provided for a range between $48.95 and $54.34. Additionally, using an average peer P/E multiple of 12.15x and a 2013 expected EPS of $4.50, a value of $54.67 was obtained. By weighing the DCF model and the P/E multiple equally, a price target of $52.80 was established and represents a 30% upside from the current market price.

**Risks**

- **Potential Increase of Imported Ammonium Nitrate.** Since May 2000, U.S. imports of fertilizer grade AN from Russia have been controlled by the terms of an antidumping "Suspension Agreement". The Agreement terminated effective May 2, 2011. As of that date, Russian and Ukrainian AN imports have been subject to an antidumping duty order. The antidumping order, unlike the suspension agreement, does not place any volume restrictions on AN imports and does not ensure that prices are tied to the prevailing U.S. market price. The cases are scheduled for review late 2012. If the antidumping orders are revoked, LSB will face large volumes of low priced AN. For 2011, fertilizer grade AN accounted for 11% of the chemical businesses net sales.
- **Dependence upon Limited Number of Customers.** In 2011, six customers of LSB's chemical business accounted for approximately 57% of its net sales and 36% of consolidated sales, and the climate control business had one customer that accounted for approximately 6% of consolidated sales. The loss or reduction in purchase levels by, one or more of these customers could have an adverse effect on the business.

**Management**

Jack E. Golsen is Chairman of the Board of Directors and Chief Executive Officer and has served in these positions since LSB's inception in 1969. Mr. Golsen is a Trustee of Oklahoma City University and has served on its Finance Committee for many years. In 1972, he was recognized nationally as the person who prevented a widespread collapse of the Wall Street investment banking industry. Mr. Golsen has a Bachelor of Science degree from the University of New Mexico.




Ownership

| | |
|---|---|
| % of Shares Held by All Insider and 5% of Owners | 16.00% |
| % of Shares Held by Institutional & Mutual Fund Owners | 74.00% |
| | Source: Bloomberg |

Top 5 Shareholders

| Holder | Shares | % Out |
|---|---|---|
| Royce and Associates LLC | 2,333,455 | 10.44 |
| Neuberger Berman Group LLC | 1,993,621 | 8.92 |
| Neuberger Berman Genesis Fund | 1,372,700 | 6.14 |
| Vanguard Group Inc | 1,086,874 | 4.86 |
| Blackrock Fund Advisors | 782,201 | 3.5 |
| | | Source: Bloomberg |