Applied Investment Management (AIM) Program

AIM Fund Investment Advisory Board Meeting
December 7, 2007

AIM Equity Fund Presentations

Student Presenter	Company Name	Ticker	Price
Joel Grebenick	Administaff	ASF	$30.74
Luke Lamanna	CLARCOR Inc.	CLC	$35.61
Luke Junk	IPG Photonics Corporation	IPGP	$20.01
Gregory Sirotek	Isle of Capri Casinos Inc.	ISLE	$15.50
Paul Simenauer	Morningstar Inc.	MORN	$80.20
Katie Provo	PAETEC Holding Corp.	PAET	$10.01

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Administaff Inc.

ASF

Price: $30.74 ($29.91-$43.66)

Fiscal Year Ends: December 31

Date: December 4, 2007 — Joel Grebenick

Russell 2000 Index: 752.06 (734.45 – 856.48) — Business Services

Administaff is the largest Professional Employer Organization (PEO) in the US based on revenue and the fourth largest PEO based on Working Site Employees (WSEs). The company provides a comprehensive Personnel Management System encompassing a broad range of services, including benefits and payroll administration, health and workers' compensation insurance programs, personnel records management, employer liability management, employee recruiting and selection, and employee training to small and medium-sized businesses in strategically selected markets. Administaff was founded in 1986 and has provided PEO services since inception. With 46 sales offices in 24 major metropolitan markets, Administaff services over 100,000 worksite employee at roughly 6,000 small businesses nationwide.

Recommendation

Based on Administaff's strong market position, its pure-play exposure to the PEO market, attractive business model, and strong balance sheet, it is recommended that ASF be added to the AIM fund.

Key Statistics	Dec. 4, 2007
Market Cap	$811.12M*
Shares Outstanding	28.0M*
Average Volume	320,805*
Beta	1.179**
EPS (TTM)	$1.74
2007 Estimated EPS	$1.70
P/E (TTM)	17.7
PEG	1.18
WACC	12.8%
Debt/Assets	0.3%*
ROE	22.8%*
Gross Margin	20.3%
Operating Margin	3.7%
Target Price	$40.00

Sources: Yahoo! Finance*, Bloomberg**

Investment Thesis

- **Strong Position in Growing Market.** With over 100,000 WSEs, the company has established itself as a leader in the PEO industry. The company offers a broad offering, sophisticated benefit plans, and advanced industry technology.
- **Pure-Play Exposure.** ASF is one of two pure-play publicly traded PEOs, with Paychex being the other. ASF gives investors a pure-play exposure to the underpenetrated PEO market.
- **Attractive Business Model.** ASF has the goal of achieving mid-teen WSE annual growth, which normally translates into 20% revenue growth and 30% operating income/EPS growth. Long-term historical CAGR has proven to be fairly consistent with these company targets.
- **Strong Balance Sheet.** ASF reported in 3Q07, $204M in net cash ($8.36 per share). In addition, the company has been returning cash to shareholders, repurchasing $48 million during the first half of 2007.

Valuation

Currently, Administaff is trading at 14.7x 2008 estimate of $2.09/share. On a historical basis, ASF trades at a five year average of 22x EPS. Due to ASF's strong growth and attractive metrics (ROE/ROIC), I believe that the company can trade at or around its average PE of 22x. Using 20x the 2008 estimate of $2.09/share, a $41.80 target price was obtained. Alternatively, a ten year DCF Model found the price of the stock to be $44.35. The assumptions used in this valuation was a growth rate of 14% for 2008-2009 and 8% from 2010-2015. A terminal growth rate of 3% and a WACC of 12.8% were used. Under a bullish assumption (3.5% terminal growth rate, 12.3% WACC), a $48.01 target price was found. On the contrary, a bearish valuation (2.5% terminal growth rate, 13.3% WACC), a $41.35 price was found. Taking into account a slowing U.S. economy with little international exposure, a $40.00 price was determined, which represents a 30% upside.

WACC	**Terminal Growth Rate**				
	2.0%	**2.5%**	**3.0%**	**3.5%**	**4.0%**
11.8%	$ 46.64	$ 47.88	$ 49.26	$ 50.81	$ 52.56
12.3%	$ 44.40	$ 45.48	$ 46.67	$ 48.01	$ 49.50
12.8%	$ 42.36	$ 43.31	$ 44.35	$ 45.51	$ 46.79
13.3%	$ 40.52	$ 41.35	$ 42.26	$ 43.27	$ 44.38
13.8%	$ 38.83	$ 39.57	$ 40.37	$ 41.25	$ 42.22

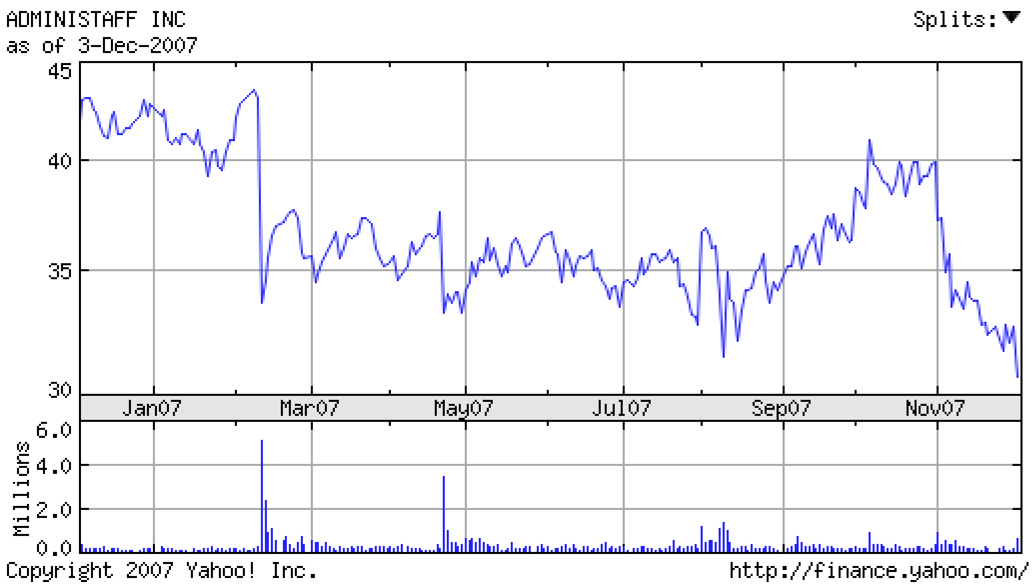
Figure 1: Scenario Analysis

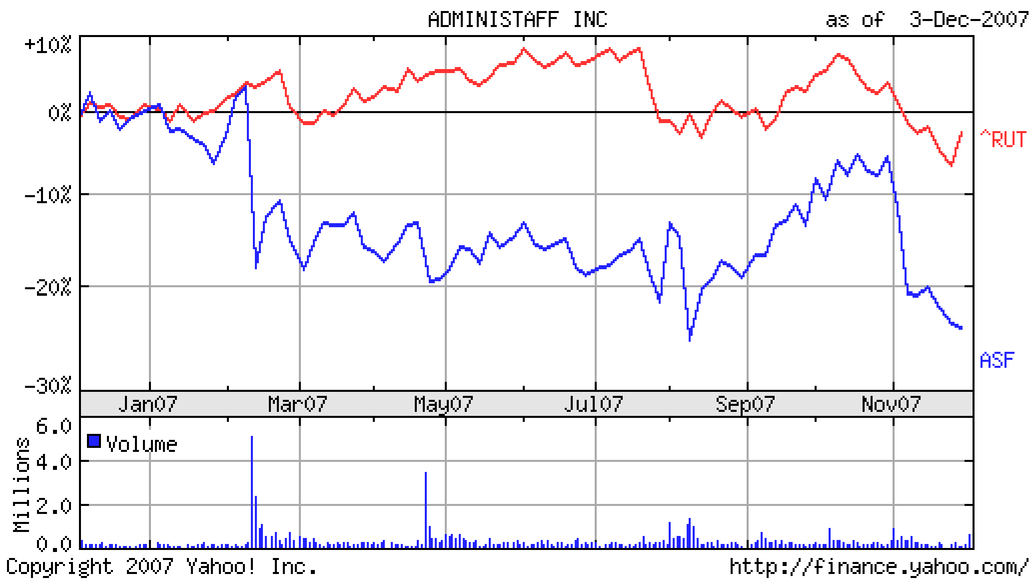
Risks

- **Increases in Claims Activity.** Due to the fixed nature of contractual agreements that ASF makes with its clients, increases in health insurance premiums, workers' compensation costs, and higher unemployment tax rates could adversely impact the company.
- **Need to Renew or Replace Clients.** The short term nature of ASF's standard contract can be cancelled with 30 to 60 days notice, which makes the company vulnerable to potential cancellations by existing clients.
- **Intensive Competition from Well-Capitalized Firms.** The PEO industry is highly fragmented with many PEOs having limited operations and fewer than 1,000 worksite employees. Paychex and Automatic Data Processing (ADP) are two of Administaff's major competitors. Both companies are well-capitalized with strong relationships with potential PEO clients through their payroll offerings.
- **Geographic Market Concentration.** While ASF has offices in 24 major metropolitan areas, roughly 36% of its revenues are generated in Texas, and over half of this is derived from the Houston market alone.

Management

Paul Sarvadi has served as Chairman of the Board and Chief Executive Officer since August 2003. He co-founded Administaff in 1986 and started and operated several small businesses prior to founding Administaff. Richard Rawson and Douglas Sharp serve as President and Chief Financial Officer, respectively.





Ownership

% of Shares Held by All Insider and 5% Owners:	23%
% of Shares Held by Institutional & Mutual Fund Owners:	81%

Source: Yahoo! Finance

Top 5 Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
Columbia Wanger Asset Management	2,642,000	9.88
Invesco PLC	1,915,850	7.16
Earnest Partners LLC	1,509,872	5.65
Price (T.Rowe) Associates	1,254,569	4.69
Barclays Global Investors UK Holdings	1,201,139	4.49

Source: Yahoo! Finance

CLARCOR Inc.

CLC

Price: $35.61 ($29.57 – $44.01)

Fiscal Year Ends: Nov 30

Date: December 4, 2007 — Luke LaManna & Andy O'Connell

Russell 2000 Index: 767.77 (734.45 – 856.48) — Industrial Materials Sector

Clarcor operates through three business segments: engine/mobile filtration, industrial/ environmental filtration, and packaging. The company's products include oil, air, fuel, and coolant filters for automobiles and industrial equipment, air filters for buildings, factories, and residential buildings, and containers and packaging for the food, confectionery, and chemical industries. Clarcor sells its products directly and through distributors. Clarcor was founded in 1904 and is headquartered in Franklin, Tennessee.

Recommendation

CLC operates as a leader in the filtration aftermarket. The company has consistently turned in solid financial results through a track record of organic growth and sound acquisitions. With a strong balance sheet, CLC is poised to take advantage of acquisition opportunities, grow market share, and execute their internal margin expansion initiatives. It is recommended that CLC be added to AIM portfolio at $35.61, which represents a 10.7% discount to the calculated intrinsic value of $39.43.

Key Statistics	Dec. 4, 2007
Market Cap	1.78B
Shares Outstanding*	49.89M
Average Volume*	332,017
Beta**	0.966
EPS (TTM)*	$1.77
2008 Estimated EPS*	$1.92
P/E (TTM)*	20.08
P/S (TTM)*	1.95
WACC	10.68%
Debt/Assets*	2.3%
ROE*	17.01%
Gross Margin	30.1%
Operating Margin	14.08%
Target Price	$39.43

*Source: Thomson, *Yahoo! Finance, **Bloomberg*

Investment Thesis

- **Attractive industry.** The filtration industry is driven by aftermarket sales, constituting 75% of the filtration market. Aftermarket sales tend to be high margin, and stable in nature. A broad spectrum of end users, friendly legislation, and a growth rate of 4.8% over the last decade has fuelled this stability. Clarcor derives nearly 80% of revenues from aftermarket sales, positioning Clarcor well for stability in various market conditions.
- **Market leader.** Clarcor is the market leader in the HVAC filtration, in-plant filtration, and aviation fuel market. They also hold a number two market share position with the heavy duty transportation aftermarket, and in industrial dust collection. Leading share and strong brand names will position Clarcor for secular growth.
- **Aggressive growth and margin improvement initiatives.** Management is continuing to target increased market share in the Engine and Industrial filtration business through the *Total Filtration Strategy.* The program has grown from $50-$100 million in revenue over 5 years, a 15% CAGR. Management is also targeting a 10% operating margin for

the HVAC business through a restructuring program. Successfully management of these programs will lead to both the top and bottom line improvements.

- **Strong financial condition.** Clarcor is in the process of acquiring Perry Equipment Corp., utilizing some of the $250 million in cash on its balance sheet. This acquisition will increase total revenue by 10%, and add $0.01-0.02 EPS in 2008. Acquisitions have added nearly 5% per year over the last decade, contributing to the average of 14% EPS growth per year. Clarcor has also approved a 3 year, $250 million buyback plan as of July 2007. Clarcor's strong balance sheet will provide a vehicle to keep revenue and EPS growth up in a modest growth industry.

Valuation

A 10-year discounted cash flow analysis indicates that CLC's intrinsic value is $39.88. The model assumes sales growth of 8.5% for 3 years followed by 8 years of 7% growth, and a terminal rate of 3%. The model factors in $10.5 million of cost savings per year by 2009 as a result of Clarcor's restructuring of their HVAC business. The P/E valuation yields a $38.98 price target, using a historical P/E of 20.3 and estimated EPS of $1.92 for 2008. Using these two valuation methods, a price target of $39.43 has been established. In addition, CLC pays a dividend, yielding 0.81% annually.

Sensitivity Analysis	Variables	Intrinsic Value
Upside Case	$14 million HVAC savings / Total Filtration Strategy fuels sales growth to 10% year / Stock buyback of $250 million	$48.68
Conservative Case	$4 million HVAC savings / Growth at 5% per year/Minimal stock buyback	$29.27

Figure 1: Sensitivity Analysis

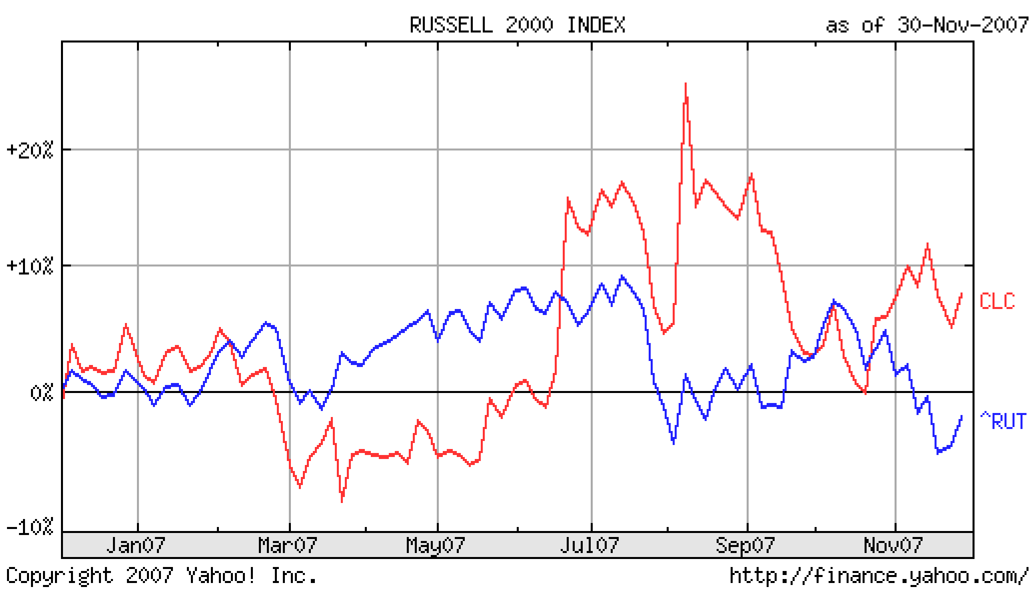
Risks

- **Business cycle.** Clarcor is affected by the general business cycle. In particular, softness in trucking and industrial markets will adversely affect Clarcor performance.
- **Execution of management initiatives.** To maintain the implied EPS growth rate of 11%, it will be necessary for management to achieve top and bottom line growth that combines to exceed the projected market growth rate of 5%.
- **Acquisition Risk.** The Perry Equipment Corp. acquisition is relatively large for Clarcor compared to historical acquisitions. Management typically grows through acquisition on 3-5% per year. This large acquisition may pose product line, systems, and cultural integration risks. It is also large enough to distract management from other portions of the business.

Management

Norman Johnson, age 58, has led Clarcor as the company's Chairman, President, and CEO since 2000. He has been with Clarcor since 1990 as a key member of management. Significant management goals include growing earnings per share 10% per year, while growing revenue 7-

10% organically, and 3-4% through acquisition. Five other executives head up various business units and functions.



Ownership

% of Shares Held by All Insider and 5% Owners:	34%
% of Shares Held by Institutional & Mutual Fund Owners:	97%

Source: Yahoo! Finance

Top 5 Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
Neuberger Berman, LLC	7,378,865	14.79%
Columbia Wanger Asset Management, L.P.	4,194,000	8.41%
Barclays Global Investors UK Holdings Ltd	2,570,019	5.15%
Gamco Investors Inc.	2,536,001	5.08%
Lord Abbett and Co.	2,367,408	4.75%

Source: Yahoo! Finance

IPG Photonics Corporation

IPGP

Price: $20.01 ($16.53 - $28.00)

Fiscal Year Ends: December 31

Date: December 4, 2007 | Luke Junk
Russell 2000 Index: 752.06 (734.45 - 856.48) | Hardware Sector

IPG Photonics is the dominant player in the fiber laser market, a disruptive technology that is taking significant market share from traditional solid state and CO_2 lasers. The company's product portfolio of low-, mid-, and high-power lasers are used in materials processing, communications, medical and advanced applications. Customers include major OEMs and system integrators, including Gillette, Mitsubishi, Reliant, Alcatel-Lucent, and Boeing. IPGP maintains sales offices throughout North America, Europe and Asia as 68% of sales come from outside the Americas. Competition primarily comes from traditional laser suppliers such as Trumpf, Rofin, and Coherent, while smaller firms provide some direct competition. IPGP has 1,000 employees and is headquartered in Oxford, Massachusetts.

Recommendation

IPG Photonics holds a 70% market share in the rapidly growing fiber laser market, which is expected to triple in size from 2007-2010. From 2005-2007E, IPGP has seen its revenues grow at a 40% CAGR while EPS has grown at a 69% CAGR. Fiber laser technology is expected to cannibalize the older, less effective laser technology in key industrial segments. Market share gains in the $2.5 billion laser market are expected to drive fiber lasers from their current 8% market share to 25% market share by 2010. The majority of fiber laser growth over the next five years is expected to come from mid- and high-power material processing segments, where IPGP holds its greatest competitive advantages. I am recommending the addition of IPGP to the AIM equity portfolio with a target price of $30.00.

Key Statistics	Dec. 4, 2007
Market Cap	$876M
Shares Outstanding	43.78M
Average Volume	151,788
Beta	0.46*
EPS (TTM)	$0.47
2008 Estimated EPS	$0.90
P/E (TTM)	42.94
P/S (TTM)	5.06
WACC	10.1%*
Debt/Assets	31.8%
ROE	30.1%
Gross Margin	46.4%
Operating Margin	25.4%
Target Price	$30.00

Source: Yahoo! Finance, Bloomberg*

Investment Thesis

- **Fiber Laser Revolution.** IPGP is a pure play in the high-growth fiber laser market. Currently a $200 million market, the fiber laser market is expected to growth at a 37% CAGR over the next five years. Growth will result as fiber lasers cannibalize the traditional laser market, which is currently a $2.5 billion market. Given IPGP's dominant 70% market share, the company is well positioned to capitalize on this explosive growth.
- **Technology Leader.** IPGP has been developing its fiber laser technology since the company's 1991 inception. It is the only fiber laser supplier that produces its own doped

fibers and pumped diodes. This has enabled IPGP to build production high-power fiber lasers, while competitors struggle to bring mid-power fiber lasers into production.

- **Cost Leader.** IPGP has reduced its diode cost by over 90% the last four years by producing the component internally. In the past, the component had been bought from JDS Uniphase. Since diodes represent a significant percentage of the bill of materials for high-power lasers (>50%). This represents a significant advantage over fiber laser competitors, none of whom are vertically integrated.
- **First Mover.** It is believed that IPGP has produced more fiber lasers (~21,000) than all other competitors combined. Given the firm's high degree of vertical integration and high production levels, IPGP should enjoy a several year first mover advantage over its fiber laser competitors.
- **High Value Proposition.** IPGP's mid- and high-power lasers are often priced below that of comparable solid state or CO_2 lasers (due to their internally produced diodes). This combines with lower operating costs to create a significantly lower total cost of ownership (a key element in choosing between laser options). Fiber lasers are also technologically superior to their traditional competitors, offering better beam quality, higher reliability, more flexible delivery system, and smaller footprint.

Valuation

A scenario analysis of my 10-year DCF model yields an intrinsic value of $30.65. The model assumes two five year growth rates and a WACC of 11.0%. The scenario analysis consists of a bear case (10% probability), base case (70% probability), and bull case (20% probability).

Scenario	Year 1-5 rate	Year 5-10 rate	Year 10-15 rate	Year 15-20 rate
Bear	15.0%	10.0%	3.0%	$16.97
Base	25.0%	12.5%	4.0%	$29.27
Bull	30.0%	15.0%	5.0%	$42.32

Figure 1: Scenario Analysis

Assuming forward valuation stays at the current 22x multiple yields a $26.18 price target on 2009 consensus EPS of $1.19. However, I think that IPGP's forward multiple will likely see some expansion from its current 22x level going forward. Considering both of these valuation metrics, a $30 price target has been established for IPG Photonics.

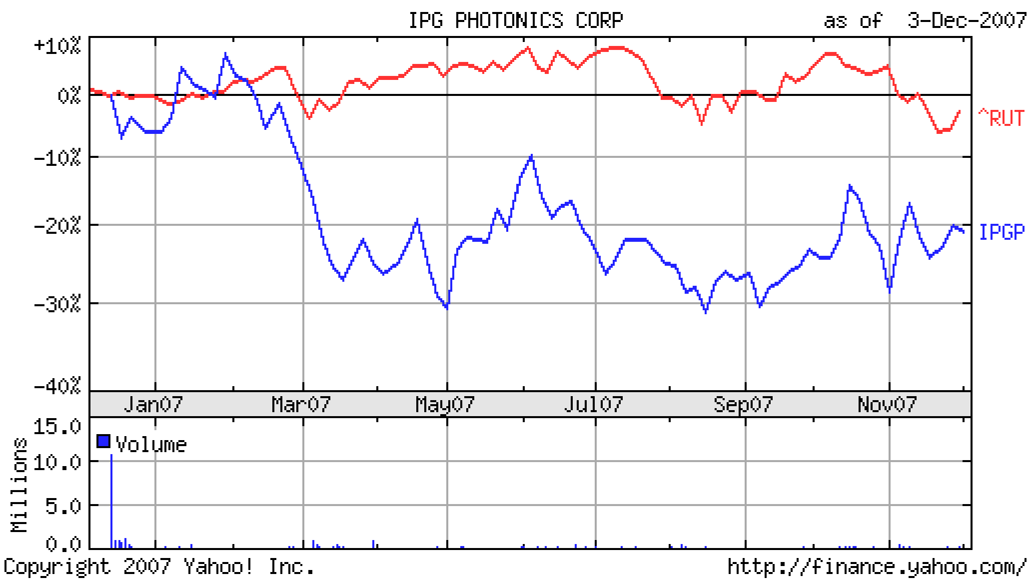
Risks

- **Slow Fiber Laser Adoption.** Many large industrial markets tend to be very conservative when switching between technologies, which could lead to slower than expected adoption of fiber lasers
- **Potentially Lumpy Business.** The large disparity in prices between low- and high-power lasers has the potential to cause lumpy revenues. Successful penetration of a single market could enhance this lumpiness even further.

Management

Dr. Valentin Gapontsev, IPGP's CEO, has more than 40 years of experience in lasers material sciences. He founded the company in 1991, and has served as its CEO ever since. While Dr.

Gapontsev is clearly an expert in laser technology, he is unproven as a CEO of a public company.



Ownership

% of Shares Held by Insiders:	52.52%
% of Shares Held by Institutional & Mutual Fund Owners:	28.60%

Source: Yahoo! Finance

Top 5 Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
TA Associates	3,083,438	7.04%
Columbia Wanger Asset Management	2,125,406	4.85%
Janus Capital Management	1,407,310	3.21%
Royce & Associates	1,376,699	3.14%
Schroeder Investment Management Group	1,407,310	3.21%

Source: Yahoo! Finance

Isle of Capri Casinos, Inc.

ISLE

Price: $15.50 ($15.40-$31.37)

Fiscal Year Ends: April 29

Date: December 4, 2007 — Gregory Sirotek

Russell 2000 Index: 752.06 (734.45 – 856.48) — Consumer Services

Isle of Capri Casinos, Inc. and its subsidiaries engage in the development, ownership, and operation of gaming facilities and related lodging and entertainment facilities in the United States and internationally. The company owns and operates casinos in Biloxi, Lula, and Natchez, Mississippi; Lake Charles, Louisiana; Bettendorf, Davenport, Marquette, and Waterloo, Iowa; and Boonville, Caruthersville, and Kansas City, Missouri; as well as a casino and harness track in Pompano Beach, Florida. It also operates two casinos in Black Hawk, Colorado. Isle of Capri Casinos' international gaming interests include a casino in Freeport, Grand Bahama; a casino in Coventry, England; and a two-thirds ownership interest in casinos in Dudley and Wolverhampton, England. The company operates its properties under the brands the isle, Isle of Capri, Colorado Central Station, and Rhythm City. As of August 2, 2007, it operated 18 casino properties. Isle of Capri Casinos was founded in 1990 and is headquartered in Saint Louis, MO.

Recommendation

Isle of Capri has been beaten down since mid-April due to poor quarterly results and negative EPS. However, it is my belief that the market has overreacted to this news, especially considering the Biloxi casino was affected by the closing of a bridge that connects Biloxi to the Florida panhandle. Furthermore, the addition of an experienced and proven successful management team and their immediate impact on EBITDA margins at existing properties suggests a likely turnaround story in this historically attractive industry. I believe in the management's ability to reposition the brand, further improve operations at existing casinos, and reduce high levels of debt. I see the current stock price as the floor for this company, and recommend the addition of ISLE to the AIM portfolio at a price target of $20.46.

Key Statistics	Dec. 4, 2007
Market Cap	$472.90M
Shares Outstanding	30.51M
Average Volume	212,560
Beta	1.24
EPS (TTM)	-0.70
2008 Estimated EPS	0.08
P/E (TTM)	N/A
WACC	8.32%
LT Debt/Total Cap	82%
ROE	-1.65%
Operating Margin	17.45%
Dividend Yield	0.00%
Target Price	$20.46

Investment Thesis

- **Opportunity to drive and improve margins.** In July 2007, ISLE hired Virginia McDowell as President and Chief Operating Officer, with her focus on improving core assets. Some casinos operate in low-growth markets with high levels of competition, and former management was over aggressive in its marketing strategy, which led to deteriorating margins in those areas. The recent focus on margin improvement was reflected in 1Q08 as EBITDA margins grew by approximately 360bps from 1Q07 and again in 2Q08 with margin expansion of 390 bps over 2Q07.

- **New management team with proven track record.** The new management team, COO and CFO, and a board of director member, all worked together previously at Trump Entertainment Resorts and prior to that at Argosy Gaming Company, which was a turnaround in itself. Already, the team decided to cancel plans of a new casino in Mississippi, which would have cost the company $320 million, and the decision was looked upon favorably by the street. Also, in early November, the company acquired the minority interest in Black Hawk from Nevada Gold at a 7.1x EV / EBITDA multiple and should be accretive when the deal closes in early 2008.
- **Attractive valuation.** Isle of Capri is down 44% since mid-April, and according to my conservative valuation, the market panicked and oversold the stock, and, therefore, the current price represents an attractive buying opportunity.

Valuation

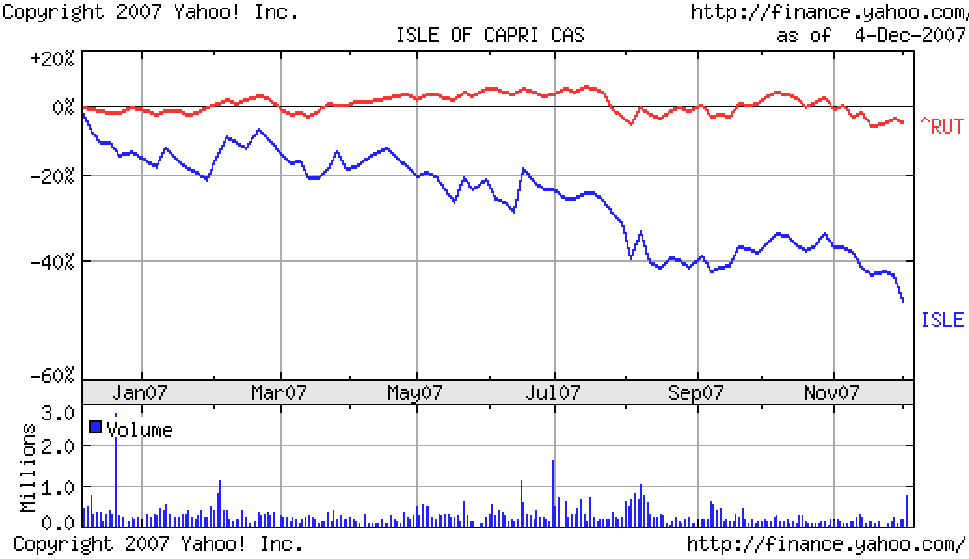
A 10-year discounted cash flow analysis indicates that Isle of Capri Casinos' intrinsic value is $18.51. Applying an 8.0x multiple to my FY09E EBITDA estimate yields a price target of $22.40. Taking both of these valuation metrics into account, my target price for ISLE is $20.46, which represents 32% upside potential to the current market price of $15.50.

Risks

- **If jurisdictions in which Isle of Capri operates choose to raise gaming taxes and fees**. State and local authorities raise a significant amount of revenue through taxes and fees on gaming activities. From time to time, legislators and government officials have proposed changes in tax laws, or in the administration of such laws, affecting the gaming industry. Periods of economic downturn and budget deficits may intensify the efforts of state and local governments to raise revenues through increases in gaming taxes. However, this phenomenon may also entice states to allow casino operation or expansion where they previously have not.
- **Increased competition could have a material adverse effect on future operations.** There are significant competitive threats in several of Isle's major markets. Specifically, new competition may arrive in Pompano Park from a Native American operator who is currently negotiating with the state of Florida to use Class III slots, which are preferred by consumers and produce more revenues. If the negotiations pass, Isle will no longer retain its competitive advantage as a Class III operator, and this could significantly damage the performance of the casino. Furthermore, competition in the Mississippi market is increasing, as existing properties have ramped up construction, especially near the Biloxi casino.
- **Gaming is a consumer leisure expense, making revenues potentially cyclical, and Isle's southern locations are exposed to weather/hurricane risk, which could also lead to revenue volatility.** Consumer spending on commercial casino gambling has increased at a 9% CAGR over a 15 year period from 1989 to 2004, and has never decreased on a YOY basis. However, revenues could be impacted by an economic downturn, and severe weather could provide for unstable visitor patterns to casinos in the south. The bridge that connects the Florida panhandle to Biloxi was destroyed and reopened with two lanes on November 1, and the lack of bridge significantly hurt Biloxi's performance.

Management

A new management team was announced in July, with Virginia McDowell, as president and COO and James Perry, a Board of Directors member who will most likely replace founder Bernie Goldstein as CEO. Most recently, Dale Black was appointed CFO. All three worked together at Trump Entertainment Resorts and prior to that at Argosy Gaming Company.



Ownership

% of Shares Held by All Insider and 5% Owners:	49%
% of Shares Held by Institutional & Mutual Fund Owners:	54%

Source: Yahoo! Finance

Top 5 Shareholders

Holder Name	Shares Held	Percent of Share Outstanding
Bamco Inc.	1,970,400	5.66%
Par Capital Management, Inc.	1,500,000	4.31%
OZ Management, L.L.C.	1,454,735	4.18%
Akre Capital Management, L.L.C.	1,136,090	3.26%
Thompson, Siegel & Walmsley, Inc.	1,087,550	3.12%

Source: Yahoo! Finance

Morningstar Inc.
MORN
Price: $80.20
Fiscal Year Ends: Dec. 31, 2007

Date: December 4, 2007 — Paul Simenauer
Russell 2000 Index: 753.47 (734.45 - 856.48) — Media Sector

Morningstar is a leading provider of independent investment research. The company helps investors reach their financial goals by offering an extensive line of Internet, software, and print-based products for individual investors, financial advisors, and institutional clients. Morningstar also provides asset management services for advisors, institutions, and retirement plan participants. Morningstar serves more than 5.2 million individual investors, 210,000 financial advisors, and 1,700 institutional clients, with operations in 15 countries.

Recommendation

Since going public in 2005, Morningstar has generated double digit earnings and revenue growth (64% and 43%, respectively), while doubling its assets under advisement from a year ago to nearly $81.5 billion. Favorable secular trends and a business model that achieves operating leverage will allow for further impressive growth going forward. An economic moat is provided by the company's branding, unique content, and deep databases that are time consuming and difficult to replicate.

Key Statistics	Dec. 4, 2007
Market Cap	3.52B
Shares Outstanding	44.02M
Average Volume	154,530
Beta v. Russell 2000	1.04
EPS (TTM)	$1.42
2008 Estimated EPS	$2.01
Forward P/E	39.81
WACC	14%
Cash Flow/Share	$4.388
Debt/Assets	0%
ROE	22.65%
Gross Margin	72.4%
Operating Margin	26.03%
EPS Growth Est (5-Year)	26%
Target Price	$99.00

Investment Thesis

- **Excellent business model.** MORN's databases can be viewed as fixed assets that the company is able to use to achieve operating leverage. This is favorable because as revenues increase, there is a strong possibility for margin expansion, which favorably impacts MORN's valuation. Morningstar achieves about 89% recurring revenue, with 23% of revenue coming from subscriptions to Morningstar.com, and 66% of revenue coming from other contractual renewals. As a result, Morningstar has a revenue run rate of about $390M. This allows management to control the business more easily and make future plans for growth, while creating visibility for shareholders. Revenue is also well diversified, coming from five main sources; Investment Consulting, Advisor Workstation, Licensed Data, Morningstar.com, and Principia.

- **Favorable Secular Trends.** Half of the world's wealth is outside of the United States, and we are seeing an emerging middle-class that is most likely planning for retirement. MORN is also levered to the Baby Boomers trend that will begin to accelerate in the next few years as more of them reach retirement. The company is well positioned to capitalize on both of these trends through strong branding, proprietary tools, and deep databases.

- **Clear Growth Strategy.** Morningstar has four key growth drivers going forward. First, management plans to continue to grow the company's internet platforms across all 3 of its segments- individual, advisor, and institutional. Next, the company plans to enter the fund of funds business and become a global leader by leveraging their extensive knowledge of managed investment products. The vast number of choices in fund of funds can be extremely daunting and Morningstar aims to simplify this process, adding value to its services by helping investors achieve better outcomes. Third, the company is planning to expand its range of products and services to meet investors' needs in the areas of hedge funds, equity research, and retirement income. Finally, Morningstar plans to continue to expand the company's international brand presence, products, and services. Their recent acquisitions of Aspect Huntley in Australia (4^{th} largest fund market in the world), and S&P's mutual fund database demonstrates Morningstar's commitment to meeting this goal.

Valuation

My price target of $99.00 is based on a DCF that incorporates a base case, bull case, and bear case, as well as a comparable multiples analysis. I took an average of the three scenarios and the comparable multiples to arrive at $99.00. My assumptions include a WACC of 14%, a consensus growth rate of 27%, and an incremental 50 basis point expansion of operating margins from 2007-2011 due to the company's favorable fixed database assets. I believe shares could trade as high as $108, based on a ceiling of a PEG multiple of 2x.

Risks

- **Failure to integrate recent acquisitions.** Morningstar recently made 4 major acquisitions, the first time the company has made sizeable acquisitions. Over the past year, the company acquired S&P's mutual fund database business, Ibbotson, Aspect Huntley, and InvestorForce.

- **Government Regulation.** Morningstar's investment advisory and broker-dealer businesses are subject to extensive regulation in the United States at both the federal and state level. Morningstar is regulated by both the SEC as well as the ERISA. Any changes in regulation could have an adverse impact on Morningstar's business.

- **Concentrated ownership.** Joe Mansueto is the founder of Morningstar and the company's largest shareholder by a considerable margin (~70% of all shares outstanding). As a result, he holds a majority of voting rights at Morningstar, and has not been friendly to buy-side and sell-side analysts.

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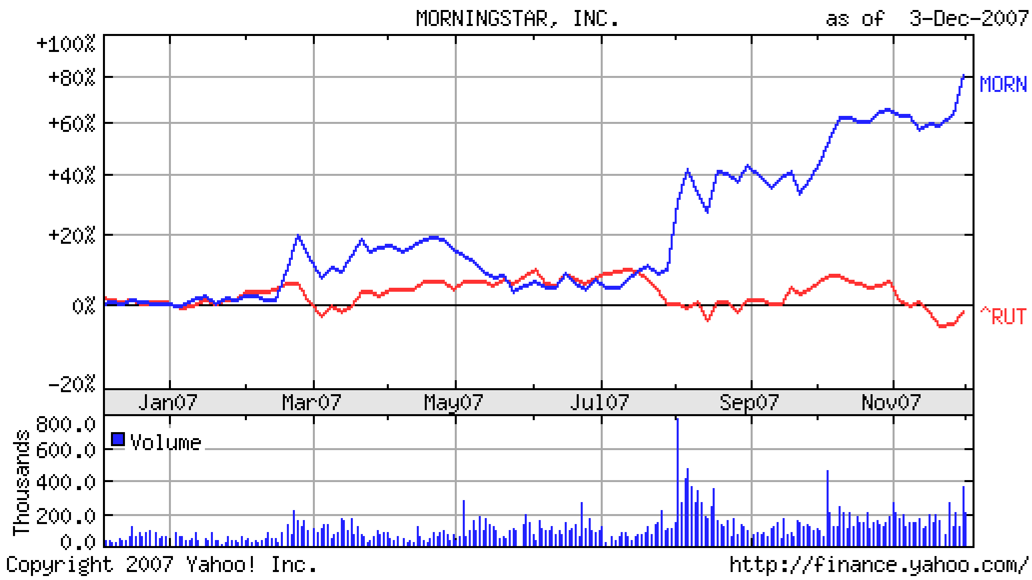
Management

Joe Mansueto founded Morningstar in 1984, and currently serves as chairman and CEO. He has a lot of experience in this industry and is the company's largest shareholder, holding 70% of shares outstanding. Under his guidance, the company's main priority has been their shareholders. The same metrics used to evaluate stocks are also used to evaluate their own business – building intrinsic value over a long period of time.



Ownership

% of Shares Held by All Insider and 5% Owners:	68%
% of Shares Held by Institutional & Mutual Fund Owners:	32%

Source: Yahoo! Finance

Top 5 Institutional Holders

Holder	Shares Held	Percent of Shares Outstanding
Morgan Stanley	2,420,971	5.5%
Bamco Inc.	1,355,500	3.08%
Chartwell Investment Partners	744,689	1.69%
Geneva Investment Management of Chicago, LLC	728,831	1.66%
Times Square Capital Management	698,550	1.59%

Source: Yahoo! Finance

PAETEC Holding Corp.

PAET

Price: $10.01 ($7.97 – $20.40)

Fiscal Year Ends: December 31, 2007

Date: December 4, 2007 Katherine Provo

Russell 2000 Index: 756.88 (734.45 – 856.48) Telecom Sector

PAETEC is a facilities-based competitive local exchange carrier offering wireline communications services to medium and large businesses in 52 of the top 100 major metropolitan areas on the East Coast and in California. The compny provides businesses with local voice, long distance, data, Internet, and other services. PAETEC Holding Corp. was created on March 1, 2007 after the merger of PAETEC Inc with US LEC. PAET is currently in the process of acquiring McLeod USA, which is on target to be completed in the first quarter of 2008.

Recommendation

PAET's current market price has been beaten down with the market turmoil and uncertainties surrounding their recent acquisitions. Using a DCF model and comparable multiples, I found an intrinsic value for the company of $13.82. Not only would an investment in PAET provide the portfolio with positive returns, but it is also an opportunity to diversify the telecom holdings and take advantage of industry trends.

Key Statistics	Dec. 4, 2007
Market Cap	$1.079B
Shares Outstanding	102.75
Average Volume	761,339
Beta	1.25
EPS (TTM)	$(0.03)
2007 EPS est.	$0.16
WACC	10.00%
Price/Sales	0.6
Price/Cash Flow	7.1
Debt/Equity	65%
ROE 2007E	8.9%
ROA	7.2%
EV/EBITDA	8.1x
Capex/Rev	7.3%
Operating Margin	8.5%
Target Price	$13.82

Investment Thesis

- **Pending acquisition will result in increased scale and scope.** McLeod is a provider of IP services to small and medium businesses. The acquisition will increase PAET’s presence to 82 of the top 100 metropolitan areas in the US. The company expects to see an increase of over 60% in revenue, along with $30 million in synergies within the first year.
- **Product offering far superior to competitors.** PAET offers approximately 3,500 different products and services that they customize to meet the specific needs of their customers. This differentiates them from their competitors who offer a far fewer number of pre-bundled service options to their enterprise customers.
- **Superior customer service is a competitive advantage.** Sales reps are compensated for the initial sale of products, as well as every year the account is maintained. When a customer is experiencing service problems they can go directly to their sales rep instead of an automated service. As a result, PAET’s churn has stayed under 1% for the past three years.

Valuation

Using a DCF to model PAET's future financial performance, I valued the company at about $15.40, using a WACC of 10% and a terminal growth rate of 3%. My DCF sensitivity analysis is included below. PAET is also undervalued given comparable multiples. Using FCF per share for 2009E FCF, a value of $12.18 was found. Weighting these two values equally, I believe $13.82 is a reasonable value for PAET, which is a 38% premium to the most recent closing price.

Terminal Growth Rate	**WACC**				
	9.0%	**9.5%**	**10.0%**	**10.5%**	**11.0%**
2.0%	17.18	15.55	14.14	12.93	11.88
2.5%	18.05	16.25	14.72	13.41	12.27
3.0%	19.07	17.06	15.38	13.95	12.71
3.5%	20.27	18.01	16.14	14.56	13.22
4.0%	21.71	19.13	17.02	15.27	13.79

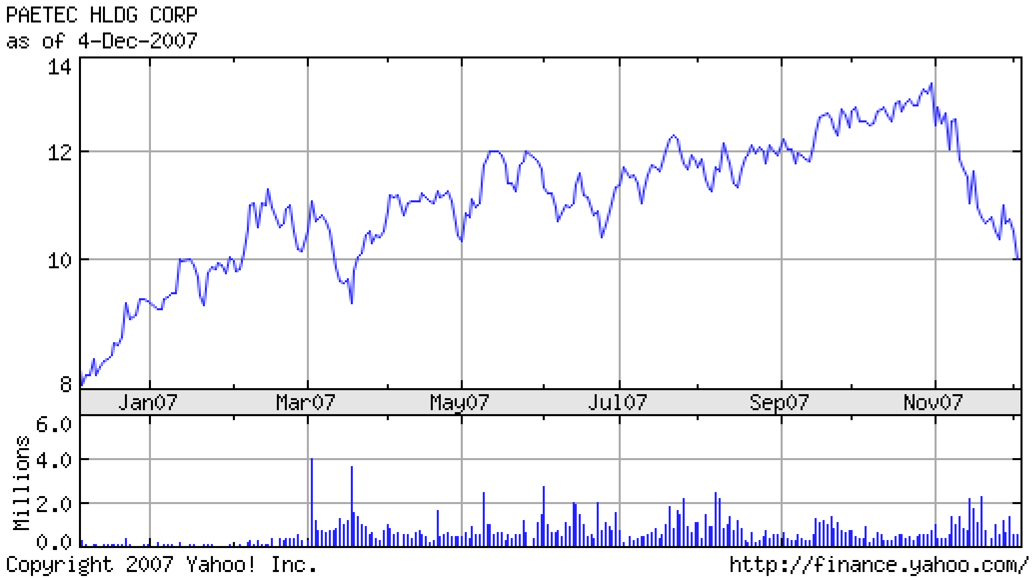
Figure 1: Scenario Analysis

Risks

- **Integration risk.** PAET will have completed two large acquisitions within the last two years. PAET may not have the ability to complete the integration on time and within budget, especially given that McLeod's assets have been underperforming and may require additional capital to redistribute them to other business segments. PAET's solution-based selling and 3,500 price points may also cause challenges with billing and service integration.
- **Dependence on incumbent local exchange carriers (ILEC) for last mile access.** To minimize capital requirements, PAET leases the last mile of fiber line from the ILEC. Since PAET cannot rely on the price the ILEC will charge, this creates risks in the long-term cost structure of the company. Changes in the regulation of pricing for special access or UNE-L, on which McLeod currently operates, would greatly increase the cost of service.
- **Increased competition in the enterprise arena.** Competition in the market is expected to increase over time. The trend of consolidation in the industry has created bigger players with more resources. PAET's largest competitors, AT&T and Verizon, have also benefited from consolidation. With the increase in competition prices have eroded at 3%-5% annually and could continue to do so into the future.

Management

Arunas Chesonis is PAET's founder, chairman, and CEO. His many years in the telecom industry included time as president of ACC Corp before AT&T purchased it in 1998. Mr. Chesonis left to start PAET and brought two of his current executives, the COO and CIO, along with him. The Chief Financial Officer is Keith Wilson, who came to the company in 2001 after serving as the VP of Telecommunications Finance Group at Union Bank of California. The board of directors is made up of nine members, six of which are independent. Richard Aab, the co-founder of US LEC serves as Vice Chairman of the Board. Mr. Aab and Mr. Chesonis possess the majority of insider shares outstanding, holding 8% each.



Ownership

% of Shares Held by All Insider and 5% Owners:	25%
% of Shares Held by Institutional & Mutual Fund Owners:	64%

Source: Yahoo! Finance

Top 5 Institutional Holders

Holder Name	Shares Held	Percent of Share Outstanding
Gilder, Gagnon, Howe & Co.	9,480,337	9.23%
Madison Dearborn Partners	5,571,906	5.42%
Fidelity Management & Research	5,148,600	5.01%
New Moon Trust	4,425,000	4.31%
Tremblant Capital Group	3,738,925	3.64%

Source: Yahoo! Finance