

23 October 2007

# Active Voice: Micro Cap

## Key Exhibits

High vs. Low Quality Sector Performance, pg 2

Industrials Foreign Exposure, pg 3

Industrials: Energy-related vs. Construction-sensitive Performance, pg 4

Micro Cap Industrials Quality Metrics, pg 5

## Market Price Performance

As of 22 October	% Change	
	YTD	Since Jan '06
Cirrus MSX Industrials	30.7	55.8
Cirrus Mid Cap Industrials	37.6	63.0
Cirrus Small Cap Industrials	22.6	49.7
Cirrus Micro Cap Industrials	18.3	34.2
S&P 500 Industrials	11.3	25.6
S&P Mid Cap Industrials	22.6	36.9
S&P Small Cap Industrials	14.3	34.3
Ind. Select Sector SPDR Fund	14.4	27.5
iShares DJ US Ind. Sector Fund	14.3	27.9
Vanguard ETF Industrials	15.6	31.7
PowerShares Dyn. Ind. Port.	18.3	---
Rydex ETF S&P Eq. Wt. Ind.	14.6	---
iShares S&P Global Ind. Fund	17.8	---
Wisdom Tree Intl Ind. Fund	6.1	---

## Active Voice: Micro Cap

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Valuation levels and high earnings expectations of industrial-based stocks force a selective posture. Three themes to isolate and leverage within the Industrial sector: High Quality, Foreign Exposure and Energy-related Spending.

## Trade Ideas

### ■ #1: Quality. Growth managers buy Quality, not Cyclical, right?

Adopt a quality bias among Industrials as the Industrial run gets into its later stages. A relative value basket that is long higher quality over lower quality industrial names allows one to maintain exposure and yet mitigate some of the valuation/cyclicality risk that can accompany this sector.

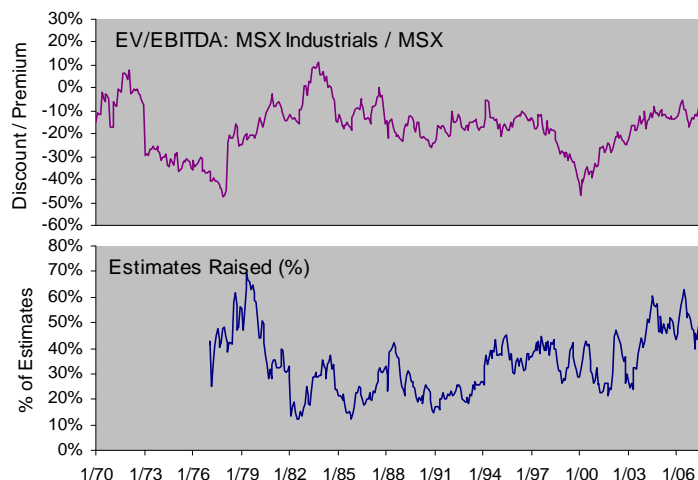
### ■ #2: Foreign Exposure & Industrials – It's all about China.

Long a basket of Industrials with high foreign revenue exposure. Such firms are likely to benefit from global industrial spending and a weakening dollar.

### ■ #3: Energy-related Industrials lead Construction-sensitive Industrials.

Long a basket of Industrials likely to benefit from increased industrial spending tied to rising energy costs. Short a basket of Construction-related Industrials to limit the downside from the on-going downturn of the housing sector.

Fig 1: High valuation levels and lofty earnings forecasts among Industrial stocks force selectivity.



Source: Cirrus Research, I/B/E/S

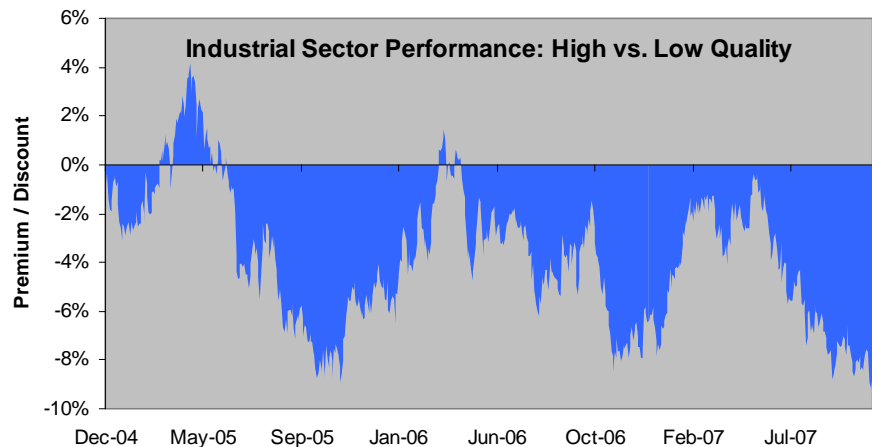
## Quality – Growth managers always buy Quality, not Cyclical, right?

**Trade Idea: Adopt a quality bias among Industrials as the Industrial run gets into its later stages. A relative value basket that is long higher quality over lower quality industrial names allows one to maintain exposure and yet mitigate some of the valuation/cyclicality risk that can accompany this sector.**

As a penchant for conservative investments and visible earnings becomes more prevalent, a higher quality bias can only become a dominant trait among Industrials. While it appears that market participants continue to chase after cyclicality, we see the Industrial sector evolving from a pure cyclical to “growth cyclical.” The incremental buyer of this sector may be the “high quality growth” manager. Furthermore, a quality bias seems appropriate as growth and quality-growth managers pay greater attention to the Industrial sector. Additionally, continuing concern over consumer credit underscores a broad market-based quality bias.

Figure 2 relates a simple performance spread between higher quality and lower quality industrials. The term “quality” is captured here via a simple combination of Return on Equity, Leverage (Debt to Total Capital), Size (Market Capitalization) and Earnings Dispersion (standard deviation of estimates divided by mean consensus estimate for the current year). Higher quality industrials have underperformed lower quality by almost 10% in just a few months.

Fig 2: The rush to lower quality Industrials appears in vogue. High sector valuations could easily reverse the low-quality bias.



Source: Cirrus Research

### Micro Cap Industrials: Quality Rankings

		Mkt Value
<b>Aerospace &amp; Defense</b>		
Cubic Corp.	CUB	1,056
TASER International	TASR	899
ARGON ST Inc.	STST	404
<b>Building Products</b>		
Comfort Systems USA	FIX	592
Insteel Industries Inc.	IIIN	345
Drew Industries Inc.	DW	856
<b>Const. &amp; Engineering</b>		
Michael Baker Corp.	BKR	364
Sterling Construction	STRL	243
ENGlobal Corp.	ENG	246
<b>Elec. Comp. &amp; Equip.</b>		
Lamson & Sessions Co.	LMS	419
LSI Industries Inc.	LYTS	435
AZZ Inc.	AZZ	343
<b>Multi-Industry</b>		
Raven Industries Inc.	RAVN	737
Standex International	SXI	306
<b>Const. Machinery</b>		
A.S.V. Inc.	ASVI	379
Gehl Co.	GEHL	291
<b>Farm Machinery</b>		
Alamo Group Inc.	ALG	249
Lindsay Corp.	LNN	476
Titan International Inc.	TWI	791
<b>Heavy Trucks</b>		
Wabash National Corp.	WNC	393
Accuride Corp.	ACW	457
Commercial Vehicle Grp	CVGI	304
<b>Industrial Machinery</b>		
Dynamic Materials Corp.	BOOM	522
Tennant Co.	TNC	787
Gorman-Rupp Co.	GRC	454
<b>Industrial Dist.</b>		
Houston Wire & Cable	HWCC	387
Kaman Corp.	KAMN	807
Rush Enterprises (CI A)	RUSHA	643

**Micro Cap: Top Foreign Sales Exposures**

	Ticker	% Sales
<b>Aerospace &amp; Defense</b>		<b>5%</b>
Allied Defense Group	ADG	52%
Astronics Corp.	ATRO	20%
TASER Intl Inc.	TASR	14%
<b>Building Products</b>		<b>1%</b>
Quixote Corp.	QUIX	17%
<b>Const. &amp; Engineering</b>		<b>11%</b>
Furmanite Corp.	FRM	56%
Michael Baker Corp.	BKR	13%
<b>Elec. Comp. &amp; Equip.</b>		<b>13%</b>
China BAK Battery Inc.	CBAK	87%
Preformed Line Prod.	PLPC	49%
Active Power Inc.	ACPW	42%
<b>Farm Machinery</b>		<b>13%</b>
Alamo Group Inc.	ALG	32%
Lindsay Corp.	LNN	26%
<b>Heavy Trucks</b>		<b>11%</b>
Miller Industries Inc.	MLR	19%
Com. Vehicle Group Inc.	CVGI	13%
Greenbrier Cos.	GBX	11%
<b>Industrial Machinery</b>		<b>31%</b>
Hurco Cos.	HURC	66%
Ampco-Pittsburgh Corp.	AP	59%
Hardinge Inc.	HDNG	59%
<b>Industrial Dist.</b>		<b>7%</b>
Kaman Corp.	KAMN	14%
Electro Rent Corp.	ELRC	13%
<b>Micro Cap Industrials</b>		<b>14%</b>

Source: Cirrus Research, Compustat

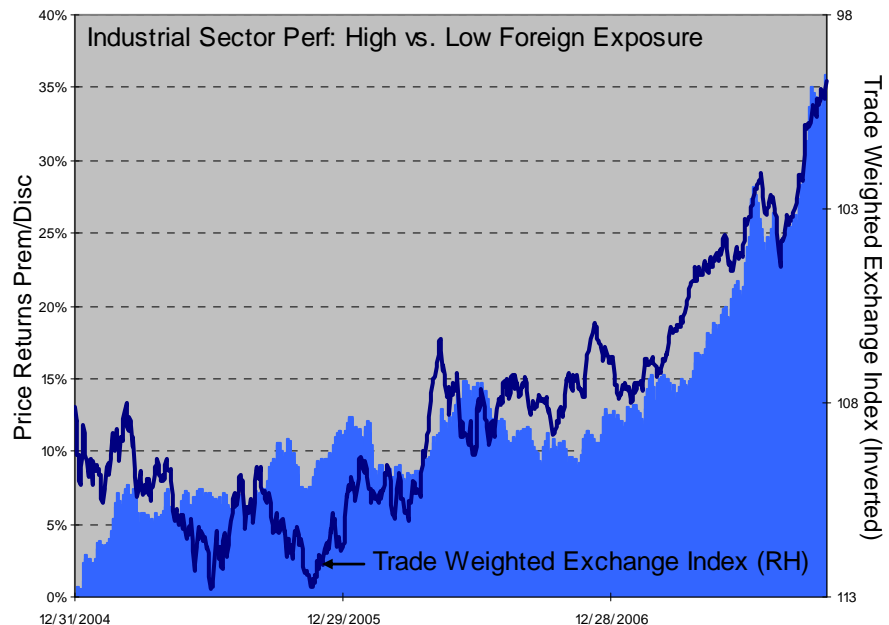
**Foreign Exposure & Industrials – It's all about China.**

**Trade Idea: Long a basket of Highly Foreign Exposed industrials to benefit from the global growth industrial spending trend and weak dollar and offset the domestic bias of small stocks.**

China. Need we say more? The industrial demand trend in Asia will continue to dwarf US industrial spending over the next few years. Consistent with this is a bias to look to firms that have strong overseas exposure. Clearly, the weakening greenback can only exacerbate current trends. The relative performance curve, Figure 3, indicates that stocks with high foreign revenue exposure in the Industrial sector are dominant. Unless one can position on a strong US dollar, this high foreign exposure basket remains a crucial way to isolate Industrial sector leadership.

The basket of Industrial firms with high foreign revenue exposure (40% or greater sales outside the US) outperformed the basket of their lower exposed counterparts by roughly 35% since January 2005. Benefits of foreign revenue sources do not appear to be limited to firms with direct business in the Far East, but also our neighboring trading partners, Mexico and Canada.

Fig 3: The Industrial build-up in Asia coupled with a plummeting US Dollar should continue to drive highly foreign exposed Industrial firms.



Source: Cirrus Research, Federal Reserve

## Focus on Industrials that benefit from rising energy costs, not on Housing/Construction

**Trade Idea: Long a basket of Industrials likely to benefit from increased industrials spending tied to rising energy costs. Short a basket of Construction-related Industrials to limit the downside from the on-going downturn of the housing sector.**

### Micro Cap Industrials: Top Energy Exposures

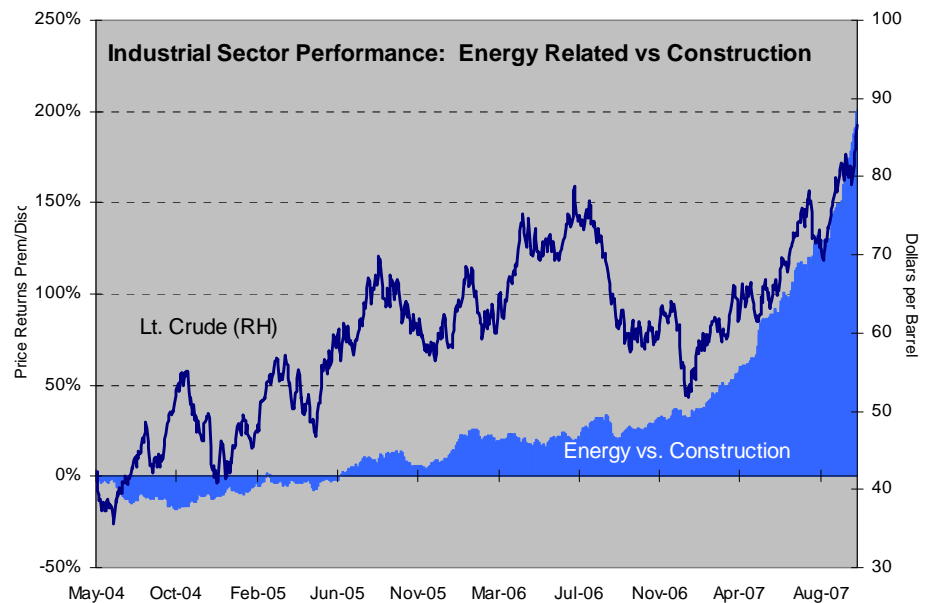
	Ticker	Mkt Cap
<b>Const. &amp; Engineering</b>		
Michael Baker Corp.	BKR	364.8
ENGlobal Corp.	ENG	246.7
Furmanite Corp.	FRM	289.4
<b>Elec. Comp. &amp; Equip.</b>		
American Superconductor	AMSC	646.9

Decomposing the Industrial sector into select end markets presents a distinct divide. The market favors those companies selling into energy- and power-related industries and is understandably cautious about those selling into construction markets. The weakness in housing-related and construction-centric groups is tied to the markets' on-going concerns that consumer credit and the housing market can only slow further.

Figure 4 depicts the performance of the energy-tied Industrials. In short, the market has continued to favor this sub-segment of the Industrial exposure. Unless one has a radically more constructive view on the Housing/Consumer Credit situation, this current leaning towards Industrials, and more importantly, Industrials with an energy/efficiency bent, this trade remains open.

Our 16 October *Active Voice* report on Industrials argues that industries such as Construction & Engineering and Construction Machinery are expensive.

Fig 4: Markets are likely to reward energy-related Industrials and penalize those firms related to Housing and Construction.



Source: Cirrus Research

## Micro Cap Industrials: Quality Metrics

		Valuation				Quality Metrics		
		Fwd P/E	EV/EBITDA	Price/Book	ROE	Debt/Cap	Market Value	Earnings Dispersion <sup>1</sup>
<b>Aerospace &amp; Defense</b>								
CUB	Cubic Corp.	28.2	14.5	2.9	10.5	0.04	1,056.2	0.02
TASR	TASER International Inc.	82.3	48.5	8.4	8.8	0.00	899.2	0.05
STST	ARGON ST Inc.	24.5	10.1	1.4	6.3	0.00	404.9	0.01
<b>Building Products</b>								
FIX	Comfort Systems USA Inc.	17.1	9.5	2.3	11.4	0.00	592.3	0.01
IIIN	Insteel Industries Inc.	11.1	6.7	2.5	20.5	0.00	345.5	0.04
DW	Drew Industries Inc.	22.1	11.7	3.7	14.3	0.05	856.5	0.03
<b>Const. &amp; Engineering</b>								
BKR	Michael Baker Corp.	24.1	N/A	3.4	19.5	0.00	364.8	0.23
STRL	Sterling Construction Co. Inc.	18.8	8.1	2.5	13.1	0.10	243.3	0.02
ENG	ENGlobal Corp.	21.9	37.4	5.1	-0.6	0.12	246.7	0.02
<b>Elec. Comp. &amp; Equip.</b>								
LMS	Lamson & Sessions Co.	14.8	7.4	2.9	20.9	0.05	419.3	0.02
LYTS	LSI Industries Inc.	18.4	10.3	2.5	11.7	0.00	435.9	0.05
AZZ	AZZ Inc.	17.5	7.5	2.6	19.3	0.06	343.6	0.03
<b>Multi-Industry</b>								
RAVN	Raven Industries Inc.	27.0	15.0	6.8	25.2	0.00	737.2	N/A
SXI	Standex International Corp.	N/A	9.8	1.5	7.8	0.35	306.5	N/A
<b>Const. Machinery</b>								
ASVI	A.S.V. Inc.	24.4	14.7	2.1	7.1	0.00	379.1	0.10
GEHL	Gehl Co.	10.7	7.1	1.2	11.3	0.20	291.2	0.02
<b>Farm Machinery</b>								
ALG	Alamo Group Inc.	21.3	11.3	1.3	4.8	0.30	249.3	0.01
LNN	Lindsay Corp.	33.6	13.8	3.4	11.2	0.07	476.1	N/A
TWI	Titan International Inc.	72.8	N/A	2.6	-3.3	0.20	791.2	N/A
<b>Heavy Trucks</b>								
WNC	Wabash National Corp.	22.4	N/A	1.4	2.5	0.24	393.3	0.06
ACW	Accuride Corp.	18.8	N/A	1.7	11.3	0.56	457.5	0.19
CVGI	Commercial Vehicle Group Inc.	43.8	5.8	1.1	11.9	0.33	304.8	N/A
<b>Industrial Machinery</b>								
BOOM	Dynamic Materials Corp.	24.5	14.9	7.7	31.1	0.00	522.0	0.02
TNC	Tennant Co.	26.7	11.8	3.3	13.5	0.00	787.5	0.01
GRC	Gorman-Rupp Co.	19.5	11.4	3.3	15.0	0.00	454.9	0.04
<b>Industrial Dist.</b>								
HWCC	Houston Wire & Cable Co.	11.5	7.1	3.9	33.5	0.02	387.6	0.02
KAMN	Kaman Corp.	20.4	N/A	2.5	12.2	0.12	807.0	0.04
RUSHA	Rush Enterprises Inc. (CI A)	14.2	7.8	1.7	15.8	0.50	643.9	0.03

<sup>1</sup> Earnings Dispersion is defined as the Standard deviation of earnings estimates divided by the consensus mean estimate for FY1.

Source: Cirrus Research

## Analyst Certification

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### Cirrus Benchmarks

Asset Class	Market Cap Range
Nano Cap	\$10 mn - \$100 mn
Micro Cap	\$100 mn - \$600 mn
Small Cap	\$600 mn - \$2.4 bn
Mid Cap	\$2.4 bn - \$10 bn
Large Cap	>\$10 bn