# The Commonsense INVESTLETTER

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**Wall Street:**

- DJ 12266
- S&P 500 1331
- NASDAQ 2271

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## Astronics E&D

***Examining financial statement is one small dose accounting and a hearty dose of skepticism.***

A company's financial statements are best taken with a healthy dose of interpretation. The statements are the raw materials that mark the starting point for evaluation. So many estimates and interpretation are present in a company's statements that you have to consider all of the particulars and massage the numbers to suit your purposes. You need to consider the companies operations and the underlying economic reality of what is really going on. From there, the next step is to apply what you know about the company's business and adjust the financial statements to account for the weaknesses in Generally Accepted Accounting Principles (GAAP).

Accounting principles are often political accommodations to the group that can spend the most money or shout the loudest. At times reason wins out and commonsense prevails. In other instances, the accounting principles are outdated and make concessions for the sake of convenience that are no longer necessary in the age of computers.

Here is an example of how the consideration of what is happening in a company's business affects how you interpret their earnings. One basic concept in accounting involves matching expenses with the associated revenue that they are related to. It is, you guessed it, called the matching principle. While it is a general principle, it is not universally followed. We need to consider the context in which changing expenses impact earnings and how to best interpret it.

When a new building is constructed it is an expense to a business. If Astronics spent $10 million constructing an addition to their plant, what would be the best way to match the expenses associated with construction with the revenues they would help generate? GAAP says that you will depreciate the building over its expected life. Without worrying about specifics, say they project the building to last 20 years. Each year the building would generate $500k in expenses (one twentieth of the cost). If the company can only generate $400k in revenue using the new addition it would be a huge money loser and a poor investment. It would need to be responsible for much more than $500k to be profitable considering the other expenses that would go along with a large addition, like added manpower. Even if the building lasts longer than fifty years, the building will generate expenses only for the first twenty. Ideally you would expense the building exactly as it was used up, but GAAP allows these simplifying assumptions like estimating the building will last 20 years to make things easier for everyone. If a company wanted to show higher earnings and had a building they new would last twenty years, they could always project it to last thirty years, thereby reducing the yearly expense and artificially reporting higher earnings.

## Astronics E&D

This example is somewhat pertinent because Astronics has recently made an addition to their East Aurora plant. So they have estimated how long their addition will last and the expenses are being matched against revenues each year, reducing earnings, as they should. During the last earnings report the company stated they will be increasing their E&D costs, and no matter how many times I see E&D, I have to stop and try and remember what it stands for. (After a noticeable pause.) It is Engineering and Development. E&D expenses are one of the exceptions to the matching principle. They are expensed as incurred. Suppose for arguments sake that Astronics is going to spend $10 million on E&D this year. This will be $10 million in expenses on the income statement that will depress earnings to a much larger extent than a similar amount spent on a building. For some companies this treatment may be very appropriate and for others it is akin to a fairy tale. For a biotech company that spend a large amount of money on developing their first drug candidate and manages to produce a major commercial success, all of the revenues will be generated a great deal after the expenses have already flowed through the financial statements. Another company that sinks a billion plus into development of a dud shows very accurate treatment when they account for their research and development expenses in the same period as they occur. There will be no future revenues to match the expense against. No matter what a company's track record with development, all development expenses are treated equally, they are all counted as expenses in the same accounting period as they occur.

***Whether it is E&D or R&D, the successful companies are treated the same as the unsuccessful. In each instance the costs are expensed as incurred, even if it creates revenues for years to come***

Astronics has a very good record in developing new products that lead to significant new revenues down the road. The significant boost in E&D spending will hurt earning in 2008 because they are expensed as they are incurred. There is an important distinction in E&D expense and R&D expense. E&D involves developing a product for a customer or new customer and adding new capabilities or improvements. R&D can mean everything from general research to exploring next generation technology or the costs of developing a new drug candidate. It matters not, it is all treated the same for accounting purposes. No matter what a company's track record for developing products or landing contracts that generate revenue, everyone is treated the same.

The last time Astronics hunkered down and increased E&D spending they experienced the current surge in revenues. Management has stated they see numerous opportunities that they are aiming at taking advantage of. The hit to earnings the company will experience will continue to put downward pressure on the share price. When this current burst in E&D expense starts to bring in new revenues, the company will see another sharp rise in new business. Nothing is guaranteed in business, but the increase in spending causes us little concern. If management had little on the horizon worthy of making added development efforts that would be cause for concern.

The company is truly being led for the benefit of long term investors. They are foregoing larger current earnings for the payoff of much better performance down the road. Our suspicion is that we won't have to wait all that long. As early as the end of 2008, the company could already be showing progress on their objective of increased new business. By 2010, the company could easily be experiencing rapid growth once again. Just as at $50 dollar per share the company had to have a lot go right to justify that price, the company has to have little future success to keep the price down at the current level. The long term horizon that the company is managed on will lead to the largest possible creation of value for the owners. If only more companies were run this way.

## Watch List

The flight to quality. Whenever the talk of recession gets tossed around, there is a flight to consumer goods, including medical goods and services, hard assets and commodities. Commodities include oil companies, gas companies, the miners, and others. Hard asset rich companies are timber companies and one of our favorites, land. On the list below we have Altria which owns a large stake in Kraft Foods and produces cigarettes, both consumer goods; Arch Coal which is self explanatory as far as what they do; Canadian Natural Resources which is active in the Canadian oil sands, Kensey Nash which makes orthopedic supplies; Landauer and SHPI which also makes medical products; and Alico and Tejon Ranch which both own large amounts of land. Many of the companies listed above have held up well in the turmoil that has been present in the market so far this year, just as would be expected. Everyone still needs to eat and healthcare is still a necessity, meaning the demand for these products doesn't change much when the economy slows. Fuel usage is notorious for being consistent even in the face of rising prices and slowing economic activity. The large price increases in gasoline over the past few years is just beginning to slow the usage of gas.

Always of particular interest to us is the land companies. Many of them have held up extremely well this year. In the face of plunging real estate prices in Florida, land prices have held up remarkably well. Some housing markets in Florida have prices down 30% off their market highs of just a couple of years ago. The land prices have barely budged. Many more houses can be built. Not much land is going to be produced (minus any large dredging efforts). Investors are more prone to invest in companies with assets that are less likely to lose value or goods which have inelastic demand. Prescription drug demand doesn't change much in the face of changing economic circumstances. The timber companies also reflect the strength in land prices. Rayonier has recently announced a couple of land purchases. One was for timberland in the northwest for prices near $4,000 per acres which is historically on the high side. Our portfolio is designed to minimize our chances of losing money and the companies we follow often exhibit traits where the odds are tilted in our favor.

| Company | February price | January price | Change from January | P/E | 52 Week High | 52 Week Low | Estimated '08 EPS | Dividend Yield |
|---|---|---|---|---|---|---|---|---|
| **Alico/**ALCO | $40.85 | $42.70 | -4.33% | n/a | $65.00 | $35.35 | n/a | 2.70% |
| **Alliant Techsystems Inc./**ATK | $104.94 | $105.85 | -0.86% | 16.4 | $120.90 | $85.50 | $6.39 | n/a |
| **Altria Group, Inc./**MO | $73.14 | $75.79 | -3.50% | 16.0 | $87.85 | $63.13 | $4.75 | 4.00% |
| **Arch Coal/**ACI | $51.09 | $43.95 | 16.25% | 21.5 | $56.15 | $27.76 | $2.38 | 0.70% |
| **Bioanalytical Systems, Inc./**BASI | $6.19 | $7.44 | -16.80% | n/a | $9.39 | $5.89 | n/a | n/a |
| **Canadian Natural Res./**CNQ | $74.84 | $63.81 | 17.29% | 18.6 | $87.17 | $48.33 | $4.22 | 0.50% |
| **Culp/**CFI | $7.30 | $6.82 | 7.04% | 13.8 | $12.30 | $5.68 | $0.53 | n/a |
| **Graham Corp./**GHM | $38.48 | $31.45 | 22.35% | 18.7 | $60.96 | $11.11 | $1.85 | 0.30% |
| **Kensey Nash/**KNSY | $27.15 | $27.15 | 0.00% | n/a | $31.80 | $22.26 | n/a | n/a |
| **Landauer, Inc./**LDR | $47.80 | $47.44 | 0.76% | 22.3 | $54.39 | $45.50 | n/a | 4.10% |
| **Markel/**MKL | $464.75 | $463.00 | 0.38% | 11.4 | $554.95 | $394.99 | n/a | 0.40% |
| **ModPac/**MPAC | $6.00 | $6.96 | -13.79% | n/a | $11.46 | $5.15 | n/a | n/a |
| **QLT Inc./**QLTI | $3.02 | $3.67 | -17.71% | n/a | $8.56 | $3.02 | n/a | n/a |
| **Servotronics Inc./**SVT | $19.35 | $14.70 | 31.63% | 21.2 | $20.00 | $8.34 | n/a | n/a |
| **Specialized Health Products/**SHPI | $0.87 | $0.79 | 10.13% | 31.1 | $0.99 | $0.66 | n/a | n/a |
| **Tejon Ranch Co./**TRC | $35.40 | $37.55 | -5.73% | n/a | $52.00 | $34.50 | $0.42 | n/a |
| **Torm/**TRMD | $30.25 | $32.37 | -6.55% | 2.6 | $47.10 | $26.52 | $3.51 | 15.80% |
| **Universal Forest Products/**UFPI | $27.78 | $36.20 | -23.26% | 25.6 | $52.70 | $26.26 | $1.13 | 0.40% |

## The Investletter Portfolio

Amtech Systems (ASYS) recently announced another $5 million in orders. The company manufactures equipment that is used in the manufacturing of solar cells. Without getting into too many of the details, solar cells are made in a similar fashion to semi-conductors and the same manufacturing equipment is used in both industries. Fortunately, Amtech's equipment is being extremely well received. They are doing extremely well selling their equipment to pacific rim companies that are the leading producers of solar panels. So much so that the company has already booked orders in the first six months of their fiscal year exceeding last years revenue. Last year the company had around $45 million in revenue and this year they have taken orders for over $47 million dollars of equipment. At some point we are going to experience the straw that broke the camels back syndrome. Last month they announced $9.5 million in new orders, this month it was another $5 million; in no quarter out of the past 5 has the company had revenue over $13.1 million. In the past two months alone they have orders for $14.5 million. The share price after they announced the past two orders has risen from $11.38 to $12.04. The company has a clear shot at having revenues rise over 50% and earnings maybe even more and the company's share price has gone dormant. The overall market has buffeted any price increase. Each news release adds a little more fuel that may eventually cause the share price to react violently. Stock price movements aren't smooth and predictable. Like dripping sand onto a pile one grain at a time, you can see the pile continually build higher and eventually you get a slide where a whole bunch of sand falls in a avalanche. You can't tell exactly which way the slide will go or how large it will be, only that you know it will eventually happen. This is a typical pattern in nature and is also present in the stock market. This typifies a fractal system as we have discussed previously.

At some point a piece of news or positive earnings report is going to send ASYS over the edge and the share price out of control. It may not be a particularly big news item either. The company would need to have an abrupt reversal of fortunes to quell all of this building backlog of good news. With oil prices remaining strong, the incentive to switch to alternative forms of energy is high. Higher oil prices make the cost of solar that much more attractive. Heating oil is twice as high as natural gas currently and natural gas has been rising as reserves have recently dropped below the five year average. It is suspected that the persistently high oil prices in relation to natural gas over the past few years is going to finally drive the conversion to natural gas, increasing pressure on gas prices. Either way solar will be that much more competitive, especially when combined with more efficient solar technology being produced with the more sophisticated production equipment... like ASYS sells.

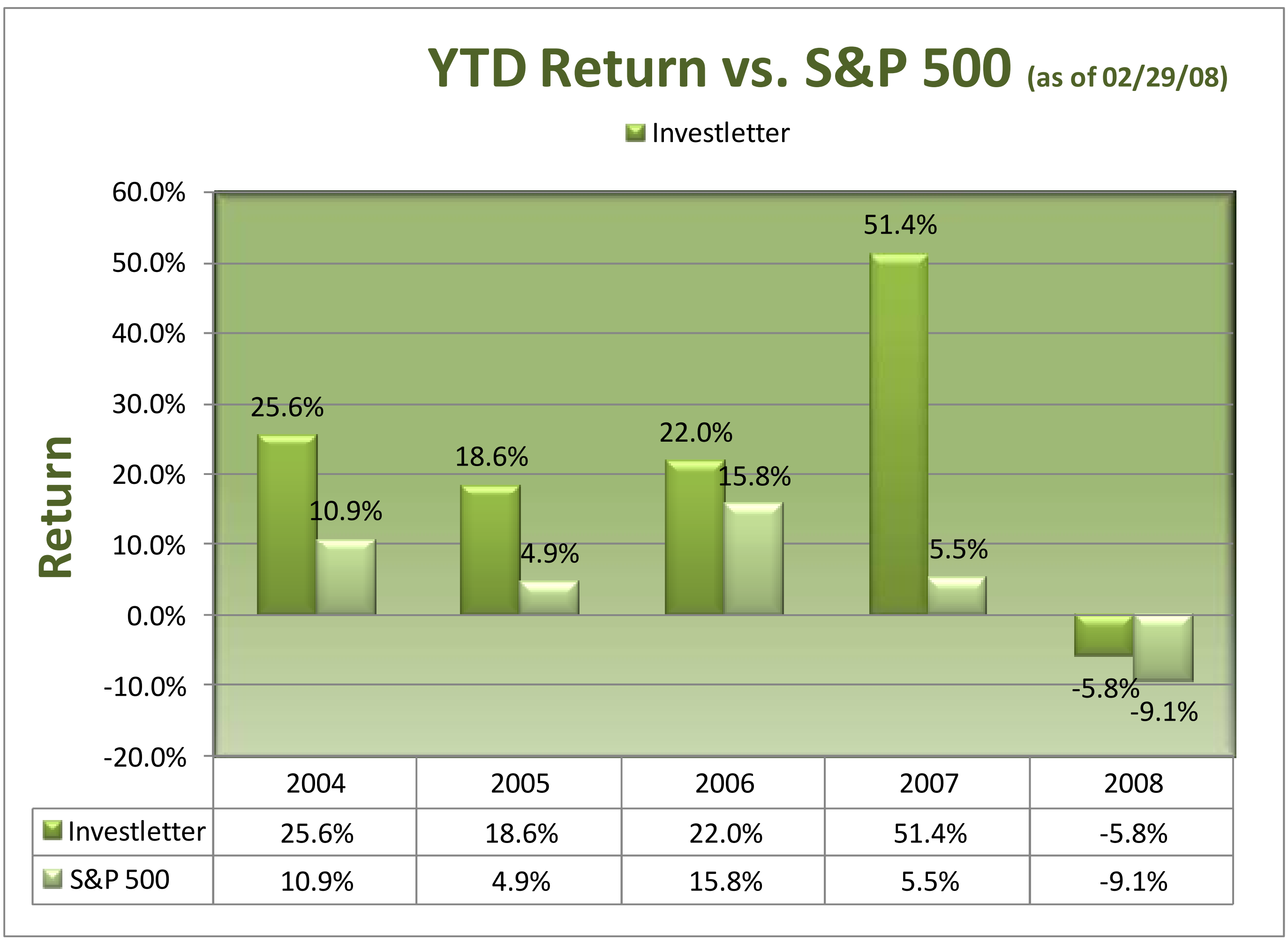
| Company | Porfolio Percentage | February price | January Price | Percentage Change | Buy Price (less than) | P/E | Dividend Yield |
|---|---|---|---|---|---|---|---|
| **American International**/AMIN | 5.90% | $4.57 | $4.35 | 5.06% | $4.95 | n/a | n/a |
| **Amtech Systems**/ASYS | 7.50% | $12.47 | $10.22 | 22.02% | $11.15 | 20.4 | n/a |
| **Astronics Corporation/**ATRO | 8.60% | $19.75 | $32.78 | -39.75% | $35.00 | 17.4 | n/a |
| **Atrion**/ATRI | 6.30% | $102.00 | $122.58 | -16.79% | $93.00 | 17.5 | 0.80% |
| **Berkshire Hathaway B/**BRK.B | 7.20% | $4,674.00 | $4,550.00 | 2.73% | $3,800.00 | 15.2 | n/a |
| **Cash** | 7.40% | $1.00 | $1.00 | n/a | n/a | n/a | n/a |
| **Chesapeake**/CHK | 7.00% | $45.22 | $37.16 | 21.69% | $33.00 | 12.1 | 0.70% |
| **CSP Inc./**CSPI | 3.80% | $6.12 | $7.38 | -17.07% | $7.00 | 7.2 | n/a |
| **Gencor**/GNCI | 12.50% | $18.00 | $10.20 | 76.47% | $9.70 | 5.4 | n/a |
| **Griffin Land & Nurseries/**GRIF | 4.20% | $33.64 | $34.01 | -1.09% | $35.00 | 30.3 | n/a |
| **Headwaters/**HW | 0.70% | $12.26 | $11.27 | 8.78% | $14.00 | 9.5 | n/a |
| **K-Tron International/**KTII | 9.80% | $116.73 | $110.24 | 5.89% | $90.00 | 16.1 | n/a |
| **Protein Design Labs/**PDLI | 0.50% | $15.98 | $14.93 | 7.03% | $15.00 | n/a | n/a |
| **QEP Corporation/**QEPC | 9.00% | $9.23 | $9.36 | -1.39% | $12.00 | 12.9 | n/a |
| **Rayonier/**RYN | 7.90% | $42.55 | $42.32 | 0.54% | $41.00 | 20.1 | 4.20% |
| **Transmeridian Exploration/**TMY | 1.70% | $1.25 | $1.42 | -11.97% | $1.45 | n/a | n/a |

## Year to Date

February was just as wild as January. Fortunately, we made up some of the ground we gave up in January. Our portfolio rose over three percent while the S&P 500 average dropped more than 3%. It is a small consolation considering we are still in negative territory after the first two months of the year. With the wild swings the stock market has experienced our position relative to the S&P 500 average is capable of changing daily.

The "r" word is still hanging over the market. Not to over simplify, but the more that the media mentions recession the more consumers are likely to adjust their spending behavior and create a self fulfilling prophecy. The rise in oil prices and the drop in real estate values are adding fuel to the fire. The rise in real estate values was used by many as a piggy bank to support their overspending lifestyle. As the price of homes rose some homeowners would do another round of re-financing, pulling more equity out of their property for additional consumer spending. Rising fuel prices and oil in particular have left less disposable income available for other purposes.

Even if we don't officially fall into a recession the slow down will still wreak havoc in the stock market. The reduced interest rates and the stimulus package will provide a needed boost. The question that remains to be answered is will the boost be large enough to kick start the economy? If nothing else it may provide a psychological boost that helps put consumers into a more positive mind frame, which will ultimately lead to a resolution.

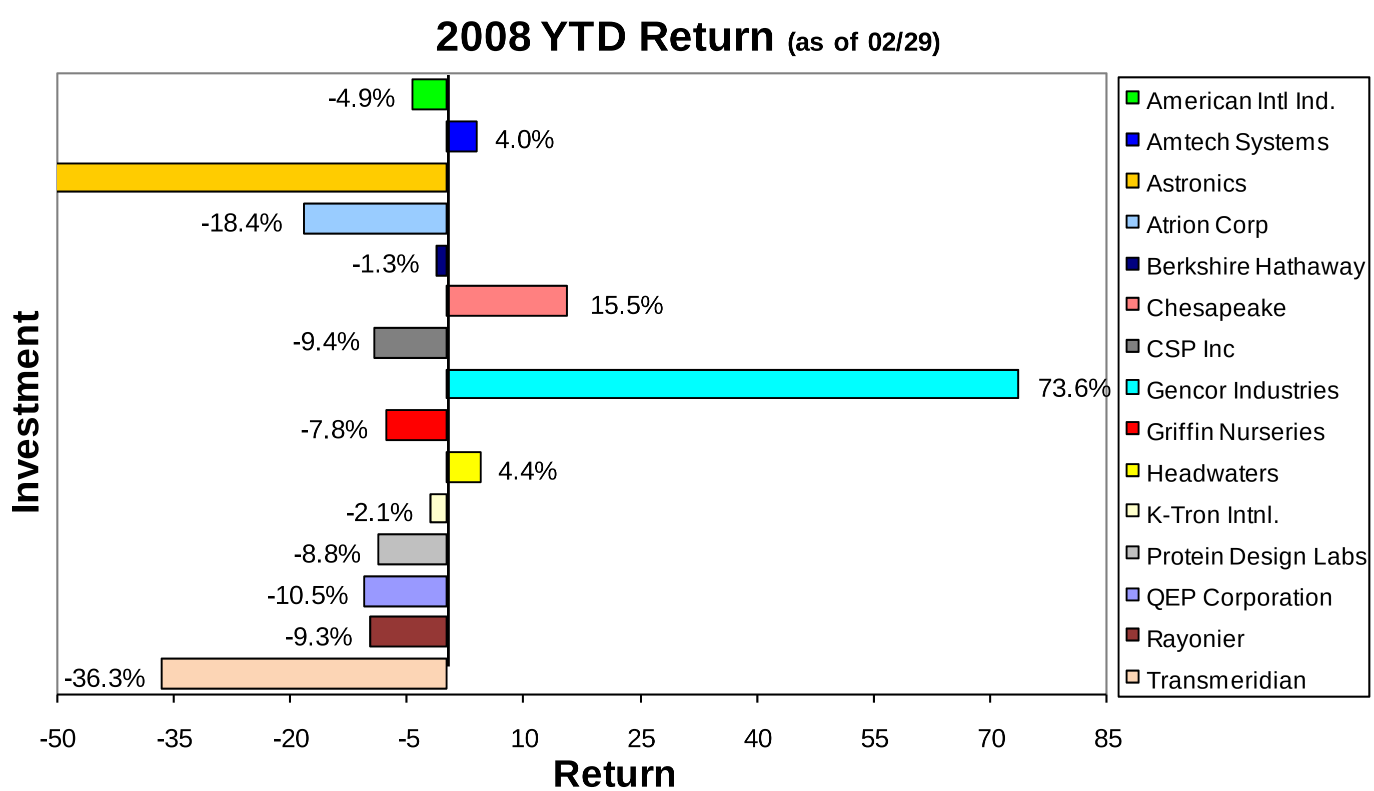


## Performance

This year has seen some wild swings in the companies we own. Our leading gainer from last year is literally off the charts. ATRO is down 53.8% on the year. Has the value of the company dropped this much? No, but the stock price sure has. The company just announced they have landed the power supply business for the Boeing 787 Dreamliner. That is a lot of seats and a lot of power supplies. If this isn't the tipping point then it may be the second half of the year before ATRO gets some lift (airline joke, laugh now).

One of our workouts is working and two are looking kinda flabby. Gencor has done exactly what we expected. The company was wildly undervalued and has moved to what is a bit overvalued pending the disposition of the partnership interests. Protein Biopharma was not able to auction themselves off. Never a good sign when you put yourself up for sale and nobody even makes a bid. They have managed to sell off some of their commercial products, their manufacturing facilities, but could not sell off their royalty stream or their developmental products.

Lastly, Transmeridian Exploration has not come close to sealing the deal. The acquisition by their CEO is looking like a hollow promise. We still believe a deal will be done, but it may be at a reduced price.

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