

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

GARP Research & Securities Company



WILLIAM W. BAKER, CFA, Founder & President, founded GARP Research in late 1995 after managing in excess of \$100 million for nine years. Through 2006, Bill has performed investment research for over 20 years. Bill was a portfolio manager at Oppenheimer Mutual Funds for nearly five years, managing several funds totaling over \$500 million. One of these funds, Oppenheimer Asset Allocation, was awarded Morningstar's 5-Star mutual fund rating in November 1990 shortly before he left the firm. Subsequently he joined Reich & Tang as one of four portfolio managers until founding GARP. Bill received his Masters in Business Administration from the Amos Tuck School at Dartmouth College in 1980, and he was granted a Bachelor of Arts degree in Economics from the University of Pennsylvania in 1978. GARP Research & Securities Co. (member NASD & SIPC) was established as a broker-dealer affiliate of GARP Research Corporation in 2003.

TWST: Can we please start with an overview of GARP Research?

Mr. Baker: I founded the company a little over 11 years ago. We have 11 people. We have grown organically because we've become known as a very high quality producer of research for institutional portfolio managers here in the United States and also in Canada and London.

We have no corporate finance activities, so we are completely independent. Odd as it sounds, we are a little different in that we have an investment philosophy, whereas the rest of the sell side maintains coverage to promote corporate finance or trading profit centers. We're looking for mid-cap and small cap growth companies that have high quality characteristics, primarily determined by return on capital and that also exhibit lower risk profiles. The other unique thing is our time perspective. We do this for a multi-year scenario; usually a minimum of three years is our time horizon. So this philosophy produces really interesting results for our clients and sets us a little bit apart.

TWST: When you say mid- to small cap, what are the parameters?

Mr. Baker: Generally we go up to a maximum of \$10 billion in market cap. Our mid-cap starts at \$1 billion. We intensely cover this space, but since we do so much research in so many sectors, we uncover a couple of good ideas in that small cap zone that we like to talk about as well, and we'll dip down to as low as \$100 million upon occasion.

TWST: What kind of returns are you looking for?

Mr. Baker: We're looking for a significant increase in earnings, say 50% to 100% or more over a three-year haul. While this coincides with our recommended minimum holding period, we also like to see a catalyst engage within a year, and we're very disciplined about what our entry point is for a recommendation so that we don't have dead money starting out. The ideal profile is a company that performs well for the next three years, but doesn't stop then — it may go on for six, seven, eight or nine years. We love to find companies that can exhibit enhanced quality and growth over time.

TWST: Do you focus on segments in the market, or is it just broad views of what is going on?

Mr. Baker: We start with this philosophy. We cover 10 different sectors, but it is not the sectors that are driving the process — it is whether the company has good prospects for a high return on capital, gaining market share, or having a lower risk profile and having rapid growth that drives it. Typically, we have a lot of representation in the medical and technology and business services areas. Therefore, we have analytical expertise such as an analyst with a doctorate in the life sciences field. But in the past, we've recommended companies that were involved in construction equipment auctions, cotton planting seed, and real estate brokerage. So we will look for these unique niche players in competitive prosaic markets where we think someone can gain a lot of share organically from doing it differently, and earn a high return there, too.

TWST: Where do the ideas come from?

Mr. Baker: We have six analysts and two people with analyst backgrounds who are in senior roles. My history is as an analyst, but now I'm maintaining more of a perspective of all of our nearly 100 names under coverage rather than specializing in a few sectors or stocks.

TWST: Do they create the ideas, or are these things that your customers mention?

Mr. Baker: The ideas come from the analysts. Every once in a while, we get an idea from a customer, but that is not the primary way. Basically, we apply this methodology, and it's a collaborative effort where we all really live, breathe, and eat this philosophy and discuss whether the new ideas make sense or not. Of course, ultimately that decision is made by the Director of Research and the analyst in a back and forth discussion with help from others at the firm.

TWST: What is at the top of the firm's list at this point?

Mr. Baker: I'm going to highlight eight different names that I think are worth owning — **ATMI** (ATMI), **Cree** (CREE), **DeVry** (DV), **Edwards Lifesciences** (EW), **QIAGEN** (QGEN), **Sabre Holdings** (TSG), **Sangamo BioSciences** (SGMO) and **Tellabs** (TLAB). In the interest of full disclosure, I must also tell you we have an affiliated money manager that owns each of these stocks, and I own them all as well.

TWST: Let's start with ATMI. What is it that you like there?

Mr. Baker: ATMI supplies materials and packaging products to manufacturers of semiconductors and flat panel displays. The technology markets have not been exciting for a number of years, but ATMI has had a number of efforts internally that are producing organic growth, which in the latest quarter was 18% top line. The real driver of this is from consumables used in manufacturing semiconductors that have copper wiring, which is about 40% of revenues; in the last quarter, that was growing about 50% year over year. About two-thirds of copper comes from cleaning, with the rest in plating. Copper is only about 10% of industry wafer starts, so as it becomes

predominant over aluminum, we're going to see continued growth on the order of 25% for a number of years to come.

On top of that, ATMI has been developing a number of other products that will be introduced, and it feels each of them could be a major product. There are four or five of those, so that is very interesting. This is a high margin company.

Another part of the story is that margins are expanding, so operating margins for the whole year are 15% and we believe are headed up to 24% by 2009. Besides having all this top-line growth, you've got a ton of bottom-line growth behind it.

Lastly, we look out three years in terms of our valuation. It's trading at 13 times our 2009 estimate, which is reasonable for us. I would also want readers to be aware that the company has \$6 a share in cash without debt attached, so if you knock that out, the valuation is even more reasonable. We do all of our estimates here at GARP after subtracting the cost of FAS 123(R) — a lot of technology analysts don't do that, but we do. So if you are in the camp that thinks that options don't count, the stock's even cheaper. We think it's pretty silly that the majority of Street analysts like to give out free passes, but I've been in this business for over 20 years and some things never change.

TWST: Where is the rather massive margin improvement coming from?

Mr. Baker: The main reason is that the copper cleans products have become very material and are growing rapidly. These carry very high gross margins on the order of 60%, about 9 points above the corporate average. Also, sales are ramping up while management is controlling overhead, and it plans to continue to do so. Going forward in the plating part of the copper area, ATMI previously took out a license from a company called Enthone and it has been sharing R&D for products targeted for 45 nanometers and below. So, as a result of this contribution, it will retain a higher percentage of sales for itself once that geometry phases in, where it's paying a pretty stiff royalty now on the older technology. The other aspect is that its new products in general carry no royalties obliged to others, so that's a richer margin stream right there.

TWST: They've got a rather substantial amount of cash. What are they going to do with it?

Mr. Baker: That's a great question. ATMI generates cash and doesn't really need to spend it or build big plants or anything. ATMI has traditionally spent a small amount to acquire technology, yet its space is diverse and rich with ancillary opportunities. We believe the \$150 million expansion of its share repurchase program announced in August signals a departure from having a subdued financial element to its strategy. It follows \$75 million announced in October 2005.

TWST: What was the second name on the list?

Mr. Baker: The second name on the list is Cree.

TWST: Is that another technology company?

Mr. Baker: Yes. We're very optimistic about technology and certain parts of the medical space. Going forward, we think there

has been a five- or six-year compression in valuation and there has been enormous investment this decade set to yield significant earnings growth over the next four or five years for both of those sectors. So GARP has populated its recommended list with a lot of stocks in those two sectors, and **Cree** is among the most interesting.

One aspect of our philosophy that I didn't highlight at the beginning was that we're contrarian growth oriented. In other words, we will look at companies that the Street doesn't like that we still think will be acknowledged as great high quality growth companies in a couple of years, and **Cree** fits that mold. It is a maker of LEDs: little electronic lights made out of silicon carbide, a diamond-hard material that is a distant cousin to the silicon used in conventional semiconductors. 40% of **Cree**'s sales are to backlight keypads in cell phones, and that market has gotten very competitive, which has sunk the stock near its five-year plus low. Nonetheless, **Cree** has a decent operating margin in it despite intense competition from Taiwan.

I think that the business is really changing, and going forward, the market is seeking higher value white light applications. These will honor a strong intellectual patent portfolio, and just as this is happening, **Cree** is emerging with better and better technology competitively. So we think that you will probably see LEDs in laptops very shortly, and then you'll see some trickling into the higher priced television sets over the next couple of years, but we're not basing the recommendation on that. Eventually, you'll see penetration of general illumination, but that could be four or five years down the road and will start out again as a specialty item.

TWST: What's going to wake investors up to Cree? As you say, it has been out a favor for a while.

Mr. Baker: The thing that will awaken them will be the laptop market. In October, **Cree** signed an agreement to license a company in Taiwan called **Lite-On Technology**. It's one of the world's largest producers of backlighting for LCD panels. Elsewhere, one of the Sony VAIO models has been using LEDs from a Japanese competitor, **Nichia**.

This year, I think that LEDs were getting competitive and intriguing to laptop manufacturers, but the fluorescent light makers saw it coming and cut prices by about 30% to basically block them out of the market for a little while longer. I think you can bar the doors temporarily, but eventually LEDs are like a battering ram that is going to knock the door off its hinges — it's just a matter of when, not if. And cost isn't the only issue; LEDs consume 30% less power, a gap that will only widen over time as efficiency improves, and this saves battery life — a goal that has been elusive and very much demanded by consumers. Think about how many LEDs might be inside a laptop panel that you look at compared to the little panel in a cell phone. It is geometrically much greater. So that's a really transformational event.

But even without that, we saw a real breakthrough, which was announced about two months ago, where **Cree** demonstrated in a lab setting a white LED with the efficiency of 131 lumens per watt. This compares to 80 lumens per watt for fluorescent or 15 for incandescent bulbs.

They've also come out with a product this year called the EZ Bright 1000, which is in a special category known as power LED chips. One of the big competitors of **Cree** is a company called Lumileds, which basically began as a joint venture between **Agilent** (A) and **Philips** (PHG), but in 2005, **Philips** bought **Agilent**'s stake, which valued the enterprise at roughly \$2 billion. Bear in mind that the market cap at **Cree** is only about \$1.6 billion.

Lumileds has had great success, and it has been isolated from the competition in the keypad space because it makes these very large LEDs, which are known as Power LEDs because they presently burn about one watt of power and are 1,000 microns in size, making these devices 3 times the size of cell phone LEDs. So Lumileds has great operating margins and **Cree** has demonstrated that it has a really terrific product in that space as well. So these would be used in really high brightness lighting applications.

TWST: So it has a couple of different opportunities then?

Mr. Baker: Yes, it does. There is more than one opportunity, and oddly enough, I mentioned that we really don't hold out any hope for LCD TVs any time soon. But we've heard from multiple sources that a commercial design win might be announced as early as March 2007. So the product that it has developed for that is called Colorwave, and that's very interesting.

There is another thing that I would point out, which is that you should not think of this as the conventional semiconductor, because it isn't. It's made out of silicon carbide, and as we progress, instead of getting smaller, LED chips get larger. The wafer is getting larger in LEDs and in conventional semiconductors, but with LEDs, the chips themselves are getting larger here, particularly when you get general illumination or other end uses where you want a big, bright device.

Probably 10 to 15 years ago, **Cree** produced its chips on 2-inch wafers. It shifted up to 3-inch wafers in Q3 of 2004, and today, about 85% of its output is now on that. In about March of 2007, it will convert to 4-inch wafers. The interesting thing that has dogged the company's return on capital — even though margins are pretty good, this is a capital intensive process — is the yields. They're not anywhere near as high as what you see in traditional semiconductors, and this applies to the whole LED industry as well as **Cree**. Bear in mind that **Cree**'s gross margins are still around 50% in keypad LEDs due to its technological advantage, even though this sector is hotly competitive.

Back in July 2006, **Cree** spent \$46 million to buy a company called **INTRINSIC Semiconductor**, which has very important technology that really improves silicon carbide yields. So we could see a dramatic competitive advantage develop, sort of like what **Nichia** used to enjoy before last year when **Cree** improved its phosphor technology and caught up in brightness. **Cree** could really step up and totally differentiate itself if it can implement this technology. So if it can distance itself and get to 4 inches, **Cree** would have a different cost structure from the industry.

There are a lot of people who have shorted this stock. The hedge fund community loves to short it because these hedge fund guys pay to fly analysts over to Taiwan where they get firsthand reports that the Taiwanese will dominate the industry. I don't know if you've ever talked to a Taiwanese businessman before, but they're optimistic people and they have an axe to grind. They won't hesitate to say, "We will have \$100 million of sales by 2007." Then 2007 rolls around, and they say, "Sorry, but in 2008, we will have \$100 million of sales." I am not denying there is cutthroat Taiwanese competition, but it may be running its course. Taiwan's cameo role may have been mistaken for the symptoms of simply being in the last year of the trend to put LEDs into phones, sort of like what happened to red LEDs a decade or more ago.

If you're in the sixth year of competing in keypads for blue LEDs, Taiwanese competition is an important thing to think about. But if you're going into white light for laptops, where someone has to build laptops and market them into the US market, the US makers of laptops — **Dell**, **Hewlett-Packard** and so forth — are not going to use patent-infringing LEDs. Last year, cross royalty agreements among the five leaders of this industry, reinforced by infringement lawsuits against everyone else, knocked out any sort of stealing of IP when you have big brand names marketing into the US. Some guy in the middle of China can use a laptop that infringes, but so what? If you want a Dell, a Compaq or a Hewlett-Packard, you're just not going to have an infringing LED, and that's the market that's going to count.

So we could see all of the people short on the stock because they're worried about Taiwan looking in their laptops and saying, "Where is the infringing chip? Oops, there aren't any. Oh gee, I thought there were." Then you see **Cree** licensing one of the largest producers of LCD panels in Taiwan. They're going to be paying **Cree** a royalty. Oops, that wasn't supposed to be under control, either.

TWST: What was the third name?

Mr. Baker: The third name is **DeVry**.

TWST: That is a divergence from technology.

Mr. Baker: It is and it isn't. It's a private provider of education, but they're really known for their Bachelors degrees in technology and electronics, and it has branched out into other areas, but it is kind of a play on technology. We're not really sanguine about the whole education sector. There are a number of stocks in the education group that have rolled over and gotten weaker in the last two years, but **DeVry** has exhibited a different pattern where it peaked out six years ago and based out, and now there is clear evidence of a fundamental turnaround.

For example, in the latest quarter, the top line grew 12%, the pretax profit nearly doubled and graduate enrollment growth is up 8%. **DeVry** gets to increase prices about 5% a year, combining for that 12% sales growth that you see. It also diversified with the acquisition of **Ross**, which is a medical and veterinary school. **Ross** is growing 31% year over year, has extremely high margins, and chips in about a third of the earnings for the company now.

TWST: So things are beginning to return to normal.

Mr. Baker: To put it in perspective, the tech students fell from 39,000 back in fiscal 2001 to 19,000 in fiscal 2006. It is a huge falloff, and now the tech students are needed and they're getting job offers. So **DeVry** is getting higher enrollment, plus at the same time, the firm started up a business offering in undergraduate, and that has tripled over the last five years and continues to rise. You're getting diverse growth, but clearly there is leverage on the tech and electronics side.

TWST: Where do they stand relative to federal government payments for education?

Mr. Baker: That is another attractive aspect of this company. It has never been seriously implicated in any sort of scandal, the reason being that it is providing an education that leads to good jobs. They're not putting people in fashion school and making them think that they're going to go work for **Conde Nast** when they're actually going to wind up at the cosmetic counter at **Bloomingdale's**, or minting chefs that go on to **McDonald's**. These are tech guys that get hired and get real jobs, and they're also business-related folks — most of the business degrees conferred are for a little bit of an older demographic. Either they're business undergrads or they're in adult education, and they're both enhancing their careers.

TWST: So they really haven't fallen afoul of any of the issues that have come up with some of the other private education companies.

Mr. Baker: It's not even an issue with this company. It is a conservative Midwestern management; it's not like the other education companies.

TWST: The next one you mentioned was Edwards Lifesciences.

Mr. Baker: Yes, that is one of my favorite names and has been for a number of years. Early in the discussion, I indicated that we love to recommend companies that can do well for three years, but then pop out at the end of that period as a company that keeps getting better and better and might do well for seven, eight or nine years. That is still the story with **Edwards** now. They've got a great core business, which is the making of bovine pericardial heart valves. Basically these valves are superior to porcine valves, which are also tissue valves, and tissue valves have advantages over mechanical valves. Therefore, tissue valves are gaining market share against mechanical valves, driving industry growth of something above the 5% overall for thoracic procedures.

So the tissue valves can grow in high single digits, and up until recently, **Edwards** has had 9% plus growth. There has been an issue in 2006 because a competitive move was made by **St. Jude** (**STJ**) with its **Biocor** stented tissue valve. **St. Jude** has gained a couple of percentage points right off the bat because there are some doctors that are extremely loyal to **St. Jude**, but we see signs that that is running its course and soon the growth rate for **Edwards'** valves will probably bounce back.

TWST: So there's a temporary derailment here.

Mr. Baker: It's a temporary deceleration, and you have to also realize that there are other things going on in **Edwards'** valve business. It introduced the Magna valve, which quickly became the leading valve in the world, and it gets a \$1,000 premium for that valve. So the margins have been expanding here and even in this latest quarter, they expanded very nicely by 1.5%. We're queued up to have a couple of other things that will expand margins. Probably the most notable is the addition of ThermaFix, which is an anticalcification treatment that is applied to the valve during its manufacturing process. That will command another \$500 per valve or 10% premium, and that should kick in early next year in the US.

There are a couple of other pipeline opportunities there, but the real pipeline opportunity is looking out about three years from now, when **Edwards** should finish its clinical trials on percutaneous aortic valve replacements and in mitral valve repair. Those two markets are extremely attractive because there are only about 200,000 open heart procedures performed a year, and yet there are 2 to 3 million patients with moderate mitral regurgitation that would affect the mitral side, and the aortic side traditionally has been 60% of the valve replacement market. So the aortic side is potentially larger, although I do think you'll get more traction in mitral for the first five years of this process.

They're getting really good results. In the US, there are 54 patients. Forty-six of them are doing well, which is an excellent result compared to the 36 that would have been expected to survive open-heart surgery. So if you do get this approved, you could see the market swell to anywhere from 0.5 to 1 million procedures a year. You can't put a mechanical heart valve inside a catheter to do this percutaneous procedure, so that immediately cuts out a large chunk of the market from today's thoracic competitors. You can't put a porcine valve inside a catheter — that eliminates **Medtronic** as a rival. **Edwards** is actually developing a bovine pericardial valve for percutaneous use, and it presently has an equine pericardial valve that fits inside its catheter.

The Street has perennially worried about CoreValve, which is a little company in Europe that is developing a valve that fits inside a catheter as well, but the problem with the CoreValve is that you need to stop the heart from beating when you implant it. So they're going to see some issues with that. In fact, it has already experienced problems. CoreValve is not as far along in trials, but it is very close.

TWST: What's the story with QIAGEN?

Mr. Baker: **QIAGEN** is a company that historically has dominated the market by making kits for use in the isolation and purification steps of using genetic samples. The research market has been the main area of usage, and **QIAGEN** has really dominated it — it has almost 90% market share and there is a nice steady single-digit growth rate to that business. Our thesis is that there is another area, molecular diagnostics, which will increasingly be the growth

engine. We like to toss in applied testing with that, and combined, these represent 35% of the company sales. We are excited about it because it is growing 20% to 25% annually.

What are molecular diagnostics? Why are they interesting? Most of the molecular diagnostics today are for analyzing infectious diseases. In other words, they might test an HIV patient or someone with hepatitis and see what type of bug is infecting the patient to determine treatment. To do that, they'll actually look at the DNA of the bug that's in a blood sample. That is a molecular test, and to prep the sample, you need the **QIAGEN** material. The growth rate here is interesting, but it has moderated from the torrid pace at the height of the human genome frenzy back in 2000.

But if you look forward, a lot of testing is beginning to happen in cancer. You want to know exactly what type of tumor a patient has and whether he is going to do better with a certain type of chemotherapy or another type of chemotherapy or with no chemotherapy at all. Personalized medicine is yet another area that can be illustrated by the downfall of drugs like Vioxx and Bextra. They've been recalled because tiny percentages of the patient populations taking these drugs had an adverse reaction. We could analyze the people with these conditions to test for the existence of single nucleotide polymorphisms or gene copy number variations and say, "You're that one in a thousand who can't take Vioxx." Guess what? You still have to test 1,000 to figure out who takes the drug.

So personalized medicine is yet another very specialized area of diagnostics that is going to happen. Presently there are 2,000 clinical trials with humans and 3,000 animal trials. The FDA has issued a series of guidance documents on the inclusion of pharmacogenomics data, and I think that the large drug companies are increasingly going to need **QIAGEN** test kits in those applications, initially for the trials but later in the general patient population.

TWST: Whom do they compete with?

Mr. Baker: In the traditional market where you have the bench scientists, their biggest competitor really is someone doing it themselves. But you can also look at other things. In the robotic or automated sample processing area, the purification of nucleic acids is often done by binding samples to magnetic beads. **Invitrogen** (IVGN) in early 2005 acquired the leading firm in that area, a company called Dynal Biotech from Norway. Dynal had about \$112 million of revenues, mostly from cell separation products. But we still haven't seen anyone other than that player, which has been around for a while there, even though **Invitrogen** rolled out a line of nucleic acid prep kits called ChargeSwitch, from technology acquired even before then, I believe in October 2004. There hasn't been that much market share gained by ChargeSwitch, perhaps owing to sample capacity issues.

The important thing is that when you move into molecular diagnostics, what is **QIAGEN's** share going to be? There are other ways to do it, but basically **QIAGEN** has partnered with **Roche** (RHHVF), Veridex, which is the cancer research part of **Johnson &**

Johnson (JNJ), Affymetrix (AFFX) and Becton Dickinson (BDX), and a number of players are already using **QIAGEN** as their first step. It only costs about \$10 per test to incorporate this, so it is a very small part of what these partners are developing.

TWST: Sabre Holdings is another semi-tech name.

Mr. Baker: Sabre is very interesting because the Street is fixated on its legacy business, Sabre Travel Network, which is the leader in the oligopolistic GDS industry. The airlines supply schedule and ticket data to the GDS, which combines it with other airlines' flight information and provides software with this data to travel agents, so it's the distribution of airline data. That business has seen its operating margins fall 2 points a year for the last five or six years. The Street has hated this stock because of that, and that's basically been the dominant trend.

But the bright spot is Travelocity. **Sabre** created Travelocity in 1996 and bought back a minority interest nearly at the bottom of the dot-com meltdown. Travelocity was losing money to the tune of over \$50 million back in 2003. It turned profitable in 2004, making small amounts of money, but this year, we think Travelocity is probably going to be earning over \$70 million. Now, that isn't much within a total corporate operating income of \$370 million, but there's clear evidence that there is an enormous amount of operating leverage and top-line growth at Travelocity. Looking out three years to 2009, we could see that \$70 million of operating profit grow to something just south of \$300 million, which would be a fair bit larger than the core GDS, which is known as the Sabre Travel Network. So it would be producing a greater amount of income than that core business.

I just don't think people are aware. The company is cheap on the current earnings, which are all driven by the GDS. It's trading at 16 times 2006, and 2006 is almost done. For 2007, it's trading at 13 times. So this is a cheap stock just based on the core business, but toss in Travelocity, and it is a growth stock, and I think the Street may be just waking up to this. We like to see a catalyst engaging because that helps our one-year performance. We recommended this earlier this year and told people, "Look, there is evidence that the GDS business is probably not going to see margin declines." Actually, for two quarters in a row, they've seen an increase in margins, and in the Travelocity business, its margins obviously are going to be on quite a roll.

TWST: So the Street is just a little bit behind in catching up to this.

Mr. Baker: Yes, they think this is the same old horrible story. There are about six other pretty mouthwatering characteristics here that make this an interesting stock. Worldspan is another GDS that has 28% of North America, and Worldspan is in the process of imploding. **Expedia (EXPE)**, which is a larger travel agent than Travelocity, has just shifted at least half of its data away from Worldspan and over to **Sabre. priceline.com (PCLN)**, which is also a GARP recommendation, is shifting over to **Sabre**, and there is a panic over at Worldspan. That's an interesting competitive develop-

ment. Plus, there is a growth story in Europe, and **Sabre** bolstered its presence there through the purchase of lastminute.com in the second quarter of 2005.

The other thing I'd tell you competitively is that up until last year, the GDS business was regulated. You had to be like a public service utility of sorts, and if the airlines gave you the data, you couldn't really be biased in any way in how you presented it. You couldn't have sidebars like **Google** has, with advertising and that sort of thing. But now that they're deregulated, they are free to do with this data whatever they want.

Now, the significance of that is you've got an oligopoly of these GDS's. You've got many airline vendors feeding into it and travel agents and corporate users at the other end consuming the information. So you have these GDS's at a chokepoint in between, and Wall Street is looking at margins and saying, "Oh, those four GDS's are so awful."

Now that they're deregulated, you see that they suddenly have some market power such that **Northwest** tried to really jerk them around and **Sabre** said, "We'll go along with what you say, but your data is going to appear off the screen and the agents will have to scroll down to get it." Within three weeks, **Northwest** came back hat in hand saying, "Oh excuse me, we never meant to try to rough you up like we've been doing for the last five years. Let's go back to the old arrangement."

Another thing you saw was that Amadeus, the other large provider in the GDS world, signed an agreement with **Sabre** to share data in case any of the airlines cut them off. So as a negotiating tool, that is very powerful. I just don't think you're going to see the margins eroding at all, and we've also seen other signs that some of these low-fare airlines have suddenly expressed interest or signed contracts to come on to the **Sabre** GDS system. So it's very interesting. The whole secular case that the Street has had against them is beginning to unravel, and I think that's another catalyst besides Travelocity.

TWST: Sangamo takes us back into the medical area.

Mr. Baker: Yes. That is one of my favorite ideas. Like I said, we concentrate on the mid-cap space, but we also find small caps from time to time that are very interesting. **Sangamo** is an early stage biotechnology company. Its drug platform is being built upon zinc finger proteins or ZFPs, and zinc finger nucleases or ZFNs. These proteins bind to DNA with great accuracy, and this gives them utility in disease therapy, biopharmaceutical production, and crop improvement.

What sets **Sangamo** apart from other biotechnology companies is that it has complete control over the IP in this space. The IP itself, which is very interesting, doesn't infringe on any sort of ownership of gene patents because the ZFPs are basically affecting the performance of a gene inside one's body, which is the distinction that enables them to do that. It was developed right around the corner here at Baltimore's Johns Hopkins, which is where GARP's analyst Alastair Mackay completed his postdoctoral work in molecular biology.

Finally, **Sangamo** can apply this technology to many, many diseases. There is a Phase I trial for AIDS that's starting up (pending FDA clearance), we think by year-end or January. There will be a Phase II trial for the treatment of diabetic neuropathy. Also, its partner **Edwards Lifesciences**, which we talked about earlier, plans to begin a Phase II trial for **Sangamo's** angiogenesis treatment of critical limb ischemia by year-end. So if any of these programs have clinical success, it validates the whole platform for many other diseases. I can't stress how important that is, because most biotech companies struggle.

MedImmune (MEDI), for example, has 60 products in its pipeline and they are spending like drunken sailors to get new products from that pipeline. It's really not happening quite so well because each one is independent of the other. At **Sangamo**, if one of these ZFPs work, the company won't just have a pipeline of one — it will have a pipeline of many. It has multiple things in the hopper.

So by year-end 2008, assuming all goes well, we think you will wind up having this diabetic neuropathy on the verge of a Phase III trial, and I think that the **Edwards Lifesciences**-led program will be accruing patients for Phase II of critical limb ischemia, and the HIV trial will have advanced too. It's hard to say exactly how fast because there could be compassionate use, but even before we've started, there has been some preliminary data that's extremely interesting. So it's a little more risky than GARP's typical recommendation.

However, with a market cap of only about \$250 million and a washed out chart, we believe the risk is ameliorated. By having this interesting technology, it was able to partner with **Edwards** and get money from **Edwards** to pay for development. It was able to cut a deal with Dow AgroSciences and bring in \$50 million. CEO Lanphier has been very careful about spending money so that **Sangamo** has not had to come to the well with secondaries. So the stock is just not known in the institutional community; if a couple of large investment bankers started trotting them around once a year to raise \$50 or \$100 million, everybody would know about it. In fact, because Lanphier has done a good job of stewardship with the share base, **Sangamo** is not well known among large institutions.

I think the story is beginning to leak out with some of the data from these trials, because **Sangamo** has a lot going on. There is an analyst day in December that will help. With a company with these kinds of prospects, you could really argue for quite a bit higher market cap even now, much less as things progress.

TWST: The last name on your list was Tellabs.

Mr. Baker: **Tellabs** is a leading telecom equipment supplier. Obviously, there are larger companies like **Nortel** (NT) and

Alcatel (ALA). The product portfolio today includes digital cross-connects, edge routers, and metro DWDM gear for next-generation optical networking and broadband data. In late 2004, **Tellabs** purchased a company called Advanced Fibre Communications, and that took it into the nascent business of developing systems for residential use of fiber optics. The major customers are **Verizon** and **BellSouth** for those platforms. In three years, you will get some hold in that area and in some other advanced products that have to do more with optics.

In the meantime, the stock is really cheap. We think it's trading at about 14 times our 2007 estimate and 18 times the number for 2006. The reason why it trades here is because there is a lot of fear about the digital cross-connect business in which **Tellabs** is the dominant player. Eventually, these will be replaced by fiber-based systems, but most of the sales growth that the firm is experiencing in digital cross-connect is coming from the backhaul through T1 lines from cellular base stations. So there is always fear that the cycle is going to end.

We've seen some weakness in the handheld market, in which it doesn't directly participate. The number of handsets keeps growing, but ASP compression and other issues are worrying companies like **Tellabs**, which are tangential to that business. Nonetheless, you're getting more usage of these towers and you need more T1 backhaul. Yes, the technology will eventually change, but I think you can run it out a couple of years before that happens. In the meantime, it has developed these other new products that really could be substantial. There have been a number of competitive wins, which bodes well for earnings through GARP's customary investment horizon now extending through 2009.

TWST: Thank you.

Note: Opinions and recommendations are as of 11/29/06.

WILLIAM BAKER, CFA

GARP Research & Securities Company

1515 LaBelle Avenue

Towson, MD 21204

(410) 825-6600 x102

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Gaineswood
Investment Management, Inc.

2800 Quarry Lake Drive, Suite 140 • Baltimore, MD • 21209
Phone: (410) 764-3500 • Fax: (410)318-5049