



“The Point of Intersection: You Might Get Double-Crossed”

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Wednesday’s (February 6) *Wall Street Journal* article, “Anyone for Some Used Corporate Debt?” caught my attention. Prof. Edward Altman, the developer of the Altman Z Score, opined that junk bonds will default at a rate of 4.644% this year. This represents a ninefold increase over the default rate in 2007. The forecast does not include the possibility of a recession, focusing solely on the continuing deterioration of a company’s financials.

Given Dr. Altman’s projections, I took a look at the Audit Integrity universe with the following thought in mind: investors in some companies may be faced with a double whammy of very aggressive accounting and governance (i.e. **low corporate integrity**) coupled with a weak balance sheet.

Searching the database of 3,578 companies in excess of \$250,000,000 market cap (Small- to Large-Cap), 243 were rated as **Very Aggressive** in their Accounting and Governance (AGR®) rating, while 516 were rated **Weak** on our Financial Condition rating.

Since my interest focused on the intersection of both weak financials and unreliable accounting and governance, I narrowed the list down to 72 candidates that met the three criteria:

- ✓ **Over \$250m market cap**
- ✓ **Very Aggressive AGR, and**
- ✓ **Weak Financial Condition**

Our analysts culled the list even further, removing gold and silver stocks, ADR’s, etc. The filtered list of 31 companies is as follows:

List of VERY AGGRESSIVE COMPANIES with WEAK FINANCIAL CONDITION

Company	Ticker	Type	Market Cap (\$MM)	Industry
Citigroup Inc.	C	F	131058.297	Money Center Banks
UBS AG (USA)	UBS	F	81871.172	Investment Services
Merrill Lynch & Co., Inc.	MER	F	47015.711	Investment Services
PNC Financial Services	PNC	F	20768.119	Regional Banks
General Motors Corporation	GM	C	12932.96	Auto & Truck Manufacturers
The Bear Stearns Companies Inc.	BSC	F	9127.197	Investment Services
USG Corporation	USG	C	3100.026	Construction-Raw Materials
Itron, Inc.	ITRI	T	2664.21	Communications Equipment
First Horizon National Corporation	FHN	F	2389.994	Regional Banks
HLTH Corporation	HLTH	T	2178.957	Computer Services
Ship Finance International Ltd.	SFL	F	1809.137	Water Transportation
Sally Beauty Holdings, Inc.	SBH	M	1545.919	Retail (Specialty)
Avis Budget Group Inc.	CAR	C	1094.361	Rental & Leasing
International Coal Group, Inc.	ICO	C	872.05	Coal
CytoCore, Inc.	CYOE	T	706.514	Medical Equip. & Supplies

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List of VERY AGGRESSIVE COMPANIES with WEAK FINANCIAL CONDITION (cont.)

Company	Ticker	Type	Market Cap (\$MM)	Industry
USANA Health Sciences, Inc.	USNA	M	652.051	Personal & Household Prod.
RAIT Financial Trust	RAS	F	491.764	Real Estate Operations
Ligand Pharmaceuticals Inc.	LGND	T	458.081	Biotechnology & Drugs
Spansion Inc.	SPSN	T	414.125	Semiconductors
Elixir Gaming Technologies, Inc.	EGT	T	381.689	Casinos & Gaming
FreightCar America, Inc.	RAIL	C	370.823	Railroads
Centerline Holding Company	CHC	F	349.497	Misc. Financial Services
Isle of Capri Casinos	ISLE	M	332.689	Casinos & Gaming
QLT Inc. (USA)	QLTI	T	324.598	Biotechnology & Drugs
Crystal River Capital, Inc.	CRZ	F	321.013	Misc. Financial Services
Medis Technologies Ltd.	MDTL	T	317.583	Appliance & Tool
Noble International, Ltd.	NOBL	C	306.082	Auto & Truck Parts
Alico, Inc.	ALCO	C	305.803	Crops
PRIMEDIA Inc.	PRM	M	305.455	Printing & Publishing
LaBranche & Co., Inc.	LAB	F	292.081	Investment Services
Composite Technology Corporation	CPTC	T	283.205	Electronic Instr. & Controls

F= Financial T=Technology C=Cyclical M=Miscellaneous

The companies on the list reflect a fairly narrow cross-section of the total Equity universe. A high concentration of these intersecting companies is found in three broad categories.

The list is dominated by highly-leveraged financial entities (11). These companies are highly dependent on access to capital markets at a reasonable cost. The second largest group is Technology companies (9). These companies, for the most part, are burning through capital and may require capital injections to remain solvent. In the third category (7) are mature cyclical companies whose future is highly dependent on economic cycles.

I am not prepared to pass valuation judgment on the securities listed above. However, investors approaching this intersection would be well advised to look both ways before proceeding.

James A. Kaplan
CHAIRMAN