Complete Growth Investor

Smart, balanced stock ideas.

CGI Free Stock Report

***PLEASE NOTE*: This Report is provided free to you as an example of our work and results. It was published January 8, 2007, when Key Technology shares stood at $13.75 a share.**

As I write this is update note on June 11, 2007, Key shares stand over $21, *for over a 50% gain in just five months*. Even at today's price, I believe that they offer an excellent opportunity for another 30%-50% gain in a year and possibly much more if the business continues its extraordinary momentum. In this detailed Free Report, you can see how investment thinking works for CGI generally and in particular the Margin of Safety Portfolio. In other words, what you see is what you get at CGI.

January 2007

Dear Friend of CGI:

Why a free stock report? Why give away the result of our hard work?

Because we want to impress you so much that you become a CGI Member, of course! And unlike the over-the-top marketing hype typical of stock services for the individual, we want to win you over by showing you our real work. We think you are a smart investor who can tell the difference between the real thing – professional money management – and selling a product. So we show what we actually do, week in and week out, for our CGI Members.

So, no tease: This is a real stock we selected for CGI Members. It's not just an opinion. I–Tom Jacobs–own it in my personal portfolio, the IRA account that is available to CGI Members as our Margin of Safety Portfolio. That's very unusual: Every service we know throws out selections left and right, but the analysts do not own the stocks. We do.

Grown-up investing is about stock selection *and* portfolio management. Grown-up investing is not just assembling random stock ideas, but managing them together for risk and return. That's what we do, Jeff in the LEGOH (large equity, growth, options and hedges), and me in the MOS (Margin of Safety Portfolio, managed according to the research-proven idea that small cap value outperforms all other strategies over time.

On your side
It's unusual, but we do it: At CGI, *we buy every stock we select* – and, of course, *after* we provide it to Members. Like the very best money managers for the wealthy, all our own investment wealth–*our entire financial future*–is invested in CGI selections in my Margin of Safety Port and Jeff's LEGOH Port.

So we are invested right alongside all our Members. We profit; you profit. And when results are sub-optimal (anyone who tells you they never are is after your money), they are for us too.

A double in a year at report release; up 50% already and still opportunity today
This free stock report highlights *a key feature of CGI investing*: we are not only interested in defense–the margin of safety in making the investment–but catalyst. One criticism of value investing is that is all about defense. We look for specific, identifiable catalysts that can boost the valuation in the foreseeable future. In all CGI investing, we do not make predictions, because no one can (anyone who says they can is after your money). We make reasoned, careful balances of risk and reward to arrive at decisions that offer unusual opportunity.

[Once more our reminder: We made this investment case on January 8, 2007, when Key shares stood at $13.75 a share. As I write this is update note on June 11, 2007, **Key shares stand over $21, for over a 50% gain in just five months.** ***Even at today's price, I believe that they offer an excellent opportunity for another 30%-50% gain in a year and possibly much more if the business continues its extraordinary momentum. Regardless, you can see how investment thinking works for CGI generally and in particular the Margin of Safety Portfolio.]***

Inspection Hardware & Software: Key Technology (KTEC)

Stock and CGI Category:	**Deep Value**
Return Potential/Timeframe:	**100% or more within 12 months**
Margin of Safety:	**Excellent**
Ticker:	**KTEC**
HQ, Phone & Website:	**Walla Walla, WA, USA; 509-529-2161 www.keyww.com**
Share Price:	**$13.75 (1/8/07)**
Suggested Buy Range:	**Under $20**
Enterprise Value (EV):	**$56.3 million**
TTM EV/True Free Cash Flow:	**15.0**
Price/Earnings TTM:	**N/A (GAAP loss)**

Please note: Sources for all tables in this report are company releases, websites and SEC filings (if any), Yahoo! Finance, and my calculations

Table 1: Key Metrics (quarters since selection)

($ in millions except per share data)	Q4 2006	Q3	Q2	Q1	Q4 05	Q3	Q2	Q1
Cash and Equiv.	$15.2	$13.4	$10.8	$12.5	$13.2	$13.2	$10.9	$11.3
Total Debt	$0.0	$0.0	$0.0	$0.7	$2.3	$2.6	$2.6	$3.3
Revenues	$24.2	$21.5	$20.0	$19.2	$21.57	$25.9	$18.3	$14.6
% Year-Over-Year	12%	(17%)	9%	32%	14%	17%	(12%)	(22%)
New Orders	$22.3	$22.5	$27.3	$18.4	$23.0	$19.7	$24.5	$16.6
% YOY	(3%)	14%	11%	11%	22%	24%	24%	(8%)
Backlog	$22.8	$24.7	$23.3	$15.8	$16.6	$15.4	$14.3	$12.8
% YOY	37%	60%	8%	11%	30%	21%	16%	(27%)
True Free Cash Flow/Diluted Share	$0.35	$0.47	($0.25)	$0.16	$0.11	$0.63	$0.03	$0.51
Earnings Per Diluted Share	($0.11)	$0.07	($0.01)	($0.10)	$0.11	$0.51	$0.03	($0.09)

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PLEASE NOTE: Key is a small cap, the kind of investment which Professors Fama and French show outperforms all other strategies over time. But it means that Key has less liquidity than most. Only about $300,000 worth of its shares trade a day. For those of you who after reading may wish to make substantial investments, you may need to accumulate your shares in several trades. And everyone, regardless of order size, should consider using limit orders.

Key's business and recent history

Key Technology makes inspection and sorting equipment for the food, tobacco, nutraceutical and pharmaceutical industries, and they have an active aftermarket segment that repairs and upgrade installed systems. They have big company competition but hold their own in China, Latin America, North America and Europe through strong customer service and nimble product development.

Their products are essential for quality control and cost savings: Customers want tobacco without sticks, pills in the right color, and so on, and they want to save on the labor costs of doing it by hand. Key's products are devices with increasingly sophisticated software that can respond to the varying and specific needs of this or that item.

The stock price today is roughly where it was almost three years ago when we started CGI, but there has been a slump and recovery in between. Key in early 2004 had business momentum and a reasonable valuation, with new and upgraded product introductions due within a year. But sales slumped, with year-over-year declines for five quarters. Bad results came in part from customers waiting for the new products, which were delayed, but also from ailing small acquisitions, from Australia's Freshline to the InspX joint venture.

Yet throughout the sales slump, the company proved phenomenally skillful at managing the cash and produced positive true free cash flow (TFCF) throughout. Savvy investors know that free cash flow–actual dollar bills–is what counts, not accounting profits that are relevant only for taxes. Key proved exceptionally adept. Despite Key's very seasonal business and revenues sensitive to quarter-to-quarter timing of expensive orders, managers have brought in positive TFCF in all but three of the last 20 quarters despite GAAP losses.

Iron-clad financials

This feat created a company with bullet-proof financials. The balance sheet for this $56 million enterprise value company over the same five-year period changed from $33 million in net *debt* to $15 million in net *cash*. That would be impressive alone, but it becomes even more so alongside a 42% boost to research and development spending and sales moving indecisively at (3.7%), 17.6%, (2.4%), and (0.4%) year-over-year to the most recent gain of 5.7%. The company did not starve its future to window-dress the financials for a quick sale.

This ability to manage capital through a business slump shows rare executive skill. And with a new CFO in 2006 and increasing sales, the company has maintained this discipline.

Catalysts: Why the next 12 months are very promising

There are four strong catalysts for Key Technology's valuation in the coming year. Three are quantitative and one qualitative.

First, **sales** trends are very positive. FY 2006 sales rose 5.7% over 2005, and the year-over-year trends bode well for management's projection of revenues in the $90 millions next year, for a gain between 5%-15%. Okay, not special, but here's something to watch: customer deposits, which are a strong indicator of coming quarterly revenues, increased 300% YOY in the quarter ending Sept. 30, the last for which Key has report. That's phenomenal.

Second, **costs** are going to come down–*way down*. The company has made significant investments in its China and Latin American sales operations, seeking customers in these important markets for its food and tobacco sorters, as well as new forays into nutraceuticals and pharmaceuticals. There have also been costs for headcount reduction, consolidating offices, closing down the offices of its Australian acquisition Freshline, and extricating itself from its poorly-performing InspX joint venture. These are all about done.

With only a few hundred thousand dollars of these costs remaining, a dramatic jump in free cash flow is all but in the bank. And that's without any starvation to the business. Far from it: Remember that research and development spending for Key's increasingly software-intensive business has been steadily rising.

The combination of reduced costs and positive sales trends should lead to dramatically higher true free cash flow starting in the current quarter. These increases won't be hidden from value and other small-cap investors, who could be expected to buy shares and bring a higher valuation based on a range of valuation multiples. But while we wait, at current prices we have a Deep Value stock's margin of safety, telling us we are buying dollars of Key for fifty cents.

Third, in light of this increased true free cash flow, which increases the intrinsic value and margin of safety, the company is making the smart move to **buy back 500,000 shares of stock**, which is slightly less than 10% of its diluted shares. This is not an announced-but-dormant buyback: It has begun. It is smart to buy back stock when your shares are selling for less than your company's intrinsic value (IV). Since I peg a medium-scenario IV in the high $20s, buying shares with the stock below $20 or so suggests an excellent return on investment. (The point is that you theoretically gain the difference because you can reissue the shares later for more.)

Last, qualitatively, **new CEO Camp** is a General Electric-trained manager with an engineering Ph.D. from MIT. On paper he is exciting, and in his first conference call for Q4 and FY 2006 this month, even more so. There is probably no business the size or even close to the size of GE with such a positive stress on business performance and shareholder value. Camp is one of the rare managers that combine top-notch technical knowledge with excellent management skills.

One note: Graham and Dodd in the 1940 edition of *Security Analysis* opine that analysts tend to count good management twice. Their point is that good management is reflected in the business performance already, but because analysts tend to awards points for both, they are double counting. My view is that the new CEO and direction of the company–the buyback was announced before Camp came on board–indicate greater likelihood that the catalysts will occur.

Here's how these potential catalysts may lead to truly excellent shareholder gains.

Risk and reward

Using the company's run rate for the last two quarters, true free cash flow (TFCF) will rise 132% in the coming fiscal year to Sept. 2007 over the prior year. That's great, but it is actually conservative to a fault, because both of these quarters are not representative run rates. They are too low because they *include* costs from headcount reduction, closing Freshline Australia, shutting Key's Medford, Oregon facility, and divesting the company's share of its InspX joint venture. Management says that the end of these expenses this quarter will reduce costs to the mid-$7 millions per quarter for FY 2007 from $8.7 million the most recent quarter. That's huge for a company with 5.2 million diluted shares – as much as $0.92 a share pre-tax.

Lower costs

So let's turn to Table 2 below. In Line E, from the $8.7 million run rate (an accounting term for the most recent period), I peg management's projection of mid-$7 millions/quarter in operating expenses at $7.5 million/quarter, a $1.2 million/quarter reduction as the best (High) case; $7.8 million (saving $900,000/quarter, $3.6 mil./year) as Medium; and $8.2 million (saving $500,000/quarter, $2 mil./year) as Low. Annualize them (multiply them by four) in Line G, and show the annual savings, or pre-tax boost to net income, in Line H.

Rising revenues

Ah, but there is also revenue growth–not super, but there and rising. Management projects revenues in the $90 millions in 2007, reasonable with the consistent trend in backlog and new orders (slightly down YOY in the last quarter due but to timing). The growth reflects newer products, growing customer interest, and new markets in nutraceuticals and pharmaceuticals. Line B provides projections of 5%, 10% and 15% from FY 2006 levels, assuming a range from $90 million to the upper $90s. Line I takes each of the possible revenue increases and uses a 40% gross margin (slightly higher than the current 37.8% but back to historic levels with cost reductions). And then we must remember the taxperson: Line J then combines the two benefits from savings and growing revenue and provides the result with a 38% tax rate.

Combined benefits

Line K takes the last two quarters' $4.3 million TFCF and is conservative again for Low and Medium, cutting it from an annual $8.6 million to $6 million for Low, and to $8 million for medium, as a small check against any too-great optimism above. For High, I take the most recent quarter's additional $1.3 million one-time expense, annualize it, and apply about 60% as an after-tax benefit. Add Lines K and J, and you have a range of estimates for 2007 TFCF.

Now we get to the bottom line. In Line N, assuming the current $56.4 million enterprise value (EV), the stock sells today based on next year's TFCF at EV/TFCF multiples of 3.1-6.8. These are, of course, extraordinarily low. Expanding these multiples to 6 (Line O, severe bear market multiple), 10 (Line P, average multiple for slow grower in average market), 15 (Line Q, more growth, better market), and even 20 (Line R, Key valued as a "growth" company with higher expectations), and you see the range of results in Lines S-V. I come down in the Medium column, or a range from 13% to 186% (just short of a triple, but with potential for between four and five times an investment at today's price).

Table 2: Where Key Could Go in Next 12 Months

	ITEM	LOW	MEDIUM	HIGH (Management)	COMMENT
A	FY 2006 Revenues (Actual)	$84.8	**$84.8**	$84.8	TTM through 9/30/06
B	Estimated FY 2007 Increase in Revenues vs. 2006	5%	**10%**	15%	Management estimates 2007 revenues "in the $90 millions"
C	2007 Increase in Gross Income at 40% Gross Margins	$1.7	**$3.4**	$5.6	(A*B)*40%
D	Quarterly Operating Expenses: Q4 2006	$8.7	**$8.7**	$8.7	Q4 2006 operating expenses
E	Quarterly Operating Expenses: Estimated for 2007	$8.2	**$7.8**	$7.5	Taking management's estimate of mid-$7s as quarterly operating exp. rate for 2007 as best case
F	D Annualized	$34.8	**$34.8**	$34.8	D*4; uses quarter as rate for four quarters
G	E Annualized for 2007	$32.8	**$31.2**	$30.0	E*4; ditto
H	Pre-tax Boost to Net Income: Lower Expenses	$2.0	**$3.6**	$4.8	F-G
I	Pre-Tax Boost to Net Income: Higher Gross Income [C]	$1.7	**$3.4**	$5.6	C
J	After Tax Boost to Net Income (38% Tax Rate)	$2.3	**$4.3**	$6.1	(H+I)*62%
K	Estimated True Free Cash Flow (TFCF) for 2007 **Without** Boost	$6.0	**$8.0**	$12.0	Last two quarters show sustainable TFCF at $8.6 a year without benefit of $1.3 mil. per quarter from one-time charges in Q4.
L	Estimated TFCF **With** Boost	$8.3	**$12.3**	$18.1	K+J
M	Enterprise Value (EV) at Jan. 8 Close **of $13.75**	$56.4	**$56.4**	$56.4	EV = (diluted shares * share price) + total debt – cash
N	EV/TFCF Multiple: 2007 Estimates at Nov. 29 Close of $13.72	6.8	**4.6**	3.1	M/L
O	Stock Price: 6x EV/TFCF	$8.92	**$18.00**	$26.46	(L*6/M)*$13.75 Severe bear market/recession multiple if business continues at current rate – *quite an if* in recession
P	10x	$14.86	**$22.90**	$35.13	(L*10/M)*$13.75 Average multiple if performance continues in average economy and market
Q	15x	$22.29	**$34.35**	$52.70	(L*15/M)*$13.75 Growth multiple in decent stock market environment
R	20x	$29.72	**$45.81**	$70.27	(L*20/M)*$13.75 Stock valued as a growth stock, bullish market
S	% Total Return from **$13.75 at** 6x EV/TFCF	(44%)	**13%**	65%	(O/$13.75)-1
T	10x	(7%)	**43%**	120%	(P/$13.75)-1
U	15x	39%	**115%**	229%	(Q/$13.75)-1
V	20x	86%	**186%**	339%	(R/$13.75)-1

Defense: Margin of safety

The next table shows that these potential gains come with a Deep Value's margin of safety:

Table 3: Shares Now at 51% of Medium Scenario Intrinsic Value

VARIABLES (thousands except per share and $)	LOW	MEDIUM	HIGH (Management's View for Year 1 – FY 2007)
Base TFCF	$3.8	**$3.8**	$3.8
Est. TFCF Year 1 From Table 2, Line L	$8.8	**$12.3**	$18.1
1 (Gain from Base TFCF to Est. TFCF Year 1)	132%	**252%**	419%
2	0%	**5%**	15%
3 SPEEDBUMP (Build in a bad year to avoid the endlessly rosy scenario)	(30%)	**(20%)**	(10%)
4-5	0%	**5%**	15%
6-10	0%	**3%**	5%
11-20	0%	**1%**	1%
Terminal	0%	**1%**	1%
Discount Rate	11%	**11%**	11%
Dilution	1%	**0%**	0%
Result	$10.50	**$23.90**	$51.25
+ Net Cash Per Share	$2.92	**$2.92**	$2.92
= Intrinsic Value	**$13.42**	**$26.82**	**$54.17**
Current Price ($13.75), % of Intrinsic Value	**103%**	**51%**	**25%**
Gain from current price to IV	**(2%)**	**95%**	**294%**

A few points.

Remember that the percentage gains in TFCF for Year 1 are based on the numbers in Table 2. While 132% for Low might seem crazy in the abstract, it isn't at all. In fact, odds favor much higher gains, which is why I prefer the Medium scenario.

Then, notice the speed bump for year three. Depending on your other assumptions, it can be a good idea to build in some kind of business disruption to see how well your numbers stand up and to make sure you aren't overly optimistic. This is highly qualitative.

Notice that I don't have a negative number anywhere for shareholder dilution. It would be double counting to reflect the buyback *and* maintain the same number for net cash per share, because the cash will be used to buy the shares. After two years of growing diluted shares over 2% annually, Key's diluted shares have been flat, and its five-year CAGR is long-term. However, even using Key's 7-year compound annual growth rate of 1.5% in diluted shares, we only bring the Medium scenario down to $24. Not enough to sweat.

Folks, remember that these or any other tables–no matter how nifty or allegedly convincing ☺–should not give an artificial sense of confidence or certainty. What they offer is, to me, a stark representation of the possibilities here, with checks on emotion. That's important to us at CGI, because we are not traders. We are investors building wealth for our Members and our own families, and we know that it's not a game. We love it and it's fun, but we are patient and rational.

And with that, we offer Key Technology as a top idea for 2007 ***[Update: And as of June 11, 2007, with a 50% gain, so far so good!].***

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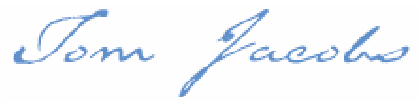
We hope that the work and thinking in this Free Report makes you want to become a CGI Member. Instead of breathless marketing hype, we give you a taste of hard work, our serious number-crunching and business analysis. Thanks for reading, and may all your investments be happy ones!

Invest well!



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