

Equity Research

December 2007

Industry Report
(07-121)

Top Sector Picks

Each year, the Equity Research Department's five sector groups—Business Services, Consumer, Financial, Health Care, and Technology—provide an outlook for the year ahead. At the same time, each group compiles two lists, one for the coming year and the other for the next three to five years, of preferred stock ideas.

The mission of the William Blair & Company Equity Research Department is to generate superior investment ideas and value-added insights for our clients through independent, in-depth research:

- of quality growth companies;
- across the market-capitalization spectrum (but focused on small- and midcap stocks); and
- with a longer-term orientation.

In this report, we discuss some key events expected in 2008 within our five sectors, potential industry and company inflection points, and profiles of all the companies selected to the lists.

Below is a combined list of the Equity Research Department's top picks for 2008.

Business Services

Blackbaud, Inc.
Coinstar, Inc.
CRA International, Inc.
Grubb & Ellis Company
MDC Partners Inc.
Portfolio Recovery Associates, Inc.
Ritchie Bros. Auctioneers Inc.
UTi Worldwide, Inc.
Valassis, Inc.
Viad Corp
Virtusa Corporation
W.W. Grainger, Inc.

Consumer

Bed Bath & Beyond Inc.
Chattem, Inc.
Delek US Holdings, Inc.
International Speedway Corporation
Life Time Fitness, Inc.
Starbucks Corporation
Tractor Supply Company
Wal-Mart Stores, Inc.
Whole Foods Market, Inc.
Wm. Wrigley Jr. Company
Zumiez Inc.

Financial

Affiliated Managers Group, Inc.
American International Group, Inc.
Argo Group International Holdings, Ltd.
Assured Guaranty Ltd.
CME Group Inc.
IntercontinentalExchange, Inc.
National Financial Partners Corp.
Signature Bank

Health Care

Animal Health International, Inc.
Celgene Corporation
Eclipsys Corporation
Henry Schein, Inc.
Laboratory Corporation of America Holdings
Medtronic, Inc.
Psychiatric Solutions, Inc.
TomoTherapy Incorporated
The TriZetto Group, Inc.
VCA Antech, Inc.

Technology

Composite Technology Corporation
Constant Contact, Inc.
CyberSource Corporation
DTS, Inc.
EnerSys
Euronet Worldwide, Inc.
Fiserv, Inc.
InnerWorkings, Inc.
Jabil Circuit, Inc.
Microsoft Corporation
QUALCOMM Incorporated
Sonic Solutions



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William Blair's six Business Services analyst teams provide equity research coverage of roughly 100 stocks, in more than 20 subsectors, across all market caps.

To aid investors in stock selection and portfolio repositioning for 2008, we have identified and present in this report 12 stocks that we believe have the potential to outperform broad equity benchmarks in 2008. We also summarize 22 stocks that we believe should outperform the market over the next three to five years.

In general, we have tried to emphasize higher-quality companies with demonstrated track records, solid business models, solid management teams, defensive competitive positions, and open-ended growth opportunities.

While we consider what we believe to be timely economic, industry, or secular themes in our stock selection process, it is difficult to categorize this broad group of stocks into themes that fit the substantial majority of our coverage list. In addition, our stock selection process emphasizes William Blair's traditional bottom-up, high-quality growth philosophy.

That said, we can segment our coverage into four areas: 1) commercial and industrial services, 2) manufacturing, 3) media, and 4) professional services, further noting the key themes we believe investors should seek to capitalize on in the year ahead. These themes are listed on the following page.

Given the consensus expectation of slowing economic growth in the United States next year, as well as some moderation in Europe and Asia, we encourage investors to have a bias toward higher-quality, larger-cap stocks with either more defensive business model characteristics or unique company-specific characteristics to drive superior relative growth.

Key Themes for 2008

Commercial and Industrial Services

- Consolidation of fragmented markets
- Convergence of distribution and logistics
- Globalization of supply chains
- Information-driven supply chains
- MRO emphasis
- Outsourcing
- Private-label and foreign-sourced products
- Product safety
- Vendor concentration

Manufacturing

- Aerospace and defense
- Consolidation of fragmented markets
- Consumer staples
- Globalization
- Energy
- Infrastructure
- Outsourcing
- Product safety
- Recurring revenue streams
- Security
- Supply chain efficiency

Media

- Consolidation of fragmented markets
- Consumer control media
- Demographic change
- Internet adoption
- Media fragmentation
- Personalized media targeting

Professional Services

- Aging population/demographic change
- Consolidation of fragmented markets
- Regulatory scrutiny/Conflicts of interest/Shift away from "Big 4"
- Defensive business models
- Environmental/energy
- International markets
- Migration to a service economy/Re-training (up-skilling)
- Outsourcing/Offshoring
- Tight labor markets/talent shortage
- Deteriorating consumer credit

All of the stock recommendations that follow incorporate several of the characteristics noted above.

2008 Best One-Year Ideas

Table 1
William Blair & Company Business Services Group
Best Ideas for 2008

Company	Ticker	Analyst	Market Cap (billions)	Rating	12/5/07 Price	Calendar 2008 EPS Estimate	Forward P/E	Long-term EPS Growth Rate
W.W. Grainger, Inc.	GWW	Germanotta	\$7.0	O/E	\$92.04	\$5.80	16	15%
Ritchie Bros. Auctioneers Inc.	RBA	Simpson	\$2.6	O/C	\$75.14	\$2.42	31	17%
UTi Worldwide, Inc.	UTIW	Germanotta	\$2.4	O/C	\$19.19	\$1.34	14	20%
Blackbaud, Inc.	BLKB	Neff	\$1.2	O/C	\$27.81	\$1.03	27	15%
Coinstar, Inc.	CSTR	Simpson	\$0.7	O/C	\$27.63	\$0.75	37	18%
Viad Corp	VVI	Mastin	\$0.6	O/E	\$30.71	\$2.28	13	10%
CRA International, Inc.	CRAI	McHugh	\$0.6	O/C	\$46.97	\$2.98	16	18%
Valassis, Inc.	VCI	Mastin	\$0.6	O/C	\$12.08	\$1.27	10	10%
Portfolio Recovery Associates, Inc.	PRAA	Neff	\$0.6	O/C	\$39.79	\$3.53	11	18%
Virtusa Corporation	VRTU	McHugh	\$0.4	O/A	\$14.25	\$0.82	17	25%
MDC Partners Inc.	MDCA	Mastin	\$0.2	O/A	\$9.38	\$1.68	6	15%
Grubb & Ellis Company	GBE	Dobell	\$0.1	O/A	\$6.16	\$0.68	9	12%

Source: William Blair & Company, L.L.C. and Reuters

W.W. Grainger, Inc.

In recent quarters, Grainger has reached a key inflection point, with incremental returns now increasingly exceeding incremental investment. As a result, Grainger's growth in operating profits and EPS has started to exceed its total asset growth. In our opinion, this positive inflection point and our expectation for higher relative EPS growth should be catalysts for modest multiple expansion in 2008. Moreover, we believe Grainger's multiple company-specific growth initiatives, facilities-maintenance-driven business model, conservative balance sheet, and strong free cash flow provide for a relatively more defensive industrial growth investment. Key concerns include sensitivity to economic cycles, intense industry competition, and the risk of execution missteps. At \$89, the stock is trading at 15 times our 2008 EPS estimate, at the lower end of its historical forward P/E range of 14 to 26 times.

Ritchie Bros. Auctioneers Inc.

We expect Ritchie Bros. Auctioneers to post another good year, driven by utilization of more and larger auction sites, stable commission rates, and operating leverage against fixed costs. We see the primary risk as valuation, as shares have climbed to 31 times our 2008 EPS estimates and 20 times 2007 EBITDA.

UTi Worldwide, Inc.

We believe the company is poised to move beyond general previous investments (new hires, internal IT project, efforts to replicate IHD in other geographic regions, new contract logistic facilities, new freight forwarding operations, and softer volume at Unigistix), which has depressed EPS by about \$0.20 over the 18-month period from January 2006 to July 2007. We are confident management can execute its cost-reduction plan, which includes limiting the number of investment projects (including a multiyear systems upgrade), eliminating underperforming operations, reducing headcount, and instituting more management accountability. These efforts should lead to renewed investor confidence, accelerating earnings growth (22.1% in fiscal 2009 versus 15.5% in fiscal 2008), and ultimately multiple expansion. The key near-term risks are execution, slower global economic growth, ongoing internal IT project spending (\$0.05 annually), operating margin pressure from an increasing mix of lower-margin contract logistic business, the DOJ investigation (not a material risk in our opinion), and reinvesting surplus cash. At \$23, the stock is trading at roughly 17 times our calendar 2008 EPS estimate of \$1.34. This compares with a six-year forward P/E range of 16-33 times, and average of 25 times. We believe the valuation appears attractive at current levels for investors who can tolerate a slightly higher degree of risk over the next year. Our rating is Outperform.

Blackbaud, Inc.

Blackbaud is the industry leader in providing software and related services exclusively to the nonprofit sector. We believe Blackbaud's leadership in a highly defensible economically insulated market, increased addressable market and go-forward operating margin expansion (thanks to the Target and eTapestry acquisitions), new product introductions, and increasingly subscription-oriented revenue model support our positive outlook. Moreover, Blackbaud has an impressive record as a public company, consistently raising guidance as well as maximizing shareholder value through extensive share buybacks and establishing a dividend. The company has outstanding financial characteristics, with a 24% operating margin, minimal debt (\$3.5 million as of November 1, 2007), free cash generation of more than 1.6 times pro forma net income year-to-date, and an impressive commitment to using this cash to fund dividends and repurchase stock.

Coinstar, Inc.

We believe that shares in Coinstar should rebound after a weak performance in fourth quarter 2007, as the entertainment services unit is stabilized. Adding firepower in 2008 should be another year of exponential growth in the Redbox business as well as the addition of GroupEx for money transfer in the key U.S.-Latin America corridor. Risks include deteriorating retail foot traffic and deceleration of same-store growth in the core coin-counting business. Enterprise value is approximately 8.3 times trailing EBITDA.

Viad Corp

We believe the place-based and event marketing industry (and trade shows in particular) is uniquely positioned in an increasingly fragmented and regulated landscape and is relatively less exposed to the economic headwinds than most other forms of media and marketing. Viad's strong position in the key market of Las Vegas, a fragmented customer base, and high barriers to entry make the company one of the best opportunities in our coverage universe. In addition, substantial technology investments and a turnaround at Exhibitgroup are expected to drive significant and sustainable revenue and profitability growth. Trading at 5.5 times EV to 2008 EBITDA and 13.7 times 2008 EPS (11.6 times when adjusting for the net cash balance), we view shares as unusually attractive.

CRA International, Inc.

We believe that demand for specialty consulting services will remain solid in 2008, so we believe that CRA International remains well positioned to continue to generate low-teens organic revenue growth, as it has done every year since 2003. We believe organic revenue growth will be complemented during the next few years by a gradual rebound in the company's operating margin to the midteens and more aggressive use of the company's balance sheet to repurchase stock or make acquisitions. We also believe that the company's forward P/E multiple could expand from 15 times today to the industry average of 19-20 times. The main risks to the company's growth in 2008 are a downturn in antitrust-related projects, competition for talented consultants, and execution, in our view.

Valassis, Inc.

Valassis is well positioned to take advantage of the strength in direct and shared mail with the recently acquired Advo business. In addition, we believe that cost savings at Advo will continue to meet or exceed targets, modest revenue growth at Advo is a reasonable expectation for 2008, and FSI cannot get much worse after 2008 (and may get better assuming the pending lawsuit against News Corp. is resolved favorably for Valassis). If the company is able to achieve the relative stability in its operations we project, the EBITDA multiple could recover to the 7.5-8.0 range, which would suggest a share price in the \$17 to \$20 range.

Portfolio Recovery Associates, Inc.

Portfolio Recovery Associates is a specialized collector of defaulted consumer debts. In our view, the company is the blue chip of the collections industry with a superior management team and an exemplary record of execution. We expect cash collections, earnings, and revenue acceleration in 2008. After two to three years of higher portfolio prices, the purchasing environment is once again improving; we believe this argues for multiple expansion from current levels, which are at or near historical lows. We believe collectability concerns are significantly overblown and that the dynamics cited above will pressure the enormous short position, which is about 44% of the float. We view Portfolio Recovery Associates as a direct beneficiary of a deteriorating consumer and economic downturn, and so is a well-positioned defensive name for 2008.

Virtusa Corporation

We believe Virtusa Corporation represents an attractive investment opportunity to participate in the growth of offshore IT outsourcing industry. The company's relatively small size puts it at a disadvantage in certain circumstances, but it also provides a significant opportunity to grow through deeper penetration of existing clients, expansion into new service offerings, and the addition of new clients. As a result of investments in the business and an experienced management team, Virtusa is better positioned to compete than its revenue run-rate suggests, in our opinion. We also appreciate Virtusa's opportunity to drive significant margin expansion. SG&A expense as a percentage of revenue is nearly twice as large at Virtusa as at some competitors, owing to the company's smaller scale and aggressive investments in the company's support functions during the last few years. Therefore, while the declining value of the U.S. dollar represents a risk to profit margins, we believe that Virtusa has the

opportunity to improve its operating margin from 9% to the mid- to high teens during the next few years. Given the opportunity for significant growth during the next few years, we believe the company's valuation at 19 times our calendar 2008 EPS estimate remains attractive.

MDC Partners Inc.

New business momentum remains strong for MDC Partners' agencies and marketing services firms, with recent high-profile account wins including Domino's Pizza, American Express (AXP \$57.11), Nike (NKE \$65.80), and Best Buy (BBY \$51.07). MDC Partners' agency Crispin Porter + Bogusky (CPB) was recognized as the top interactive agency of the year, and would have taken overall top agency of the year honors if the awards for print and television and interactive had been aggregated. With the recent pullback in shares following strong third-quarter results, MDC Partners is attractively valued, in our view, trading at 6.1 times enterprise value to MDC's share of 2008 EBITDA.

Grubb & Ellis Company

While we anticipate the overall macroeconomic themes affecting commercial real estate will play into our investment thesis, we believe the pending merger with NNN Realty Advisors (December close) provides the combined company with the opportunity to enact fundamental changes in the business model, making the "new GBE" a stronger competitor. We see an opportunity for the pending merger to accelerate this process, as NNN's business boasts higher operating margins and strong free cash flow that will enable GBE to expand into new geographies, continue to upgrade the broker ranks, and fill out the product suite across its existing geographies with an immediate improvement in the investment management business. Beyond cyclical factors in commercial real estate, we believe integrating the two firms (particularly broker retention) and legal challenges to the IRS 1031 tax code are the primary risks we see for GBE. While integration of two diverse businesses and cultures presents risks, we believe GBE's current valuation at approximately 3-4 times our pro forma EBITDA estimate of \$90 million (pro forma for the merger) provides an attractive risk/reward trade-off.

Best Long-Term Ideas

Table 2
William Blair & Company Business Services Group
Best Long-Term Ideas

Company	Ticker	Analyst	Market Cap (billions)	Rating	12/5/07 Price	Calendar 2008 EPS Estimate	Forward P/E	Long-term EPS Growth Rate
Google Inc.	GOOG	Mastin	\$218.1	O/A	\$694.05	\$21.71	32	30%
Danaher Corporation	DHR	Germanotta	\$26.9	O/E	\$86.50	\$4.33	20	15%
Omnicom Group Inc.	OMC	Mastin	\$15.9	O/E	\$48.42	\$3.27	15	14%
Apollo Group, Inc.	APOL	Dobell	\$12.8	O/C	\$76.32	\$3.01	25	15%
Ecolab Inc.	ECL	Simpson	\$11.5	O/E	\$51.94	\$1.89	27	14%
Expeditors International of Washington, Inc.	EXPD	Germanotta	\$10.0	O/E	\$46.95	\$1.52	31	20%
Moody's Corporation	MCO	Neff	\$9.4	O/E	\$38.46	\$2.28	17	15%
Fastenal Company	FAST	Germanotta	\$6.0	O/E	\$43.49	\$1.82	24	25%
IHS Inc.	IHS	Neff	\$4.3	O/C	\$66.28	\$1.86	36	17%
FactSet Research Systems Inc.	FDS	Neff	\$3.1	O/C	\$66.00	\$2.50	26	18%
New Oriental Education & Technology Group	EDU	Dobell	\$3.0	O/A	\$88.00	\$1.70	52	25%
Ritchie Bros. Auctioneers Inc.	RBA	Simpson	\$2.6	O/C	\$75.14	\$2.42	31	17%
Knight Transportation, Inc.	KNX	Germanotta	\$1.3	M/C	\$16.07	\$0.79	20	15%
Huron Consulting Group Inc.	HURN	McHugh	\$1.3	O/A	\$74.96	\$3.06	24	20%
Pool Corporation	POOL	Germanotta	\$1.1	M/E	\$21.87	\$1.63	13	15%
CoStar Group, Inc.	CSGP	Neff	\$0.9	O/C	\$46.18	\$0.86	54	30%
Polypore International, Inc.	PPO	Germanotta	\$0.7	O/A	\$17.29	\$0.80	22	15%
Duff & Phelps Corporation	DUF	McHugh	\$0.7	O/C	\$19.15	\$1.10	17	20%
Heidrick & Struggles International, Inc.	HSII	McHugh	\$0.7	O/C	\$34.81	\$3.00	12	15%
Standard Parking Corporation	STAN	McHugh	\$0.4	O/C	\$47.50	\$1.97	24	13%
ICF International, Inc.	ICFI	McHugh	\$0.4	O/C	\$25.05	\$1.80	14	15%
FTD Group, Inc.	FTD	Mastin	\$0.4	O/C	\$14.28	\$1.27	11	14%

Note 1: FTD 2008 EPS estimate is fiscal year ending June; calendar year is unavailable

Source: William Blair & Company, L.L.C. and Reuters

Google Inc.

We believe Google will continue to create value with its record of innovation and timely partnerships with, and acquisitions of, industry leaders such as Dell (DELL \$23.60), Double-Click, Firefox, MySpace, Sun Microsystems (JAVA \$20.85), and YouTube and the recently announced Open Handset Alliance. Revenue growth continues to be driven by monetization improvements in its advertising system, which now has an estimated 500,000 customers. Google's search engine leads the industry, as the company continues to gain market share at the expense of Yahoo (YHOO \$26.42) and MSN. We view the stock as reasonably valued, trading at 32.1 times our 2008 EPS estimate.

Danaher Corporation

We consider Danaher to be a best-in-class diversified manufacturer, positioned to generate earnings growth superior to the market and peer group. The company's strengths include a proven management team; diversity in terms of end-markets, customers, and geographic presence; superior sales growth, operating margin, cash flow generation, and return-on-equity compared with most other diversified industrial investments; a demonstrated acquisition record; and a continuous-improvement culture rooted in the Danaher Business System (DBS). Potential risks include a downturn in the industrial economy; pressure from strong, global competitors; regulatory changes; and seasonal dynamics. At \$86, shares trade at 20 times our 2008 EPS estimate of \$4.33, compared with the historical range of 17-23 times. This multiple reflects an approximate 30% premium to the market and diversified industrial peer group, in line with the stock's historical premium.

Omnicom Group Inc.

We view the increasing fragmentation of media as a favorable trend that will continue to benefit the full-service agencies, and we view Omnicom as the best-positioned large-cap holding company, with nearly 60% of the company's revenue coming from high-growth, high-margin marketing services. We project that secular trends toward marketing services as well as strong new business wins should continue to drive organic growth at Omnicom and its best-in-class agencies. At 9.1 times enterprise value to 2008 EBITDA and 14.6 times 2008 EPS, shares are trading at a discount of 15%-25% to historical multiples; we strongly recommend purchase at current levels.

Apollo Group, Inc.

Apollo Group is in the early stages of addressing the key issues of student retention and operating leverage (through more-efficient marketing, cost containment, and a value-driven investment philosophy) that we believe will continue to play out favorably over the coming two to four years. Specifically, we continue to believe 1) Axia retention should improve as Apollo puts more focus on more programs and better customer service, 2) UOP retention and growth should improve as more Axia students matriculate and new degrees and specializations drive more interested students, 3) the pending roll-off of the Ad.com deal and Aptimus integration should drive student-acquisition costs lower starting in early calendar 2008, and 4) international acquisitions should provide a new and exciting growth opportunity with the ability to create significant long-term economic value. We believe execution vis-à-vis new student growth and retention are the primary risks Apollo shareholders face, but also are cognizant of the impact of more expensive student-acquisition costs and competition on Apollo's business model. Shares are trading at about 26 times our fiscal 2008 (August) EPS of \$2.83 and 22 times our fiscal 2009 EPS of \$3.40, 10%-15% discounts to the group averages.

Ecolab Inc.

We believe that Ecolab is well positioned to outperform the overall markets because of its leadership position targeting secular trends in sanitation, broad product portfolio, and solid history of execution. New product development, salesforce growth, and cross-selling should support growth in the domestic cleaning and sanitizing business, while investments in Europe and GCS, the company's kitchen equipment repair business, should begin to make material contributions over the next two to three years. Risks include exposure to a cyclical slowdown in hospitality and foodservice. The stock is trading at 26 times our forward EPS estimate and 13 times on an EV-to-trailing EBITDA basis.

Expeditors International of Washington, Inc.

Expeditors' nonasset-based operating model, growth opportunities (new branch openings and expanding share on Asia-Europe and intra-Asia trade lanes), execution capability, entrepreneurial culture, and leading position in a market with favorable secular trends (globalization, international trade, foreign sourcing, outsourcing, and improving supply chain efficiency) should combine to deliver favorable shareholder wealth creation and long-term stock price appreciation, in our view. Near-term risks include slower global economic growth, the DOJ investigation (not a material risk in our opinion), reinvesting surplus cash, and a new CFO search. At about \$46, the stock is trading at 30 times our 2008 EPS estimate of \$1.52. This compares with the historical (1999-2006) one-year forward range of 22-48 times with an average of 31 times; therefore, we recommend buying on temporary corrections. Despite softer U.S. economic growth and decelerating international freight volume trends, Expeditors continues to gain market share while driving labor productivity, and is projected to produce superior relative EPS growth averaging 19% between 2007 and 2009. Our rating is Outperform.

Moody's Corporation

Moody's is a leading global provider of credit ratings and analysis on more than \$30 trillion in corporate, structured, public, and sovereign debt. Given the recent meltdown in the housing market, Moody's is suffering from the subprime turmoil and broader slowdown in

debt issuance volumes, speculation of lawsuits in relation to RMBS losses, and reduced standing in the debt capital markets. We believe that Moody's regulatory, reputational, and legal liability is limited. We consider Moody's a true global business franchise with fantastic financials (50%-plus operating margins, minimal capital expenditures, and substantial free cash flow) protected by long-standing barriers to entry. We continue to view Moody's as the best combination of quality and value in our coverage and believe it will eventually emerge from the credit market turmoil with its franchise intact.

Fastenal Company

We believe Fastenal provides excellent long-term investment potential and should be considered a core growth industrial holding. Longer term, we believe Fastenal's new growth formula (emphasis on improving same-store sales and margins) as well as multiple other company-specific growth drivers should continue to drive superior relative earnings growth. While the sales potential is similar under its new growth formula, EPS and ROA are anticipated to be materially higher as the new store model drives more sales per store with less incremental overhead and capital spending. In our view, long-term-oriented investors will be rewarded by accumulating this high-quality name at a cyclically depressed valuation. Key concerns include a change in growth formula, sensitivity to economic cycles, and intense industry competition. At \$40, the stock is trading at 22 times our 2008 EPS estimate, at the lower end of its historical forward P/E range of 18 to 40 times.

IHS Inc.

IHS is the leading global provider of critical technical information, decision-support tools, and related services to customers in the energy, defense, aerospace, construction, electronics, and automotive industries. IHS is uniquely positioned at the center of several promising growth themes—from energy, to environmental solutions, to infrastructure—and offers investors an information and subscription-based way to invest in those themes. In addition, new growth areas are being created by the increasing overlap of what IHS calls its four “domains”: energy, environmental, security, and product lifecycle management. IHS's clients increasingly have to make business decisions—investment, operational, and strategic—considering all four of these domains simultaneously, and only at IHS are these four domains converging into proprietary, integrated solutions. IHS enjoys clear market leadership and an attractive financial model that features highly recurring revenues, margin expansion, and strong free cash generation.

FactSet Research Systems Inc.

FactSet is a leading provider of financial information and related applications to the investment community. The primary stock risk for FactSet has historically been P/E multiple contraction during a prolonged downturn in the equity markets and resulting layoffs at FactSet's Wall Street clients. Although there has been some recent stock market volatility, FactSet's forward-looking metrics provide some level of reassurance. Subscription value continues to exceed our estimates, a real testament to the momentum in the business; strong nonsubscription revenue growth is a positive signal about FactSet's standing vis-à-vis competitors in its industry; and DSO are at or near all-time lows. All of this speaks to continuing momentum in the business and what remains a healthy backdrop for FactSet. FactSet has an 11-year record of consistent growth that is virtually unequaled in the U.S. market and should be a core long-term holding, in our view.

New Oriental Education & Technology Group

New Oriental is the market leader in the highly fragmented English language instruction and test preparation markets in China and has the best brand name, in our view. We believe New Oriental can grow revenue at a compound annual rate of more than 25% over the next five years; we expect operating margin to grow from 23% in fiscal 2007 to 30%-35% in that same period. The primary risks we see to the business and the stock over the longer term are 1) increasing competition in a number of the company's segments, potentially leading to pricing pressure down the road; 2) the potential for unexpected regulatory changes;

and 3) reliance on the chief executive officer, who is a well-known and respected figure in China. At the current price of about \$88, shares are trading at about 27-28 times and 22-23 times our unpublished fiscal 2011 and 2012 EPS estimates, respectively, compared with about 70 and 48-49 times our fiscal 2008 and 2009 estimates. While we would not normally be willing to look at earnings estimates this far into the future as a proxy for valuation, we believe the long tail on growth at New Oriental warrants looking further out than we do on other education providers. We look for shares to remain volatile and would be fairly aggressive on significant dips caused by broader market weakness.

Ritchie Bros. Auctioneers Inc.

We believe that Ritchie Bros. Auctioneers will continue to expand the number and size of its physical auction sites around the world over the next few years. Growth in average auction sizes, Internet participation rates, and international awareness should enhance growth, while scale and process standardization should allow for operating leverage. We see the primary risk as valuation, as shares have climbed to 31 times our 2008 EPS estimates and 20 times 2007 EBITDA.

Knight Transportation, Inc.

Recently, slower domestic truckload industry volume growth, a softer pricing environment, and numerous cost pressures (fuel, hours of service, and less efficient 2007 engines) have combined to limit near-term earnings growth at Knight, which we consider to be among the best-in-class truckload carriers. While these risks will likely not dissipate for at least the next several quarters, we hold a favorable long-term outlook for the company. We are confident in Knight's ability to produce favorable operating results and superior earnings growth compared with other asset-based truckload carriers in a more stable GDP growth environment. Knight has the opportunity to open new dry van branches and further expand its presence in truck brokerage and refrigerated trucking. At \$15, the stock is trading at 19 times our 2008 EPS estimate of \$0.79. This compares with Knight's historical six-year average one-year-forward P/E multiple of 22 times, with a range of 12-32 times. An eventual recovery in the domestic TL market (late 2008), coupled with Knight's superior historical performance and cost discipline, should provide long-term price appreciation. Our rating is Market Perform, reflecting the numerous near-term risks previously mentioned.

Huron Consulting Group Inc.

While Huron Consulting's revenue shortfall during the last two quarters increases the level of uncertainty about the company's growth outlook, we believe the demand environment for the company's services remains solid. We believe the company continues to employ high-quality consultants in an increasingly diversified set of service lines and is still led by an experienced management team. We therefore believe that the company remains well positioned to continue to generate strong revenue and earnings growth during the next few years. The company's valuation has pulled back to the low 20s since the company reported third-quarter results, which we believe represents an attractive entry point for investors.

Pool Corporation

We consider Pool to be an open-ended, superior long-term growth story, with ongoing prospects for an industry-leading ROIC, and an attractive valuation. In our opinion, Pool has the opportunity to grow sales by three times and profits by four times over the next decade by outgrowing the pool industry, adding complementary products, and expanding into the irrigation and landscape business. We believe long-term-oriented investors should take a hard look at Pool given its superior earnings growth prospects (more than 20% with ongoing acquisitions) and ROIC (18%), as well as significant repair- and replacement-driven sales model (60% of sales). Challenges for the year ahead include weak real estate markets, continued gross margin pressure, a record pace of branch openings, and tight credit. At about \$21, the stock is trading at 13 times our 2008 EPS estimate, compared with its historical range of 10 to 27 times.

CoStar Group, Inc.

CoStar is the leading provider of information services to the commercial real estate industry in the United States and United Kingdom. The commercial real estate boom of the past few years is likely coming to an end, with absorption of existing space waning and a large amount of new space soon to be delivered. But we continue to believe that CoStar is well positioned not only to continue its 10-year record of sequential revenue growth, but also to deliver very robust earnings growth over the next five quarters. The company has been investing heavily in its products, coverage, and service, and is now beginning to see the payoff in terms of operating leverage and EPS growth. CoStar has \$8.43 per share in cash and no debt, generates 96% of its revenue from subscriptions with renewal rates above 91%, and is exiting a major investment spending phase with essentially complete U.S. coverage. We view CoStar as one of the most competitively advantaged names in our coverage and believe it is increasingly well positioned for the future.

Polypore International, Inc.

Polypore is a leader in several growing markets, benefits from a meaningful recurring revenue stream, and has consistently reported adjusted EBITDA margins well above the peer group average. With a leading position in several membrane/separator markets, Polypore is positioned to benefit from strong growth in the lithium battery and hemodialysis industries (projected growth of 10% and 7%, respectively). The company also has the potential to benefit from adoption of lithium batteries in the hybrid electric vehicle and power tool markets, which could add substantial upside to our forecast over a five-year time horizon. Risks include relatively high debt levels, investor overhang, customer concentration, and potential inefficiencies related to significant capacity additions in 2008. At \$17, Polypore shares currently trade at an EV/EBITDA ratio of about 9 times, representing an approximate 25% discount to the peer group—an attractive valuation, in our opinion.

Duff & Phelps Corporation

We believe Duff & Phelps represents an attractive investment opportunity for long-term investors. We believe the combination of the company's brand with the experience and relationships of its management team and consultants creates an attractive platform for growth. Through both organic growth and acquisitions, Duff & Phelps intends to use this platform to expand its geographic presence, grow in existing markets, and add service lines, in our view. While a decrease in the pace of M&A activity could create a headwind for the company in 2008, we believe the potential for earnings growth remains solid owing to favorable secular trends and anticipated growth in countercyclical and noncyclical services. Over the long term, we believe the company's forward P/E multiple could expand modestly from 18 times today to the low-20s.

Heidrick & Struggles International, Inc.

Secular trends such as the globalization of corporations, heightened scrutiny of corporations, and an increasing shortage of talent will drive increased demand for executive search services in the future. As one of the largest and most-respected providers of these services on a global basis, Heidrick & Struggles is well positioned to capitalize on these trends. Heidrick & Struggles also generates significant free cash flow and has a strong balance sheet with approximately \$12 per share of cash, which management is using to repurchase stock, pay a small dividend, and potentially make small acquisitions. Demand for the company's services could be negatively affected in the short term by weakness in the global labor market. But we believe this is reflected in the company's forward P/E multiple of 11 times 2008 EPS projections, which is relatively close to trough valuation multiples that staffing-related companies have traded at during past recessions.

Standard Parking Corporation

Standard Parking is a unique outsourcing franchise encountering favorable trends that should continue to outpace the market over the long term, in our view. The company's management contract model is mostly noncyclical and requires little capital to grow, and the competitive and acquisition landscape is favorable. Risks include pricing pressure, the failure to add on adjacent services such as shuttle bus operation, and valuation multiple compression. The stock is trading at 25 times our forward EPS estimate, or nearly double our projected EPS growth rate, and 14 times on an EV-to-trailing-EBITDA basis.

ICF International, Inc.

We believe ICF International continues to perform well on the important Road Home contract, which could be meaningfully larger than we currently assume in our estimates. We also believe ICF continues to generate strong revenue and earnings growth in its legacy business, which is important since we believe investors are increasingly looking past the Road Home program when valuing the business. Execution among a competitive government consulting industry remains the company's primary challenge, but we are confident that management will leverage the cash flow and credibility generated by the Road Home contract to drive future revenue growth in the company's legacy business through acquisitions and large new implementation projects. Over the long term, we also believe that the company's expertise in environmental-, health-, and energy-related issues will be an important asset, as we believe these issues will receive increased attention and funding from governments and corporations. Lastly, we believe ICF's valuation remains reasonable at 15 times our 2008 earnings per share estimate.

FTD Group, Inc.

FTD's leadership positions in the florist and consumer segments create a reinforcing revenue cycle, and an industry-leading brand with 96% recognition drives low acquisition costs and high retention rates. Despite a modest growth rate, we remain bullish on FTD, given the likelihood of future accretive acquisitions, the possibility of a takeout, a 4.9% dividend yield, and an unusually attractive valuation, trading at 7.1 times enterprise value to our 2008 EBITDA estimate, 9.3 times 2008 free cash flow, and 10.6 times 2008 EPS.

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- The Retail/Consumer team at William Blair & Company recently released its 2008 investment strategy and top stock recommendations, maintaining its constructive approach to the sector.
- The William Blair & Company Retail/Consumer team formally shifted to a constructive approach to the sector in September 2007. We believe the multiyear period of retail/consumer stock underperformance may be nearing its end. Our shift from a cautious to constructive approach to the sector was driven by the favorable interest rate outlook; the relationship between consumer expenditures and industrial production, which is becoming more favorable; and the multiyear minimum wage increase, which should support consumer spending.
- Our top recommendations for 2008 include (in order of market capitalization) Wal-Mart Stores, Starbucks, Wrigley, Bed Bath & Beyond, Whole Foods, International Speedway, Life Time Fitness, Tractor Supply, Chatter, Delek US, and Zumiez.
- There is no change to our long-term recommendations list. This portfolio, which was initiated on January 13, 2003, and is up 85% over the past five years, represents our top 12 ideas for the next three-to-five years. Our long-term recommendations list includes (in order of market capitalization) Target, Walgreen, Wal-Mart de México, Carnival, Starbucks, Bed Bath & Beyond, Whole Foods, CarMax, Dick's Sporting Goods, Life Time Fitness, Tractor Supply, and Blue Nile.

2008 Retail/Consumer Sector Outlook

The William Blair & Company Retail/Consumer team formally shifted to a constructive approach to the sector in September 2007. While retail stocks overall underperformed the broader market during 2007 for a third consecutive year, stock performance for the group has lagged more than earnings growth (relative to the S&P 500).

We believe the multiyear period of retail/consumer stock underperformance may be nearing its end. Our shift from a cautious to constructive approach to the sector on September 10, 2007, was driven by three fundamental developments: the outlook of lower interest rates, the relationship between consumer expenditures and industrial production is becoming more favorable, and the multiyear minimum wage increase should support consumer spending.

Lower Interest Rate Outlook

The relative stock performance of the broader retail composite has been inversely correlated with short-term interest rates over the past 25 years, although there have been periods of sector underperformance while the Fed was in an easing mode. While relative earnings growth drives relative stock performance for retailers over the long term, we view an easing interest rate environment positively.

Consumer Expenditures and Industrial Production Becoming Favorable

The relationship between consumer expenditures and industrial production is becoming more favorable. Retail stocks relative price performance has historically tracked the difference between consumer expenditures and industrial production. While employment and wage growth have been relatively solid, and retail/consumer spending has been stable/modestly slowing, the decline in the NAHB index points to further weakness in industrial production.

Wage Growth Should Support Relative Earnings

Relative earnings growth drives relative stock performance over the long term. While we acknowledge the slowdown in housing and high consumer debt levels, we also recognize the importance of growth in employment and real wages. Average hourly earnings growth has historically been a key factor in retail earnings growth, as it is both a key driver of consumer spending and also an important factor affecting overall corporate profit margins. The current multiyear minimum wage increase should provide support to consumer spending, while it penalizes margins across the corporate sector.

Consumer Valuations at 10-Year Low

Expectations for retail stocks appear to be low, as the valuation for the broader retail index that we track is now near a 10-year low (relative to the S&P 500). Given our constructive approach to the sector, we view valuation as attractive.

2008 Best One-Year Ideas

Table 3
William Blair & Company Consumer/Retail Group
2008 Top Stock Recommendations

(Rank ordered by market cap in millions)

Company	Ticker	Rating	Analyst	11/23/07 Mkt Cap	11/23/07 Price	C2008 EPS	C2008 P/E	LT Growth
Wal-Mart	WMT	O/E	MM	\$186,040	\$45.73	\$3.41	13.4	11%
Starbucks	SBUX	O/E	SZ	\$17,032	\$23.07	\$1.08	21.4	20%
Wrigley	WWY	O/E	JA	\$13,672	\$62.47	\$2.50	25.0	10%
Bed Bath & Beyond	BBBY	O/E	JM	\$8,109	\$30.62	\$2.42	12.7	15%
Whole Foods	WFMI	O/C	MM	\$5,664	\$40.75	\$1.42	28.7	19%
International Speedway ^	ISCA	O/C	BS	\$2,249	\$43.00	\$3.30	13.0	9%
Life Time Fitness	LTM	O/A	SZ	\$1,959	\$50.10	\$2.22	22.6	25%
Tractor Supply Co.	TSCO	O/C	JM	\$1,530	\$39.70	\$2.84	14.0	20%
Chattem	CHTT	O/C	JA	\$1,272	\$66.98	\$3.80	17.6	13%
Delek	DK	O/A	MM	\$1,069	\$19.92	\$2.35	8.5	11%
Zumiez	ZUMZ	O/A	SZ	\$802	\$27.94	\$1.15	<u>24.3</u>	<u>28%</u>
Average (unweighted)							18.3	16%
S&P 500 Retail Index*					837.0			
S&P Retail Index					416.5			
S&P Food/Staples Index					198.0			
S&P 500					1,440.7	\$101.00	14.3	8%
NASDAQ					2,596.6			
Russell 2000					755.0			

List Initiated: November 23, 2007

^ Price and EPS estimate for International Speedway reflects the "A" shares; market capitalization combines "A" and "B" shares.

* Weighted average of S&P Retailing and S&P Food & Staples indices

Note: S&P 500 EPS estimate is bottom-up.

Source: Reuters, William Blair & Company, L.L.C. estimates

Wal-Mart Stores, Inc.

Rationale

- Wal-Mart now appears to be on firmer operational footing in the United States, helped by significant clearance activity during the summer, conservative buying, increased emphasis on more basic assortments in the apparel and home categories, and improved store labor scheduling.
- While the external operating environment remains quite challenging, we believe Wal-Mart should be able to sustain double-digit earnings growth over the next year (likely ahead of the S&P 500). The key swing factor will be Wal-Mart's ability to recover gross profits in the apparel and home categories, as the other key sectors of the store (health & wellness, grocery, electronics) continue to generate strong growth.
- The improved earnings growth, coupled with moderated capital spending plans, positions Wal-Mart to generate significant free cash flow in coming years, which the company is likely to use to aggressively repurchase its stock.

Valuation

- The shares currently trade at 13 to 14 times our calendar 2008 EPS estimate, representing a modest discount to the S&P 500 (below the historical 20% average premium).

Key Risks

- While sales declines in apparel have moderated somewhat in recent months, it is not yet clear if the department is likely to show sustainable improvement. Continued subpar performance could pressure the gross margin rate.
- Persistently high gas prices and/or accelerated inflation in food or other packaged goods categories could continue to partly offset the benefit to consumers' purchasing power from improved real wage growth.

Starbucks Corporation

Rationale

- Fiscal 2007 was a challenging year for Starbucks, with lackluster traffic (pervasive throughout the restaurant space), spiking dairy costs, and rising labor expenses. Despite this triple whammy, the company still achieved a 5% comp gain in fiscal 2007 (right in the middle of its 3% to 7% guidance) and met the low end of original earnings expectations, with EPS up 19%.
- Investors have seemingly extrapolated Starbucks' recent traffic weakness as indicative of long-term fundamental issues regarding the strength of the brand or changing competitive dynamics. Still, we have yet to see any evidence that Starbucks' traffic slowdown is anything other than reflective of broader macro weakness, particularly as the vast majority of restaurant and retail companies have also exhibited slowing trends this year.
- While macro trends may remain challenging, we continue to believe high visibility exists on forward earnings projections. Moreover, we see the opportunity for Starbucks to bolster fiscal 2008 comps through increased operational focus, stabilizing new domestic unit development, and enhanced marketing initiatives.

Valuation

- At 21 times our calendar 2008 EPS estimate, we believe Starbucks is being afforded very little benefit of the doubt as to its ability to more than double global units from 15,000 today (10,700 domestic and 4,300 international). From here, we believe muted valuation risk, combined with good earnings visibility, creates a favorable risk/reward scenario for investors.

Key Risks

- We see the potential for the stock to remain at depressed levels on muted earnings growth and continued negative U.S. traffic trends over the next one to two quarters. In addition, continued publicity surrounding other entries into the specialty coffee market may feed investor angst pending a pickup in Starbucks' traffic trends.

Wm. Wrigley Jr. Company

Rationale

- Wrigley's relative stock performance could be helped by improved relative earnings strength in 2008.
- Fundamentals appear solid: 1) innovation (versus price)-driven competition, lack of PL threat; 2) gum consumption continues to expand rapidly in emerging markets; 3) new products and price driving growth in developed markets; and 4) new CEO and enhanced productivity focus favor additional margin expansion and improved capital returns.
- Less-sensitive to U.S. economy and macro factors: 1) international diversification (two-thirds of sales outside the United States); 2) relatively low price point (affordable indulgence); and 3) growing recognition of important alternative benefits (dental health).

Valuation

- Wrigley shares currently trade at 25.0 times our 2008 EPS estimate, a 6% discount to the five-year average historical forward P/E multiple of 26.5 (adjusted for stock option expense).
- In both 2007 and 2008, we expect Wrigley should increase earnings by 11%, the high end of the company's long-term EPS growth target.
- As such, we believe the multiple is sustainable, and shareholder returns (EPS growth plus ~2% dividend yield) could exceed the broader market should growth continue to become more scarce during 2008.

Key Risks

- Heightened competition (Cadbury's efforts in the United States and the United Kingdom)
- Currency exposure (weak dollar has benefited the company during 2007)

Bed Bath & Beyond Inc.

Rationale

- Ample growth opportunity: An ultimate target of more than 1,300 core BBBY format stores (compared to the current BBBY store count of 830) supports high-single-digit square-footage growth. Merchandising initiatives support future comp growth. Direct sourcing provides a sales growth and margin expansion opportunity. In addition, BBBY is accelerating growth in Christmas Tree Shops to 30% store growth in 2008 from 18% in 2007.
- Beneficiary of weak industry. BBBY is well positioned to capitalize on recent retrenchment by a number of home furnishings competitors in a difficult environment. BBBY's most direct competitor, Linens 'n Things, has reported comparable store sales declines, negative EBITDA, and dramatically reduced capital spending throughout 2007.

Valuation

- BBBY's current 11.0% discount to the S&P 500 index is 46.3 percentage points below its historical average of a 35.3% premium. We view BBBY's current multiple of 12.7 times our 2008 EPS estimate as attractive. We expect shares to rise with multiple expansion as sentiment eventually improves and with earnings growth.

Key Risks

- While BBBY accounts for only less than 6% share of the home furnishings industry, and enjoys a significant opportunity to gain market share, the overall home furnishings sector faces exposure to the depressed housing market.

Whole Foods Market, Inc.

Rationale

- The improving comp-store sales trends (up 8.2% last quarter, ahead of our 7.5% estimate), combined with solid gross margin trends, suggest Whole Foods Market is positioned to drive growth despite of the challenging consumer environment.
- The early sales improvement in the acquired Wild Oats stores reinforces our belief that this deal could be \$0.20 EPS accretive over the next three to five years. Fiscal 2009 EPS growth should be accelerated as the company laps the initial dilution, which is now reflected in fiscal 2008 estimates.
- Whole Foods remains one of our top long-term recommendations, as we believe the company possesses a special culture of empowerment that is extremely difficult to replicate, giving it an enduring competitive edge.

Valuation

- The shares currently trade at 29 times our calendar 2008 EPS estimate, representing a 100% premium to the S&P 500 (below its 5-year average historical premium of 120%). Looking beyond the short-term dilution of Wild Oats, the 23-times P/E on our 2009 EPS estimate may be the more appropriate comparison.

Key Risks

- Integration risk and near-term dilution from Wild Oats acquisition.
- Continued deterioration in home prices, resulting in a “negative wealth effect” for consumers who aspire to shop at Whole Foods.

International Speedway Corporation

Rationale

- Positive earnings swing factors in a soft economy:
 - Broadcast profits by contract will increase 3.2% in 2008 versus a 12% decline in 2007. In 2007, we estimate broadcast after-tax profits will decline by \$0.19 per share but rise \$0.06 per share in 2008, a swing of \$0.25.
 - We estimate a \$2 million pretax profit as a result of Motorsports Authentics in 2008, ISCA's joint venture with Speedway (TRK \$33.05), versus an operating loss of \$14.7 million in 2007. That would be a swing of \$16.7 million, or \$0.19 per share, in 2008 versus 2007.
 - Barriers to new entrants are formidable.
 - The revenue mix shift toward higher-margin, more predictable sponsorship and broadcast fees increases earnings consistency and predictability. This shift should allow margins to rise, and therefore profits should grow faster than revenues. Contracted broadcasting fees and sponsorship should rise to nearly 80% of profits by 2014.
 - Cash flow from operations should consistently exceed capital expenditures over the next several years. The cumulative excess cash flow from operations over expenditures will allow the company, based on our estimates, to fund future growth internally and still have the option to reduce debt, increase dividend payments, and buy back shares.

Valuation

- ISCA's valuation appears attractive, selling at a 9% discount to the S&P on 2008 earnings, despite the company's potential to achieve more rapid long-term growth, exhibit lower-than-average cyclical volatility in earnings, and generate free cash flow at a pace in excess of the S&P 500. In our opinion, an investor can currently buy ISCA's superior investment characteristics at a discount to the market average valuation.

Key Risks

- In the highly discretionary motorsports industry, ISCA may be affected by rising interest rates and rising gasoline prices, which pressure an already squeezed consumer. A corporate spending slowdown would have an adverse effect on sponsorship spending.

Life Time Fitness, Inc.

Rationale

- Life Time's stock has dropped over 15% since it beat third-quarter earnings expectations, as investors have worried that slowing comps are reflective of 1) economic sensitivity and 2) emerging competitive issues, as L.A. Fitness enters Life Time's home court of Minneapolis.
- We believe the slowdown in third-quarter comps is primarily the result of 1) fewer high-comping new clubs entering the comp base and 2) inefficiencies surrounding the June implementation of higher dues for new members at five over-capacity clubs (which intentionally slows member additions). Both of these issues should abate somewhat in the fourth quarter.
- Life Time already overlaps in roughly 40% of its markets with L.A. Fitness, with no adverse impact on Life Time's business. L.A. Fitness has only opened one club thus far in Minneapolis, with Life Time's management indicating no subsequent loss of memberships at its three nearby clubs.
- We believe Life Time continues to have enviable earnings visibility given its annuity-like revenue stream. In addition, we continue to see the potential for Life Time to grow at least another decade at its current 15% to 20% club growth pace.

Valuation

- At 23 times our 2008 EPS estimate, the stock is trading at a rare discount to its 25% long-term growth rate, representing a compelling valuation, in our opinion. Longer term, we believe investors will be rewarded with strong and predictable 25% EPS growth with the possibility of upside.

Key Risks

- Life Time's valuation multiple could be at further risk should the company begin to manifest obvious signs that the broader consumer slowdown is beginning to negatively impact business trends. In addition, management's plan to increase new member dues to rationalize membership at overcapacity clubs can create near-term dislocations in membership levels and/or comp trends, which can create investor confusion.

Tractor Supply Company

Rationale

- Unique Format: TSCO operates a differentiated format supplying the lifestyle needs of recreational farmers and ranchers. TSCO is the clear leader in its niche and faces little direct competition.

- High Square-Footage Growth: With an ultimate core store base target of approximately two times the current store base of 720 stores, we estimate the company will generate midteens square-footage growth in the core concept for at least five years. The acquisition of Del's Farm Supply, an 18-store rural lifestyle retailer in the Pacific Northwest, may serve as a second growth vehicle.
- Initiatives: Comps should be supported by continued merchandising innovation, particularly in the clothing and pet categories. In addition, TSCO is piloting a reset of major tool categories and has launched an e-commerce-enabled Web site during the fourth quarter of 2007.

Valuation

- TSCO's current 7.1% discount to the S&P Mid Cap index is 23.5 percentage points below its historical average of a 16.3% premium. We view TSCO's current multiple of 14.0 times our 2008 EPS estimate as attractive. We expect shares to rise as a result of multiple expansion as sentiment eventually improves and with earnings growth, given TSCO's attractive long-term growth opportunity.

Key Risk

- Results are volatile quarter-to-quarter. Unseasonable weather can have an impact on quarter-to-quarter results. The riding mower business (roughly 10% sales) is affected by the housing market. Along the path to long-term EPS growth of 20%, we expect continued volatility.

Chattem, Inc.

Rationale

- Fundamentals appear solid: 1) base business continues to grow; 2) acquired brands proving responsive; and 3) margin expansion under way.
- Multiple sources of upside potential: 1) robust new product pipeline; 2) a full year's experience with the acquired brands; 3) further margin expansion from manufacturing refinement; 4) additional leverage of A&P and SG&A; and 5) accelerated debt retirement.
- Below-average economic sensitivity.

Valuation

- Chattem shares currently trade at 17.6 times our 2008 EPS estimate, a modest discount to the five-year average historical forward P/E multiple of 18.1 (adjusted for stock option expense).
- Chattem should increase earnings by more than 50% in 2007 and achieve compound annual EPS growth of 25% from 2007 to 2009.
- As such, we believe Chattem should continue to outperform on a relative basis during 2008.

Key Risk

- Competition from larger consumer and pharmaceutical companies
- Customer concentration (one-third of sales with Wal-Mart)
- Growth may be "lumpy" (uneven quarter-to-quarter)

Delek US Holdings, Inc.

Rationale

- The \$60 million refining "productivity enhancement" projects are on track to be completed by fourth quarter 2008. These investments will allow the company to replace roughly 20% of its sweet crude feedstock with lower-priced sour crude, which could yield a 50% cash-on-cash return based on the historical price spread between the two feedstocks. We estimate these projects could add \$0.25 to EPS starting in 2009.

- We estimate Delek's retail profits should grow faster than peers, driven by increased penetration of prepared food and private label. The more than 100-basis-point improvement in merchandise margins in 2007 year-to-date has exceeded management's goal for 50 to 100 basis points of year-to-year improvement, and Delek has room to further improve from its 32% in-store margin versus industry peers The Pantry (37%) and Casey's (33%).
- Solid balance sheet (net debt-to-capital at 25%) and free cash flow (estimate \$80 million in 2008, \$100 million in 2009) put the company in a strong position to acquire refining and/or energy retail assets.

Valuation

- The shares currently trade at a 15% discount to the company's convenience-store and refinery peers on a blended estimated 2008 EBITDA basis (70% refinery/30% convenience store). In our view, such a discount is unwarranted given Delek's continued solid operating performance relative to its peers.

Key Risk

- An economic slowdown combined with higher input costs (\$100+ oil) could pressure refining gross margins (i.e., the crack spread) below our current forecast of \$11.50 in 2008.
- High gas prices could negatively affect driving patterns/retail gasoline demand.

Zumiez Inc.

Rationale

- Despite a healthy 13% comp in the third quarter, Zumiez's stock declined more than 25%, following a modest downward revision to earnings guidance of approximately 5%. Unlike most retailers, Zumiez's change in earnings guidance did not stem from uncertainty surrounding sales trends, but rather was primarily related to forecasting issues from a change in CFO. Indeed, management remains confident in a strong holiday season, expecting high-single-digit comps in the fourth quarter, against a 12% year-ago comparison.
- In addition, we see good potential for Zumiez's monthly comps to accelerate from October's 5.1% on colder weather (unusually warm weather dampened October's comp by roughly five percentage points) and easier comparisons (12% to 13% versus recent comparisons of 15% to 16%).
- Longer term, we continue to expect annual store expansion of 20% and midsingle-digit comps will yield EPS growth of roughly 25% per year.

Valuation

- With the stock now trading at 24 times our calendar 2008 EPS estimate (which we expect will be upwardly revised), Zumiez's shares are trading at a rare discount to its 25% long-term growth rate, representing a compelling investment opportunity, in our opinion. In addition, Zumiez's stock multiple tends to track with comp trends, and we see the potential for multiple expansion as sales firm.

Key Risk

- Zumiez continues to face difficult double-digit comparisons in 2008, and any deceleration in comp trends against these comparisons could negatively affect the stock's multiple. While we believe the company continues to execute well, Zumiez could prove vulnerable to slowing mall traffic trends and/or execution misses in its fashion assortment.

Best Long-Term Ideas

Table 4
William Blair & Company Consumer/Retail Group
Top Long-Term Stock Recommendations

(Rank ordered by market cap in millions)

Company	Ticker	Rating	Analyst	11/23/07 Mkt Cap	11/23/07 Price	Date Added	% Chng Since Added	% Chng Since 1/13/03*	C2008 EPS	C2008 P/E	LT Growth
Target	TGT	O/E	MM	\$48,309	\$57.17	Dec-04	10%	---	\$3.80	15.0	14%
Walgreen	WAG	O/E	MM	\$39,386	\$39.73	Jan-03	22%	22%	\$2.36	16.8	15%
Wal-Mart de Mexico	WMMVY	M/C	MM	\$29,783	\$35.10	Dec-06	(9%)	---	\$1.84	19.1	18%
Carnival	CCL	M/E	RS	\$26,663	\$42.73	Jan-03	72%	72%	\$3.30	12.9	15%
Starbucks	SBUX	O/E	SZ	\$17,032	\$23.07	Sep-03	60%	---	\$1.08	21.4	20%
Bed Bath & Beyond	BBBY	O/E	JM	\$8,109	\$30.62	Jan-03	(17%)	(17%)	\$2.42	12.7	15%
Whole Foods Market	WFMI	O/C	MM	\$5,664	\$40.75	Dec-04	(9%)	---	\$1.42	28.7	19%
CarMax	KMX	O/C	SZ	\$4,501	\$20.65	Jan-03	138%	138%	\$1.15	18.0	20%
Dick's Sporting Goods	DKS	O/C	RS	\$3,681	\$32.01	Dec-04	82%	---	\$1.55	20.7	20%
Life Time Fitness	LTM	O/A	SZ	\$1,959	\$50.10	Dec-06	(0%)	---	\$2.22	22.6	25%
Tractor Supply Co.	TSCO	O/C	JM	\$1,530	\$39.70	Dec-05	(28%)	---	\$2.84	14.0	20%
Blue Nile	NILE	M/A	JM	\$1,216	\$75.74	Dec-06	125%	---	\$1.26	60.1	24%
Average (equal weight*)								85%		23.4	19%
S&P 500 Retail Index**					837.0			15%			
S&P Retail Index				RLX	416.5			53%			
S&P Food/Staples Index				GSPFD	198.0			(1%)			
S&P 500					1,440.7			56%	\$101.00	14.3	8%
NASDAQ					2,596.6			80%			
Russell 2000					755.0			91%			

* List initiated on January 13, 2003. The performance of the long-term recommendations list is weighted according to time held on our list. Starbucks was added as a 10% holding on 9/5/03, replacing Expedia, which rose 98% until it was acquired on 8/8/03. Target, Whole Foods, and Dick's were added as holdings on 12/9/04, replacing Lowe's, Kohl's and 99 Cents Only, all of which were added when the list was initiated on 1/13/03 and had stock performances of 54%, -18%, and -48% respectively. Tractor Supply was added on 12/3/05, replacing Ebay, which rose 144% until it was removed. Wal-Mart de Mexico, Life Time Fitness, and Blue Nile were added on 12/4/06, replacing Wal-Mart, which registered -11% stock performance while on the list.

** Weighted average of S&P Retailing and S&P Food & Staples indices

Note: S&P 500 EPS estimate is bottom-up.

Source: Reuters, William Blair & Company, L.L.C. estimates

Target Corporation

Rationale

- Target remains one of the best-managed companies in retail, in our view. We believe the company still has a substantial long-term opportunity to further enhance the merchandise mix (i.e., upgrade the assortment of good/better/best) across major categories such as home, apparel, and electronics, as a result of its long-standing investments in product development, sharp advertising that communicates Target's "Expect More. Pay Less" philosophy, and the stores' customer service.
- Target management has identified a number of areas (including receiving, replenishment, and cashiering, among others) to manage expenses even more conservatively in the event of a further slowdown in consumer spending and store traffic.
- We estimate that the recently authorized \$10 billion share repurchase plan should contribute more than \$0.15 to EPS in 2008 (and a greater amount beyond that), assuming the company completes roughly half of the authorization by the end of 2008.

Key Risks

- While management has planned conservatively thus far, in our estimation, continued softening of sales trends within the higher-margin home and apparel categories could create an increasingly adverse sales mix and necessitate accelerated markdown activity.
- Target's credit card business could experience worse-than-expected delinquency and write-off trends, requiring additional increases in the bad debt provision (although we believe management has reserved conservatively to date).

Valuation

- The stock is currently trading at a P/E-multiple discount of roughly 10% relative to the S&P 500, below its five-year historical premium of 10%.

Walgreen Co.

Rationale

- The wave of drug patent expirations (estimated \$80 billion over the next five years) should continue to lift profit growth, as we estimate gross profit dollars are 50% higher on a generic prescription than a branded script. While the generic uplift in 2008 could moderate versus that experienced during 2007, we estimate that the step-up in generics could drive reacceleration in profit growth in 2009.
- We believe Walgreens' 2007 fiscal fourth quarter (August) earnings miss could be the catalyst for improved expense control going forward, as the company was slow to respond to weaker-than-expected pharmacy volume growth and above-trend growth in operating expenses. In order to reduce expenses, management has reduced pharmacy technician labor and TV/print advertising, eliminated outside consultants, and reduced corporate and other spending.
- Some investors have pushed the company to slow its unit growth—we estimate EPS would benefit by \$0.04 per share annually for every 1% that the company slowed the rate of new store expansion. However, given that management expects new stores to achieve a midteens after-tax return on invested capital over time, we do not expect a significant reduction in unit growth. Rather than experiencing significant cannibalization, which has caused other retailers to slow unit expansion, we believe Walgreens derives important scale benefits with its rapid store growth and higher market share.

Key Risks

- The merger between CVS and Caremark (CVS \$41.94) could create a more formidable competitor, forcing Walgreens to reassess its primarily “organic” growth strategy.
- Third-party payors (including federal and state governments) could demand a larger share of the profit coming from increased utilization of generics.

Valuation

- Walgreens is trading well below its historical average relative P/E premium of 50% versus the S&P 500 (on forward EPS estimates). While the company needs to reestablish credibility after its fiscal fourth-quarter earnings shortfall, investors may be attracted to the relative predictability of the business in a weakening economic environment.

Wal-Mart de México, S.A. de C.V.

Rationale

- We believe “Walmex” should be able to sustain double-digit square footage growth, midsingle-digit real same-store sales growth, and superior return on capital with expanded perishable offerings, improved quality of apparel, favorable demographic trends, and growth of consumer credit over the long term.
- Relative to its peers, the company's substantial comparative strengths include its well-trained personnel, technology and distribution advantages, relationships with local vendors, and reputation for having the lowest selling prices in Mexico.
- Entrance into the domestic banking sector creates a long-term, open-ended opportunity to drive growth and further elevate the company's return on invested capital. While we do not anticipate a profit contribution from the bank until 2010, the incremental foot traffic into the stores should immediately benefit retail comp-store sales.

Key Risks

- Macroeconomic risks (inflation, currency, taxation, etc.) are associated with investing in any developing country. Government tax receipts are meaningfully dependent on oil-related revenues. Remittances from the United States are affected by the housing cycle.
- While any disruption in Soriana's acquisition of most of Gigante's stores could create a short-term market share opportunity for Walmex, we expect Soriana to be a much better operator of Gigante's assets in the long run.
- Risks related to success include the potential for complacency and increased scrutiny by special interest groups.

Valuation

- The stock is currently trading at a 30% relative P/E premium versus the S&P 500, just below its five-year historical premium of 40%.

Carnival Corporation

Rationale

- Strong capacity growth and 3% to 5% price increases are projected to produce low-double-digit growth for the cruise industry; this industry growth, along with margin expansion and balance sheet deleveraging, should produce midteens earnings growth for the company.
- Carnival has the strongest balance sheet, will internally fund future needs, and has the industry's highest margins.
- Secular demand growth in the cruise industry will be at a high rate that can exceed consensus expectations for an extended period of time. This would result in faster yield expansion and earnings growth than is generally anticipated.

Key Risks

- In a highly discretionary industry such as cruises, rising energy prices, interest rates, and a credit slowdown may prove to be a deterrent to sustaining growth. If these concerns convert into a slower-growing economy, then the favorable secular outlook will remain dampened by the continuing cyclical interruption.

Valuation

- Based on our 2007 estimate of \$2.94, Carnival is selling at 14.5 times trailing earnings, compared with a historical trading range of 14.0 to 23.3 times. This suggests that the stock is fairly valued and we will maintain our Market Perform rating, at least until our nonconsensus concern regarding 2008 net yields is proven incorrect.

Starbucks Corporation

See description in the "2008 Best One-Year Ideas" section.

Bed Bath & Beyond Inc.

See description in the "2008 Best One-Year Ideas" section.

Whole Foods Market, Inc.

See description in the "2008 Best One-Year Ideas" section.

CarMax, Inc.

Rationale

- We view CarMax's competitively differentiated consumer proposition as unrivaled, featuring no-haggle pricing, a no-pressure salesforce, quality guarantees, and an unparalleled selection. In addition, we believe significant barriers to entry will allow CarMax to maintain its market leadership in the used car arena, including a substantial investment of capital, time, and expertise in proprietary information systems; ever-growing market intelligence on more than 2.5 million used-car purchase and sale transactions; strong and growing brand equity; first-mover advantage; and auto manufacturers' limits on the consolidation of new-car dealer franchises.
- From a market share of approximately 2%, CarMax's growth prospects are virtually open-ended within the huge and fragmented million used car industry, and we remain optimistic that CarMax can increase its domestic presence more than threefold to 300 to 400 locations, translating into revenue potential of \$25 billion to \$30 billion and another decade of expansion potential at the current 15% to 20% new store growth pace.
- We remain enthusiastic about CarMax's ability to generate 20% annual EPS growth, reflecting strong store expansion, used unit comps of 4% to 8%, and modest SG&A leverage on fixed costs.

Key Risks

- Uncertainties surrounding overall consumer spending and credit availability have the potential to translate into a more difficult sales and earnings environment for CarMax in calendar 2008, particularly if these trends deteriorate going into next year's high selling season (spring and summer). Given CarMax's dependency on one category of product (used cars), the company has little buffer should broader used car traffic trends worsen. While we would expect CarMax to continue to gain share regardless of the health of the overall market, this scenario could put earnings estimates at risk and create additional pressure on the stock.

Valuation

- The stock is currently trading at 19 times our calendar 2008 estimate, below its three-year average multiple of 23 times due to investor concerns on consumer spending and CarMax's finance operation. We believe the current valuation is reasonable given CarMax's growth trajectory, with the potential for multiple expansion when sales firm.

Dick's Sporting Goods, Inc.

Rationale

- Dick's has a strong inventory management system that allows it to outdistance top-line growth relative to its industry, while expanding gross margins and managing expenses.
- The recent acquisition of Chick's Sporting Goods gives Dick's entry into the important California marketplace, with 15 stores that average about 50,000 square feet. With Chick's sales of \$120 million in the year ending June 2007, we expect this to be a positive acquisition that will be marginally accretive to 2008 results.
- The sporting goods industry grows slowly, but remains highly fragmented, which we believe is the key for an individual retailer to sustain above-average growth over an extended period of time.

Key Risks

- In the sporting goods industry, difficult weather and a softening retail environment may jeopardize earnings. Rising interest rates and gasoline prices may continue to pressure an already squeezed consumer, which in turn may hurt discretionary spending.

Valuation

- Currently Dick's Sporting Goods sells at 24 times and 21 times our 2007 and 2008 estimates. These are significant premiums to the S&P 500 multiple. The multiple on our 2008 estimate is slightly above our expectation for Dick's long-term earnings growth of 20%. Companies are accorded and sustain premium valuations for a number of reasons, including consistency of growth, predictability of growth (absence of economic sensitivity), high margins and returns and an ability to finance growth internally. With the exception of an absence of economic sensitivity, Dick's Sporting Goods shares all of these characteristics and deserves a premium valuation.

Life Time Fitness, Inc.

See description in the "2008 Best One-Year Ideas" section.

Tractor Supply Company

See description in the "2008 Best One-Year Ideas" section.

Blue Nile, Inc.

Rationale

- High return model: Blue Nile is highly capital-efficient due to a proprietary supply chain structure and large cost advantage over traditional competitors. We estimate free cash flow will be more than two times earnings in 2008.
- Consolidating industry: In the highly fragmented U.S. retail jewelry industry, the top 25 held only a 33% share in 2006. Blue Nile's disruptive business model should fuel continued share gains in the diamond engagement market as well as the overall jewelry market. We estimate the company's share of the diamond engagement market will grow to 3.2% in 2007, up from 2.7% in 2006.
- Substantial growth opportunity: We estimate 18% long-term sales growth driven primarily by the core diamond engagement business. Assuming scale-driven margin gains, operating profit growth should be 21%-23%. With share repurchases, our long-term EPS growth estimate is 23%-25%.

Key Risks

- The jewelry industry historically has experienced cyclical patterns similar to other discretionary consumer purchases. Blue Nile's sales growth is difficult to regulate because changes in diamond pricing affect consumer demand. Also, the company faces well-capitalized traditional retail competitors ranging from Tiffany (TIF \$47.99) to Wal-Mart.

Valuation

- Valuing Blue Nile is difficult because of the company's early stage of growth and its unique business model, which results in a lack of good comparables. Blue Nile's current 2008 price-to-earnings multiple is 377% of the S&P Mid Cap index, 110 percentage points above its historical average of 267%. Blue Nile's 2008 free-cash-flow yield on enterprise value is 3.9%. Based on several analyses, valuation is only reasonable. However, we do not believe that valuation will prevent outperformance over a three- to five-year period.

Financial

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- William Blair & Company's Financial Services Group issued its outlook and top investment ideas for 2008 after the markets closed on December 6: American International Group, CME Group, IntercontinentalExchange, Affiliated Managers Group, National Financial Partners, Assured Guaranty, Argo Group, and Signature Bank (in order of market capitalization). We also updated our long-term list (3-5 years), replacing Investors Financial (acquired by State Street) with Northern Trust, and SLM Corp. with T. Rowe Price.
- Depending on how you cut the numbers, 2007 (through December 4) has been the worst year of performance for financial services stocks since 1987 and Black Monday, when the Dow dropped 23% in one day. This performance has been driven by a complete meltdown in the subprime RMBS market, stoking fears in credit markets more broadly and concerns about the potential spillover impact on the overall economy.
- While our 2007 lists were positioned to be more defensive than our 2006 lists, both were weighed down by credit-sensitive stocks. Our one-year and long-term lists continued to outperform their relevant financial services benchmark, although they failed to outperform broader market indices for the first time, given significant underperformance in financial services stocks as a group and too much exposure to credit markets.
- Our investment approach continues to be bottom-up—we are not making macroeconomic forecasts—although we are cognizant of the challenges. The outlook for financials heading into 2008 is as ambiguous as it has been at any time over the past four years, in our opinion. We expect continued volatility in the near term as the financial markets adjust to Fed easing and seek signs of stabilization in the residential mortgage market.
- We continue to embrace some balance on our one-year list by selecting names from different segments, including defensive, defensive growth, and some credit-sensitive names. We therefore expect some variability in share price performance within the list, given that the drivers of these segments can be very different.

2008 Best One-Year Ideas

Table 5
Financial Services Group
Best Stock Picks for 2008

Company	Ticker	12/5/07 Market Cap	Rating/ Profile	12/5/07 Price	2007E EPS	2008E EPS	2008 P/E	Div. Yield
American International Group	AIG	\$141,908	O/C	\$58.15	\$6.23	\$6.60	8.8x	1.4%
Chicago Mercantile Exchange	CME	\$35,133	O/C	\$697.25	\$14.50	\$17.85	39.1x	0.5%
IntercontinentalExchange	ICE	\$11,294	O/A	\$171.50	\$3.56	\$4.70	36.5x	0.0%
Affiliated Managers Group	AMG	\$3,674	O/C	\$126.50	\$6.85	\$8.10	15.6x	0.0%
National Financial Partners	NFP	\$1,794	O/C	\$46.68	\$3.00	\$3.55	13.1x	1.5%
Assured Guaranty	AGO	\$1,482	O/C	\$21.89	\$2.63	\$2.60	8.4x	0.7%
Argo Group	AGII	\$1,182	O/A	\$38.57	NA	\$4.00	9.6x	0.0%
Signature Bank	SBNY	\$1,080	O/A	\$35.64	\$1.38	\$1.69	21.1x	0.0%
Average (unweighted)							19.0x	0.5%
S&P 500 Financials Index				\$411.59				
S&P 500 Index				\$1,485.01	\$91.57	\$100.00	14.9x	1.8%

Source: FactSet, William Blair & Company, L.L.C. estimates.

American International Group, Inc.

Rationale

- Best play within insurance on the continued growth of Asia (about one-third of earnings)—including the continued deregulation of Japan and the growth of major emerging markets, including China, India, and Vietnam
- We expect more aggressive capital management over time and we expect the company to continue to face pressure to unlock the underlying value among its disparate businesses
- Serves as a more defensive large-cap financial services name relative to banks given lower earnings sensitivity to changes in equity/capital markets; fundamental outlook by major segment is mixed
- We believe exposure to mortgage market is manageable, but will be a modest negative drag to earnings and create some book value volatility in the near term

Risks

- More conservative stance on capital management
- Pricing pressure within property-casualty insurance
- Continued drag from more economically sensitive businesses, including consumer finance and mortgage insurance, and a lower contribution from partnership investments

Valuation

- Shares trade at less than 10 times our 2008 EPS estimate and only 1.6 times book value per share excluding other comprehensive income
- AIG's stock has not been this inexpensive since the early 1990s on an absolute and relative basis
- On a sum-of-the-parts basis, we see a stock price easily in excess of \$70, using peer group multiples

CME Group Inc.

Rationale

- Core name within the exchange space, with the largest and most diversified futures exchanges: interest rates (64%), equities (25%), foreign exchange (5%), and commodity and alternative investments (6%); about 80% of volume is traded electronically
- Favorable financial characteristics within volatile markets—a beneficiary of higher financial market volatility, minimal credit risk, and exchange-listed derivatives, the company is even more attractive given transparency and elimination of counterparty credit risk through CME's clearinghouse
- Increasing confidence that the company will capture revenue synergies once it moves the CBOT's U.S. Treasury complex onto the CME's Globex electronic trading platform (late January)
- Expect the company to continue to be a consolidator—energy and credit are major product gaps—and seek partnerships/joint ventures overseas
- Opportunity to expand into large OTC derivatives markets over the long term (e.g., credit derivatives, foreign exchange, and interest rate swaps)

Risks

- Sudden drop in volatility coupled with high valuation
- Legislative changes

Valuation

- The stock is currently trading at 39 times our 2008 EPS estimate, but our estimate will be too low if volatility continues, and we view the stock as a hedge on continued higher financial market volatility

IntercontinentalExchange, Inc.

Rationale

- Among the fastest growing global exchanges—42% OTC electronic energy trading, 37% electronic energy futures, and 21% soft commodities—and one of the more dynamic growth companies within financial services
- We see the development of electronic energy derivatives trading still developing, particularly within the OTC markets
- Favorable financial characteristics within volatile markets—a beneficiary of continued energy price volatility, minimal credit risk, and exchange listed and cleared OTC derivatives, the company is even more attractive given transparency and elimination of counterparty credit risk through centralized clearing
- Move to self-clearing in mid-2008 highly accretive and strategically important
- Expect the company to continue to be a consolidator within and outside energy markets
- Attractive takeover candidate itself for exchanges looking to enhance growth or diversify—CME Group, Deutsche Boerse, and NYSE Euronext are the major global consolidators
- No benefit in our estimates from the launch of the Russell index futures

Risks

- Sudden drop in volatility coupled with high valuation.
- Move to self-clearing carries execution risk
- Legislative changes

Valuation

- Rich at 36 times our 2008 EPS estimate, but its financial characteristics are attractive in volatile markets and a potential takeover provides some valuation support

Affiliated Managers Group, Inc.

Rationale

- Operating model has been well tested through various market cycles and has delivered compounded cash EPS growth of greater than 20% over the past 10 years, driven by solid organic growth, accretive investments, market gains, and return-focused capital management
- Major affiliates represent some of the top specialty asset managers in the industry; AMG's equity asset base is one of the most diversified of the public managers, and domestic equities are well balanced by style—including 30% in U.S. growth and 15% in value
- Alternatives and international (the two highest margin and fastest growing areas in the industry) generate greater than 15% and 35% of revenue, respectively
- Performance fees provide meaningful upside potential to earnings (performance-fee-generating AUM is growing—now over \$40 billion—and we believe AMG's stake in performance fees generated by affiliates is 25% to 30%)
- Additional acquisitions (including possibly larger transactions) offer long-term growth opportunities not available to most asset managers, and the current investment pipeline is very strong and balanced between traditional firms and alternative managers; AMG maintains nearly \$1 billion in investment capacity and deals are not included in estimates

Risks

- Weak equity markets
- Potentially volatile quarterly net flows given institutional focus
- Increasing contribution from less predictable performance fees—estimated to be 14% of total cash earnings in 2008 after relatively disappointing years for performance fees in 2006 and 2007

Valuation

- The shares trade at about a 10% discount to the company's asset management peer group based on our 2008 cash EPS estimate for AMG and GAAP estimates for the peer group, versus a three-year average discount of about 20%
- We estimate the shares trade at a 15% premium compared with the peer group based on enterprise-value-to-EBITDA using the run-rate for the most recent quarter (including adjustments for noncash taxes) and a 20% premium on an "if-converted" basis incorporating the full dilution from the impact of contingent convertibles

National Financial Partners Corp.

Rationale

- Pure-play independent distributor of high-end financial services: life insurance and wealth transfer (about 55% of revenue), corporate and executive benefits (about 35% of revenue), and financial planning and investment advisory (about 10% of revenue)
- One of largest distributors of life insurance in the U.S. national distribution network comprising 180 wholly owned firms, more than 320-plus affiliated firms, and more than 2,200 producers
- Unique and value-added acquisition model delivers significant value to acquired firms
- Attractive growth opportunities: demographics support growth of target market (8%-10% long-term organic growth), distribution channel is highly fragmented (6,000 to 7,000 producer firms), and 15% cash EPS growth is reasonable long-term target
- Near-term organic growth should continue to improve given improvements in the life insurance sales environment and easier growth comparisons

- Compelling financial characteristics with minimal capital requirements within underlying business, no direct interest rate or equity market exposure, and no credit exposure; recent acquisitions have been heavily focused on benefits-oriented firms, which should drive higher recurring revenue

Risks

- Quarterly organic revenue growth and margin volatility

Valuation

- Particularly attractive, down more than 20% from its recent high and now at a 15% discount to the S&P 500 based off of 2008 EPS estimates

Assured Guaranty Ltd.

Rationale

- Bermuda-based financial guarantor—largest reinsurer and sixth-largest insurer by year end; ACE Limited owns approximately 28% interest
- Insured portfolio as of September 30, 2007: 6% domestic public finance, 65% domestic structured finance, and 29% international; financial guaranty insurance constitutes about 70% of our 2008 underwriting income estimate
- Only quantifiable subprime RMBS exposure among its publicly traded financial guaranty peers given no exposure to multisector CDOs from recent years, in our opinion
- Market opportunity and returns should expand over the next 12 months given the company's recent upgrade to triple-A by Moody's, particularly in the lower-risk U.S. public finance market; the company's new business pipeline at the end of third quarter 2007 was about triple the size of its pipeline 12 months earlier and the company has taken share from other companies recently suffering from mortgage woes
- Margins should improve over time given the benefits from increasing scale—expense ratio within financial guaranty was 59% in 2006, more than double the market leaders; however, more normalized loss ratios will put pressure on underwriting margins in 2008

Risks

- Recession
- Changes in rating agency's view of industry

Valuation

- Trading at an 8% discount to book value per share excluding other comprehensive income and the cumulative negative mark to market on the credit derivatives portfolio
- By far the highest among its peer group given lower mortgage exposure, but absolute valuation remains low and allows significant room for appreciation as concerns about the mortgage market dissipate

Argo Group International Holdings, Ltd.

Rationale

- Bermuda-based specialty commercial lines property-casualty insurer; 2008 estimated net written premiums: 55% excess and surplus lines (E&S), 35% specialty commercial, and 10% international specialty (roughly 20% property exposure)
- Emerging excess and surplus lines and specialty underwriting franchise
- PXRE merger represents major strategic development—more flexible Bermuda-based operating platform, larger balance sheet allows more risk retention, and acquisition of significant excess capital improves financial flexibility dramatically

- Return on equity should increase over time from better capital management and expense reductions
- Company should become increasingly attractive acquisition target over the next few years
- Very defensive name at current valuation if financial markets remain volatile

Risks

- Greater-than-expected price competition
- Management's unwillingness or inability to quantify the benefits from merger or its excess capital position

Valuation

- Shares trade at about a 15% discount to book value per share given return-on-equity dilution from the PXRE merger, uncertainty associated with the use of capital acquired in the merger, and uncertainty related to the hiring of a new chief financial officer

Signature Bank

Rationale

- We expect robust EPS growth to produce strong stock performance over the next 12 months; we believe better-than-peer EPS growth will be driven by Signature's ability to capture market share from its larger bank peers by attracting veteran bankers, and by improving its earning asset mix
- The company is building on its reputation as the bank of choice among seasoned relationship bankers, as the bank has added 14 group directors in 2007, an increase of 24% on the year; experienced bankers are increasingly attracted to Signature as a result of its entrepreneurial culture, lean organization structure, and attractive incentive-based compensation model
- Signature has an opportunity to expand its net interest margin as loans become a larger percentage of earning assets—loans represent only 36% of average interest-earning assets, up from 30% one year ago—as loans carry a higher yield than the investment securities they are replacing
- On the other hand, the lower percentage of loans as interest-earning assets means the company has less exposure to deteriorating credit quality than its bank peers, and its loan portfolio has not fully matured

Risks

- Signature has excellent credit quality and lower net charge-offs than most of its peers, but it is not immune to credit risk; a downturn in the New York economy that negatively affects those businesses located in the area could increase credit losses for the company
- Unpredicted and/or significant changes in interest rates can cause the company's net interest margin to contract, reducing net interest income

Valuation

- We believe Signature Bank's shares deserve to trade at a premium to its peers as a result of its superior growth prospects, and we expect the company to increase its EPS at a compound annual rate of 20% over the next five years, versus its peer group average of 12%; its shares trade at 21 times our 2008 EPS compared with 13 times on average for its closest peers

Best Long-Term Ideas

Table 6
Financial Services Group
Best Stock Picks for the Next Three to Five Years

Company	Ticker	12/5/07 Market Cap	Rating/ Profile	12/5/07 Price	2007E EPS	2008E EPS	2008E P/E	Div. Yield
American International Group	AIG	\$141,908	O/C	\$58.15	\$6.23	\$6.60	8.8x	1.4%
Goldman Sachs	GS	\$90,451	O/C	\$218.26	\$24.14	\$22.40	9.7x	0.6%
CME Group	CME	\$34,740	O/C	\$697.25	\$14.50	\$17.85	39.1x	0.5%
Northern Trust	NTRS	\$17,690	O/C	\$79.56	\$3.62	\$4.02	19.8x	1.2%
T. Rowe Price	TROW	\$15,843	O/C	\$62.41	\$2.37	\$2.85	21.9x	1.1%
Affiliated Managers Group	AMG	\$3,674	O/C	\$126.50	\$6.85	\$8.10	15.6x	0.0%
Ambac Financial	ABK	\$2,388	O/C	\$23.52	NA	NA	NA	3.6%
PrivateBancorp ¹	PVTB	\$850	O/C	\$30.94	\$1.13	\$1.07	28.9x	0.6%
Average (unweighted)							18.0x	1.1%
S&P 500 Financials Index				\$411.59				
S&P 500 Index				\$1,485.01	\$91.57	\$100.05	14.8x	1.8%

¹Estimates reflect First Call consensus.

Source: FactSet, William Blair & Company, L.L.C. estimates.

American International Group, Inc.

See description in the “2008 Best One-Year Ideas” section.

The Goldman Sachs Group, Inc.

Rationale

- Among highest-performance plays within large-cap financials. The quality of its franchise cannot be replicated in the near term and the company should be a prime beneficiary from the continued development of global capital markets over the long term
- Strong market share in high-margin equity underwriting, M&A, and prime brokerage: equity underwriting and M&A activity feed other business lines
- Trading activities are diverse and benefit from global franchise with high barriers to entry: an increasing percentage of trading revenue from higher-margin derivatives and structured products—a leader in commodities, credit derivatives, and FX
- Company has a history of outperforming its peers during good and bad market environments, and recent risk management practices have outshined other major competitors
- Emerging asset management business (\$796 billion of AUM as of 8/07) with heavy emphasis on alternative investments (19% of total AUM)

Risks

- U.S. recession
- Volatile business even during good environment
- Lack of transparency makes it difficult to identify all risks

Valuation

- Shares trade at about 2.6 times our book value per share estimate as of November 30, 2007, above its five-year average of 2.2 times
- We view valuation as relatively full in the near term

- We forecast in excess of a 20% ROE in fiscal 2008, compared with a five-year average of 20%. Goldman's trough ROE in 2002 was 11% and the trough price to book multiple was about 1.6 times in October 2002—the stock traded as high as 2.8 times in May 2007

CME Group Inc.

See description in the “2008 Best One-Year Ideas” section.

Northern Trust Corporation

Rationale

- The company is highly focused on attractive businesses (global custody, wealth management, and private banking)
- Growth in Northern's Corporate and Institutional Services (C&IS) business will continue to be driven by the privatization of retirement assets and globalization of investing; we believe Northern Trust has an opportunity to capitalize on potential disruption caused by M&A activity (Bank of New York/Mellon Financial merger and State Street acquisition of Investors Financial)
- Our outlook for Northern's Personal Financial Services (PFS) business, which includes wealth management, is supported by strong demographics—growth in the millionaire population (wealth creation) and wealth transfer (driving demand for fiduciary services); PFS business could benefit from disruption caused by M&A activity (U.S. Trust sale to Bank of America)

Risks

- Northern Trust's revenue is sensitive to changes in the equity markets
- Securities lending and foreign exchange revenue are dependent on customer volumes, which can be volatile on a quarter-to-quarter basis

Valuation

- The shares currently trade at 20 times our 2008 EPS estimate, a 35% premium to the S&P 500 versus a three-year average of a 15% premium
- Its shares have traded at 15-20 times forward EPS over the last five years; we believe positive momentum in both of its businesses should keep its multiple at the top end of its five-year range, and could push it over 20 times forward EPS
- We believe Northern's shares deserve to trade at a premium to its closest peers due to its higher profitability and diverse revenue stream

T. Rowe Price Group, Inc.

Rationale

- High integrity growth financial
- Consistent investment performance and strong balance (by equity style and distribution channel)
- Represents the best opportunity to ride the retirement wave; 401(k) channel produces consistent net flows and more durable AUM
- Long-term beneficiary of the Pension Protection Act (AUM in Price Retirement Funds of \$27.1 billion have nearly doubled in each of the last two years)
- Extension of platform in institutional, third-party, and international provides additional growth—with international likely the largest opportunity (TROW was not able to sell products abroad until 2000 due to joint venture)
- Potential to benefit from consolidation (with fixed income a possibility), history of opportunistically buying assets, not organizations

Risks

- Weak equity markets
- IRA rollovers
- Capacity constraints
- Lack of alternative products

Valuation

- The shares trade at about a 25% premium to the asset management peer group based on our 2008 EPS estimates; over the past three years, the shares have traded at a relative forward premium of 7%, and about an 11% premium over the past five years
- We estimate the shares trade at about a 20% premium to peer group on an enterprise-value-to-EBITDA basis (run-rate of the most recent quarter)

Affiliated Managers Group, Inc.

See description in the “2008 Best One-Year Ideas” section.

Ambac Financial Group, Inc.

Rationale

- Strong, long-term history of success and industry-leading profitability
- Expect no major structural changes in the financial guaranty industry as a result of industry’s exposure to subprime RMBS markets
- Expect customers/distributors within the municipal finance market to regain confidence in Ambac once near-term capital concerns are addressed
- New business environment has improved dramatically given wider credit spreads and increasing demand in certain segments
- Should get clarity regarding capital needs in the near term

Risks

- Recession
- Difficult to quantify loss potential to subprime RMBS exposure; capital requirements may be greater than expected
- Changes in rating agency’s view of industry

Valuation

- 55% discount to book value per share excluding other comprehensive income and the cumulative negative mark-to-market on its credit derivatives portfolio
- Heavy discount driven by difficulty in quantifying the loss potential associated with subprime RMBS exposure
- We see value even if capital requirements are in the \$3 billion to \$4 billion range

PrivateBancorp, Inc.

Rationale

- PrivateBank represents a unique opportunity to own shares of a rapidly growing financial institution that caters to small businesses and affluent individuals
- The company’s ability to transfer its business model to other metropolitan markets, gain market share within its current geographies, and leverage its banking relationships into its wealth management segment will result in better-than-peer EPS growth over the long term
- The addition of more than 30 managing directors from LaSalle Bank in the fourth quarter of 2007, including LaSalle’s former CEO, should accelerate the franchise’s growth over the next several years

Risks

- While PrivateBank has excellent credit quality, it is not immune to credit risk
- Its net interest margin can be negatively affected by changes in interest rates and the shape of the yield curve

Valuation

- Significant managing director additions in fourth quarter 2007 and expected additions in first quarter 2008 dilute near-term EPS and cloud 2008 and 2009 EPS visibility; shares trade at 17.5 times our estimated 2009 EPS estimate
- Its shares trade at 1.6 times book value and 2.0 times tangible book value, compared with 1.6 times and 2.2 times, respectively, for its closest peers

Health Care

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- The health care team is taking a focused approach to 2008 in light of sensitivity to the reimbursement environment due to the upcoming presidential election. We believe investors should focus on novel, differentiated therapies and technologies, self-pay markets, consumer-driven health care, and services that decrease overall health care spending.
- Our top stock recommendations for 2008 (in order of descending market capitalization) are Medtronic, Celgene, LabCorp, Henry Schein, VCA Antech, Psychiatric Solutions, Eclipsys, TomoTherapy, TriZetto, and Animal Health International.
- We have added several new names to our top long-term recommendations due to new coverage. Our complete long-term list (in order of descending market cap) includes Medco Health Solutions, IMS Health, IDEXX Labs, ResMed, Brookdale, Healthways, ICON, NuVasive, Cepheid, Allscripts, Exelixis, TriZetto, and NxStage Medical.

2008 Health Care Outlook

We believe the 2008 environment for health care investors will be defined by two factors: first, the looming presidential election and its implications for the reimbursement environment, and second, emerging methods to account for this issue. In our opinion, it appears that there is a strong likelihood for a Democratic president, which would expand access to health care for lower income individuals. However, a Democratic victory would also lead to a more sensitive reimbursement environment, as the new administration strives to reduce burgeoning health care spending.

Against such a backdrop, we see a number of alternatives for health care investors. Namely, we believe investors will benefit from focusing on break-through, cost-effective therapies and medical technologies; self-pay markets, such as veterinary and dental; consumer-driven health care; and services that reduce overall spending, such as PBMs, CROs, HCIT applications such as electronic medical records, disease management, and increased usage of diagnostics that aid disease prevention and facilitate targeted therapies.

2008 Best One-Year Ideas

Company	Ticker	Rating/ Profile	Analyst	11/30/2007 Market Cap	11/30/2007 Price	C2008 EPS	C2008 P/E	3-Year Earnings Growth
Medtronic	MDT	O/E	Andrew	\$57,670	\$50.85	\$2.83	18.0x	15%
Celgene	CELG	O/C	Sonnier	\$23,750	\$61.55	\$1.45	42.4x	45%
LabCorp	LH	O/E	Murphy/Kreger	\$8,372	\$72.67	\$4.67	15.6x	15%
Henry Schein	HSIC	O/C	Kreger	\$5,296	\$59.15	\$2.96	20.0x	15%
VCA Antech	WOOF	O/C	Daniels	\$3,457	\$41.03	\$1.57	26.1x	18%
Psychiatric Solutions	PSYS	O/C	Daniels	\$2,007	\$36.53	\$1.85	19.7x	25%
Eclipsys	ECLP	O/A	Tobin	\$1,245	\$23.20	\$1.04	31.0x	20%
TomoTherapy	TTPY	O/A	Andrew	\$922	\$18.60	\$0.44	41.6x	35%
TriZetto	TZIX	O/A	Tobin	\$704	\$15.43	\$0.68	17.0x	23%
Animal Health	AHII	O/A	Kreger	\$292	\$12.00	\$0.74	16.2x	15%
Average (unweighted)							22.6x	23%
S&P 500					1481.14			
NASDAQ					2660.96			
Russell 2000					767.77			

Source: William Blair & Company, L.L.C. estimates, Thomson One Analytics, and Reuters

Medtronic, Inc.**Rationale**

- Medtronic is highly diversified and a multinational leader in most med-tech markets in which it participates. Regardless, one product area (implantable defibrillators) has dominated investor psychology, but, in our view, is stabilizing following a period of significant uncertainty around the Fidelis lead recall and previous market slowdown. Medtronic's market share—as well as overall market implant rates—appear to be holding up better than feared.
- Several new product launches expected next year should drive solid top-line results and provide a catalyst for the stock. We expect product launches in vascular, spine, diabetes, and neuro—as well as the acquisition of Kyphon—to bolster revenue growth in the coming year.
- The company generates approximately \$200 million in cash each month. This cash generation allowed Medtronic to spend \$4 billion cash for Kyphon and positions it to continue repurchasing its shares in coming years and pursue additional strategic opportunities.

Risks

- Uncertainty around ICD market recovery. As discussed, we believe concerns here have been overblown, and the recent quarterly results, as well as Medtronic's comments that it hasn't seen any significant erosion of the market or implant share, suggest that this business, while not growing much in the United States, at least will not collapse from here.
- Political risk heading into the 2008 election year. Reimbursement risks in the company's spinal and vascular franchises will likely remain high, with cuts likely over the next few years. That being said, at least the company has done high-quality clinical work to support the cost-effectiveness of its products, and we see the risk as manageable.

Valuation

- The stock is trading at its lowest relative P/E multiple in more than 10 years.

Celgene Corporation

Rationale

- In our view, Celgene has the best growth profile in biotechnology, based on:
 - Top-line acceleration: Sales of Revlimid from extended use and expanded indications should drive 40% revenue CAGR from 2007 through 2010.
 - High-margin earnings: High-margin products funnel into high growth earnings, with projected 45% CAGR from 2007 through 2010.
 - Strategic business steps: The Pharmion acquisition provides best-in-class opportunity and product diversification that we believe will be accretive in 2009.
 - Attractive valuation: Discounted growth compared with large-cap peers.

Risks

- Earnings power and opportunity are driven predominantly by a single flagship drug that will affect earnings in the event of setbacks or delays in expanded use.
- Therapeutic space for cancer drug development is competitive.

Valuation

- The stock is trading at P/E of 42.4 times and PEG of 1.0 times 2008 estimates.
- PEG (17%) is discounted relative to peer group on 2008 earnings.

Laboratory Corporation of America Holdings

Rationale

- We believe strong fundamentals should drive an acceleration in the underlying utilization of routine laboratory testing over the next three to five years and could accelerate organic volume growth to levels seen in the early 2000s (up to 3% to 5% versus today's levels of 2% to 3%). Moreover, the increased usage of highly complex, resource-intensive specialty (or esoteric) tests, as personalized medicine continues to gain traction, should drive further revenue growth and margin expansion for the labs, in our view.
- In our opinion, LabCorp's focused strategy to drive top-line growth and margin expansion by continuing to grow its leading specialty testing capabilities and develop more value-added partnerships with managed care offers a less risky and proven avenue for earnings growth acceleration (to an expected longer-term run-rate of 15%).
- Based on our channel checks, we believe the managed care reimbursement environment has stabilized. In addition, in our view, there is a clear (and a relatively untapped) opportunity for labs to increase the value they add to health plans to generate a more favorable managed care reimbursement environment and gain share from other lab segments (e.g., hospital labs) in the longer term.
- The stock's valuation, at 15.6 times our 2008 EPS estimate (which is both a significant discount to its three-year average of 17.9 times and a 6% discount to Quest), is compelling given our growth outlook for the company.

Risks

- Inability to maintain (and grow) industry-leading EBITDA margins in light of the recent managed care price reset—including the impact of the UnitedHealthcare (UNH \$54.33) contract (effective January 1, 2008), the recent Cigna (CI \$53.53) price reset (effective July 1, 2008), and the loss of the Aetna (AET \$56.11) contract (also effective July 1, 2008).
- A lack of innovation and commercialization of tests in the pipeline and a failure to drive adoption of more complex testing, which could prevent LabCorp from executing its strategy to grow the esoteric portion of its business.

- Government reimbursement pressure, given the company derives roughly 20% of its revenues from Medicare and Medicaid. The labs may face some “headline risk” in 2008 if/when CMS launches the Medicare Competitive Bidding project (expected in the spring).
- Increased competition from hospital labs, considering the incentive for hospitals to continue to bring more profitable molecular lab tests in-house.

Valuation

- The stock is trading at 15.6 times our 2008 EPS estimate versus its three-year range of 15 to 20 times and its peer (DGX) trading at 16.5 times.

Henry Schein, Inc.

Rationale

- Henry Schein’s concentration in the North American and European dental, physician office, and vet markets gives the company exposure to attractive demand characteristics and steady margin leverage, while limiting risk from economic slowdowns or reimbursement cuts.
- The company has been executing quite well in recent quarters and continues to undergo a positive mix shift. For example, Schein is reducing exposure to low-margin pharmaceuticals, while increasing exposure to higher-margin categories, such as CAD/CAM and dental implants.
- Through the acquisitions of The Demedis Group, ProVet, and others, Schein has built a global infrastructure that gives investors access to foreign markets and margin leverage potential as those businesses continue to develop under Schein.
- Finally, we believe Henry Schein is the best broad-based and lowest-risk way to invest in the dental market given a solid position in both the dental consumable and dental equipment markets.

Risks

- Flu vaccine is a factor in earnings volatility each year due to the unpredictability of vaccine manufacturers’ delivery timing, as well as concerns about demand.
- Growth rates in the company’s dental equipment business have been robust for several quarters, and we believe difficult comparisons may lead to a modest slowdown.
- Though Schein’s dental equipment business is growing at a double-digit pace, a disappointing launch of the E4D CAD/CAM system in the coming months could dampen investor sentiment toward that important business.

Valuation

- The stock is trading at 20.0 times our 2008 EPS estimate versus its three-year range of 17 to 22 times and its peers trading in a range of 16 to 25 times.

VCA Antech, Inc.

Rationale

- VCA Antech operates in the low-risk veterinary health care market. Veterinary health care is a cash-based business with no third-party payors and very limited bad debt exposure. As a result, the company has low working capital requirements and generates strong cash flows. Moreover, the veterinary health care space has historically proved to be recession-resistant, with 40 straight years of growth (through the last five U.S. recessions). We view these as attractive investment characteristics given the uncertainties in the current macro environment.
- VCA Antech dominates the two primary animal health care markets in which it operates. We estimate the company’s freestanding animal hospital segment is approximately three to four times larger than its nearest competitor, while its veterinary diagnostic laboratory

business controls more than two-thirds of the domestic companion animal laboratory testing market. As such, we believe the company is well capitalized to maintain its leadership position in the attractive veterinary health care market.

- A highly fragmented market provides ample acquisition opportunities and is compelling with approximately 37,000 practicing veterinarians and more than 17,000 animal hospitals. Management made comments during its recent earnings conference call that the company is focused on acquisitions at the moment and therefore is keeping cash on hand to be competitive if any near-term opportunities present themselves. In addition, management's guidance is typically conservative, so any sizeable acquisition can lead to earnings upside, in our opinion.

Risks

- There is potential for volatility in the stock in the first half of 2008, in our opinion, as the company faces difficult same-facility revenue comps on the lab side of its business. More specific, same-store laboratory revenue growth was 17.4% and 15.9% in first quarter 2007 and second quarter 2007, respectively, versus a 15.2% quarterly average in 2006.

Valuation

- WOOF is currently trading at roughly 26 times forward EPS forecasts (at historical means)—notably, this represents a slight discount to its veterinary health care peers, such as IDEXX Laboratories, Abaxis (ABAX \$31.97), and MWI Veterinary Supply (MWIV \$40.05).

Psychiatric Solutions, Inc.

Rationale

- As the largest provider of inpatient behavioral health care services in the United States, Psychiatric Solutions is uniquely situated to sustain its leading position, in our opinion. More specific, we believe Psychiatric Solutions is: 1) the largest provider of inpatient services (in terms of total number of patient beds), 2) the employer-of-choice in the industry (attracting some of the most experienced senior and regional managers in the business), and 3) the acquirer-of-choice of freestanding facilities (based on its strong reputation of taking care of both patients and employees). Moreover, we believe the company is well positioned to sustain this position given the large entry barriers in the space (due to certificate of need requirements and the hesitation of local communities to allow psychiatric facilities into their communities).
- A significant supply/demand imbalance (between available beds and demand for behavioral health care services) is creating a strong operating environment for providers. As such, we remain comfortable with management's long-term goal of 7% to 9% same-facility revenue growth—the strongest projected organic growth rate we see in the health care facilities marketplace over the next several years.
- Lastly, we believe Psychiatric Solutions has good potential for earnings upside, primarily because our estimates do not include any acquisitions. Psychiatric Solutions embarked on a refocused strategy of acquiring and operating behavioral health facilities in early 2001. Since then, the company has generated consistent growth in revenue and operating income. We expect the company will continue this record over the coming years, driven by the previously discussed organic growth opportunities, margin expansion potential, and future acquisitions.

Risks

- Reimbursement exposure, as the company derives approximately one-third of its revenue from State Medicaid programs and approximately 13% of sales from Medicare.

- “Headline risk” of adverse events at company-owned facilities, which have arisen periodically over the past several years and typically place near-term pressure on the company’s shares.
- Fourth quarter 2007 presents difficult same-facility growth comparisons. More specific, fourth quarter 2006 registered at 9.6% same-facility comp, which could pressure fourth quarter 2007 same-facility comps toward the lower end of management’s long-term guidance of between 7% and 9%.

Valuation

- The stock is currently trading roughly 20 times forward EPS forecasts, below its historical average of approximately 24 times.

Eclipsys Corporation

Rationale

- Eclipsys’s recurring revenue model offers a high degree of revenue visibility.
- The company’s competitive momentum appears have improved, as a result of enhancements to the product line and salesforce in recent years, in our view.
- Exit of low-margin Networking Services business should continue to facilitate mix shift toward higher-margin, software-oriented revenue sources.
- We also believe other expense reduction initiatives, such as Eclipsys’s offshoring initiative, should help improve the company’s operating margin profile.

Risks

- The market for in-hospital clinical systems is competitive and increasingly penetrated.
- Margin-improvement initiatives may not materialize as rapidly as expected.

Valuation

- The shares trade at just over 2 times our 2008 revenue estimate; we believe this is a reasonable multiple given Eclipsys’s product momentum and the progress management is making in improving margins.

TomoTherapy Incorporated

Rationale

- Superior technology platform, which should drive greater than 30% top-line growth annually in the next several years. Varian’s (VAR \$49.58) use of only one rotation severely limits how completely and precisely the RapidArc can deliver the radiation dose. Elekta’s patent on multiple arcs creates this constraint. Varian’s marketing gurus have smartly painted this constraint as a speed advantage, while our conversations with multiple physicists indicate that using only a single arc will lead to suboptimal dose distribution. TomoTherapy has always sold its system as the one to deliver the optimal dose distribution, and we do not see that situation changing with the introduction of RapidArc; we expect sustained market share gains as a result.
- Manageable exposure to likely reimbursement pressure in 2008 and beyond. Given that most clinical sites are able to recoup the up-front cost of a linear accelerator (linac) within 12-18 months, this is a technology that should attract additional centers over the next several years. That being said, we expect Medicare and other payors to pressure reimbursement rates going forward, but believe that will occur gradually (this year’s CMS proposal is for a manageable 7% overall cut to reimbursement).
- Stable market growth in the low teens. This \$2.3 billion market should see solid growth over the next several years, given the profound opportunity to upgrade many of the existing 9,000 linacs worldwide, as well as to place additional units in the United States and, in particular, overseas (where these systems are vastly underused today).

Risks

- Change of market dynamics due to competitive launches. While Varian Medical and Elekta both recently announced new products for market release next spring, we expect TomoTherapy to highlight the technology advantages it retains, and expand its product's capabilities to be more of a workhorse linac over the course of 2008.

Valuation

- The stock is trading at a discount to its IPO (5/9/2007) price of \$19, and at a 20% discount to its primary competitor, Varian Medical, on a multiple-to-revenue basis. On an earnings basis, the stock is trading near 40 times forward earnings, but given the high level of investment in the field organization and infrastructure that should persist for another couple years—as well as the high revenue growth rate—we believe the stock is attractive at current levels.

The TriZetto Group, Inc.

Rationale

- TriZetto is very well positioned in the market for administrative payor systems.
- We believe the company's care management solution, which today has very little market penetration, should contribute to healthy revenue growth.
- The company recently announced it is exiting its low-margin/labor-intensive BPO business; this, combined with expense leverage, should continue to help drive EPS well in excess of revenue growth.
- Preliminary revenue and EPS guidance for 2008 from management has helped reset Street expectations at more realistic levels.

Risks

- We believe TriZetto continues to seek out acquisition opportunities; should a transaction be consummated, it could introduce valuation, business disruption, and other related risks.
- Adoption of the care management solution may not accelerate as fast as the company expects.

Valuation

- TriZetto's valuation is very compelling, in our opinion, at roughly 7 times our 2008 EBITDA estimate.

Animal Health International, Inc.

Rationale

- Animal Health International is the dominant player in the \$2.5 billion production animal vet market, which we believe is growing at 1%-3% per year. The company has particular strength in the beef and dairy markets, where it maintains market share of approximately 30%. In addition, roughly 20% of the company's revenue comes from an emerging companion animal business. While this remains in an investment mode at present, companion typically grows much faster than production and carries higher margins.
- In our view, the veterinary market is an attractive niche within health care given limited economic sensitivity and virtually no reimbursement exposure. Veterinary spending has increased every year over the last 40 years, through five recessions, and the industry has no exposure to health care reform and reimbursement cuts. Given these defensive characteristics, we believe veterinary investments such as Animal Health should experience growing investor appeal in the coming one to two years.

- Expectations for the stock have been reset downward in recent quarters in light of a reduction in rebates from one of the company's largest vendors. We believe the company's fundamentals beyond this specific rebate reduction are strong and should translate into improved earnings growth within a few quarters (when the anniversary of the rebate reduction is passed).

Risks

- While expectations have been tempered, uncertainty around rebates from one of the company's largest vendors may result in further earnings volatility.
- Adverse movements in commodity prices—such as a spike in corn, or a drop in beef or dairy products—could pressure Animal Health's production customers, leading to a short-term slowdown in revenues.

Valuation

- The stock is trading at 16.2 times our 2008 EPS estimate versus its range (since the company's IPO in January 2007) of 16 to 21 times and its peers' trading range of 16 to 25 times.

Best Long-Term Ideas

Company	Ticker	Rating/ Profile	Analyst	11/30/2007 Market Cap	11/30/2007 Price	Date Added	Since 11/27/2006	Since 12/2/2005	Since 12/2/2004	Since 12/31/2003	C2008 P/E	3-Year Earnings Growth
Medco	MHS	O/C	Kreger	\$26,743	\$99.99	12/3/2007	--	--	--	--	23.0x	15%
IMS Health	RX	M/C	Kreger	\$4,530	\$23.35	12/31/2003	--	--	2%	-6%	13.7x	12%
IDEXX Labs	IDXX	O/E	Daniels	\$3,704	\$60.50	11/27/2006	43%	--	--	--	32.9x	18%
ResMed	RMD	O/A	Andrew	\$3,540	\$45.80	12/31/2003	-7%	12%	81%	121%	27.9x	20%
Brookdale	BKD	O/A	Daniels	\$3,363	\$33.10	12/3/2007	--	--	--	--	NA	NA
Healthways	HWAY	O/A	Daniels	\$2,080	\$58.37	12/31/2003	30%	27%	80%	145%	27.9x	25%
ICON	ICLR	O/A	Kreger	\$1,707	\$59.31	12/31/2003	71%	--	214%	172%	26.5x	20%
NuVasive	NUVA	O/A	Andrew	\$1,495	\$42.57	12/2/2004	96%	141%	331%	--	NA	25%
Cepheid	CPHD	O/A	Weinstein/Andrew	\$1,200	\$21.63	12/3/2007	--	--	--	--	NA	NA
Allscripts	MDRX	O/A	Tobin	\$1,005	\$17.69	12/3/2007	--	--	--	--	26.0x	25%
Exelixis	EXEL	O/A	Sonnier	\$912	\$8.73	12/3/2007	--	--	--	--	NA	NA
TriZetto	TZIX	O/A	Tobin	\$704	\$15.43	12/3/2007	--	--	--	--	17.0x	23%
NxStage	NXTM	O/A	Andrew	\$471	\$12.86	11/27/2006	44%	--	--	--	NA	NA
Average (unweighted)											25.3x	20%
S&P 500				1481.14						33.2%		
NASDAQ				2660.96						32.8%		
Russell 2000				767.77						37.9%		

Source: William Blair & Company, L.L.C. estimates, Thomson One Analytics, and Reuters

Medco Health Solutions, Inc.

Rationale

- We expect drug utilization will reaccelerate in the next three to five years (potentially reaching utilization levels of 8% to 9%, up from current levels of 4%), driven by an aging population, the increasing prevalence of treated disease, and, most important, a reacceleration of branded drug consumption as the recovering pharma pipeline comes to fruition.
- Medco's holistic disease management approach to trend management via the TRCs and use of technology to influence patient behavior may prove a differentiator among the Big Three PBMs. In our opinion, we view this approach as a viable alternative to

CVS Caremark's (CVS \$39.06) vertical integration strategy, and based on our channel checks, it is being well received by clients looking for new and more effective ways to manage prescription drug and overall health care cost trends.

- Given Medco's focus on driving market share gains, we believe Medco's growth may be more balanced between units and margin expansion than the industry overall and thus may represent a less risky way for investors to gain exposure to the space.
- If CVS Caremark is unsuccessful in continuing to manage prescription drug trends and/or the potential disruption from any required integration, we believe there will be upside if the independent PBMs, including Medco, can pick up share in an otherwise maturing market.

Risks

- Loss of the United Healthcare contract, which is up for a price check in 2009 and renewal in 2011.
- Erosion of generic profitability as competitive dynamics whittle away excess economic returns.
- Heightened competition from captive PBMs, particularly those owned by large health plans.
- Increased governmental involvement in health care.

Valuation

- The stock is trading at 23.0 times our 2008 EPS estimate versus its three-year range of 16.5 to 24.4 times and its main competitor, Express Scripts, trading at 24.0 times.

IMS Health Incorporated

Rationale

- IMS is the dominant player in the \$7 billion market for pharmaceutical industry data and consulting. We believe the company's strong competitive position can be maintained over the next several years due to the emphasis on continual new product innovations in high growth areas such as regulatory management, oncology, and health outcomes research, which can drive high-single-digit revenue and low-double-digit income growth over the long term.
- In spite of recent turmoil in the pharmaceutical industry, internal reforms implemented by the recently appointed CFO, Leslye Katz, should be able to drive steady margin improvement of 150 basis points over the next three years.
- As the pharmaceutical industry pipeline begins to recover over the next three to five years, we believe IMS represents a low-risk and technology-agnostic way to participate, given pharma and biotech companies' increased need for data and consulting services on a maturing product pipeline.

Risks

- In the near term, the possibility of additional negative news from the challenging pharmaceutical market environment both in Europe and the United States may cause continued earnings volatility—creating risk around the release of 2008 guidance next February.
- In addition, pressure on the pharmaceutical industry to rein in a bloated cost structure could lead to further budget pressure on SG&A spending.

Valuation

- The stock is trading at trough levels (13.7 times our 2008 EPS estimate versus its three-year range of 16 to 20 times), providing investors the opportunity for multiple expansion once the earnings outlook stabilizes.

IDEXX Laboratories, Inc.

Rationale

- IDEXX Laboratories is the clear leader in an attractive veterinary diagnostics marketplace. In the United States, for example, IDEXX is the No. 1 provider of rapid assays, in-clinic diagnostic testing equipment and consumables, and veterinary practice management systems. IDEXX also operates the second-largest veterinary reference laboratory network in the United States. Moreover, many national distributors of the company's test kits, instrument consumables, and pharmaceutical products have decided to exclusively carry IDEXX's diagnostic products, which we believe further bolsters the company's leadership position in the companion animal market.
- The business is based on a private-pay model with no insurance or bad-debt risk. We estimate that more than \$21 billion will be spent on veterinary health care in 2007. Moreover, we expect the veterinary health care market over the next two decades will grow at more than 5% annually, or about twice the growth rate of total consumer expenditures. In addition to these attractive growth characteristics, there also are no significant third-party payors in the veterinary health care market. As a result, IDEXX's sales are not subject to the reimbursement risks common to most human health care providers.
- The company is about to embark on its next-generation product life cycle, as it launches the Catalyst Dx Chemistry analyzer in early 2008. We believe this could accelerate IDEXX's earnings growth over the coming years and should further solidify the company's (already dominant) position in the point-of-care veterinary diagnostics marketplace.

Risks

- In our view, the key risk for IDEXX is the upcoming launch of Catalyst Dx in early 2008. Currently, the product is expected to launch at the North American Veterinary Conference in late January 2008. Orders will be taken beginning in February and U.S. shipments will begin in March, followed by European shipments during the second quarter. If the company's launch is slower than anticipated, or if quality issues arise after the product ships, we would view this setback as a key risk to IDEXX's near-term share price performance.
- Other risks include foreign currency risk and a prolonged consumer spending slowdown.

Valuation

- The stock is trading at approximately 33 times forward EPS forecasts, well above its historical mean of 28 times.
- While we view earnings multiple expansion as unlikely at these levels, we do believe IDEXX can hold its multiple and appreciate in line with (consistent) earnings growth over the coming years.

ResMed Inc.

Rationale

- ResMed is a leader in the \$2.0 billion market for sleep disordered breathing. We expect the market will continue to grow in the high teens for several years, as penetration of the total number of people with the disease remains low (roughly 10%-15% worldwide) and the connection between SDB and numerous co-morbidities increases awareness in the clinical community.
- ResMed continues to introduce innovative new products that clearly differentiate the company from its competitors and, in our view, offer patients a superior option in managing sleep disordered breathing, which should allow the company to maintain its premium pricing structure.
- It appears that after several years of resisting, CMS may approve home testing for the diagnosis of sleep disordered breathing, which will likely increase the number of patients following into the system to receive therapy.

Risks

- The growing technology divide forces the company's competitors to compete largely on price, which has cost ResMed some share in recent quarters.
- CPAP products are included in Medicare's trial program for competitive bidding, which could create an overhang for the market in the coming years.

Valuation

- The stock is trading at 27.9 times and above its historical relative P/E multiple (21% premium to RESP).

Brookdale Senior Living Inc.

Rationale

- Brookdale is the largest provider in the attractive private-pay senior housing space. The company, which has been the most active consolidator in the senior living space over the last several years, focuses primarily on owned/leased facilities and currently operates approximately 550 properties, with capacity for more than 51,500 residents.
- The supply/demand environment in the senior housing space remains benign, in our opinion. This should drive high occupancy rates, solid pricing power, and strong same-community revenue and net operating income growth over the coming years, in our view.
- The company's nearly 7% dividend yield and 20%-plus cash flow growth should create an attractive return profile. Moreover, future site expansions (i.e., adding capacity to existing facilities) should continue strong cash flow growth beginning in mid-2009, in our view.

Risks

- Occupancy weakness—due to continued housing market slowdown—may affect the company's operations, particularly its entrance-fee communities.
- Overhang from Fortress stock ownership (61% owners).
- Quarterly volatility in operating results due to integration challenges and expenses.

Valuation

- BKD is trading at approximately 20 times our forward cash flow from facility operations (CFFO) forecast.
- Importantly, large noncash charges (mainly depreciation and amortization) make price-to-earnings valuations irrelevant (the company had negative GAAP EPS). As such, most investors tend to value on cash flows or dividend yield (which, at nearly 7%, creates an attractive entry point, in our view).

Healthways, Inc.

Rationale

- Healthways is the largest and most successful operator in the emerging field of disease and wellness management. The company has more than 25 years of experience working with patients to improve health outcomes, increase patient satisfaction, and reduce health care expenditures. At present, the company has contracts to provide health and care management services to more than 27 million individuals.
- With approximately \$1 trillion spent annually on caring for the chronically ill, we estimate the potential market for disease and care management in the United States is \$10 billion-\$15 billion. Despite the market's potential size, Healthways has few competitors that can match the depth and breadth of its health and care management services, in our opinion. The company has an industry-leading technology platform, strong brand equity, skilled management team, and more than 25 years of industry experience.

- The company has numerous growth avenues, including new product launches, selling more programs to existing clients, potential entry into the Phase II Medicare Health Support initiatives, and several internal opportunities. As such, we believe the growth outlook for Healthways is robust, and continue to believe the company can achieve 25% top-line growth over the coming years—the strongest organic growth in our coverage universe.

Risks

- Risks include managed care industry consolidation (which could affect the company's contracts with the acquired company) and the limited visibility of the Medicare disease management initiatives (which, to date, have not been successful enough to allow the company to recognize any revenues).
- Also, fiscal 2008 EPS will likely be a heavily back-end-loaded earnings year, so any market dynamics throughout the year could potentially cause volatility in the share price.

Valuation

- HWAY is trading at approximately 28 times calendar 2008 forecasts (in line with historical average).

ICON plc

Rationale

- An increase in the number of clinical development compounds moving from early stage to late stage testing as well as an increasing percentage of work being outsourced to CROs suggests that the demand environment, particularly for those focused on late-stage testing (like ICON), should continue to be strong over the next several years.
- Improving operating results from ICON's central lab offer a significant margin expansion opportunity in the long term. The company's current 11.2% consolidated margin (as of third quarter 2007) trails the industry leaders by several points, suggesting that the possible benefit from operating leverage is in its early stages.
- Given the robust demand environment, which should drive strong top-line growth, and the significant margin leverage opportunities, we believe ICON should produce the best long-term earnings growth among major CROs over the next three to five years (22% estimated in 2008, 20% long term).

Risks

- New business wins across all business units have been among the best in the industry for the past few years, but we believe the inevitable slowdown in new business momentum within either the core CRO business or central lab could prompt a valuation correction.

Valuation

- The stock is trading at 26.5 times our 2008 EPS estimate versus its three-year range of 14 to 26 times and its peers trading in a range of 18 to 27 times. Given this valuation premium, we shifted ICON this year from our one-year list to our longer term three- to five-year list.

NuVasive

Rationale

- Continued surgeon adoption of lateral approach and differentiated product portfolio should drive robust top-line growth. The company's investment early on in the exclusive salesforce is paying off as revenue per trained surgeon per quarter increased to \$27,200 in third quarter 2007 from \$23,500 in second quarter 2006, when the salesforce conversion was just completed. New product releases continue to round up the company's

offerings. Several new products launched earlier this year have performed well so far. These include the XLP lateral plate, the SpheRx II pedicle screw system (allowing multilevel fusions in the thoracic spine), and the Formagraft products.

- International expansion is expected to become a significant growth contributor. While we believe there is a lot more room for the company to grow in the \$4 billion U.S. spine market, in which the company currently has just perhaps 3% market share, we view the company's plan to expand outside the United States with its more differentiated products, including NeoDisc and Cerpess, as a smart strategy, as it allows the company to start building the foundation in Europe and to gain more clinical experience with these new products.
- NuVasive has an outstanding management team that clearly has the vision and capabilities to take the company to a revenue base of at least \$500 million in the coming years, while an acquisition of the company remains possible.

Risks

- Political risk heading into the 2008 election year. Reimbursement risks for spinal implants remain high, with potential cuts likely over the next few years. That being said, the company's differentiated technology platform and products should help minimize its exposure compared with other manufacturers viewed as commodity producers.

Valuation

- The stock is trading at 7.0 times of our 2008 revenue estimate of \$199 million.

Cepheid

Rationale

- Cepheid's GeneXpert remains the only fully automated PCR-based molecular diagnostic system. This technology, which has been validated both in the biothreat and clinical settings and has moderate-complexity CLIA status, has made the company a major player in the molecular diagnostics space, which we believe is approaching \$3 billion and growing at 30%.
- Within molecular diagnostics, testing for methicillin-resistant *Staphylococcus aureus* (MRSA) and other hospital acquired infections (HAI) are emerging as a significant multi-billion-dollar market opportunity. We believe that Cepheid is best positioned to capitalize on this space with a first-mover advantage, an intense focus on this market in terms of R&D spending and salesforce buildup, and a proven solution for MRSA, as seen from the significant contract wins from the Veteran's Administration in the past six months.
- The company is adding numerous other tests to its platform to round out its HAI portfolio and is developing tests for women's health, infectious disease, and oncology. As these tests roll out over the next one to five years, the utility of the company's instruments will increase. In addition, Cepheid is developing high-output instruments that will be able to run up to 1,440 tests/hour, which should appeal to high-volume testing locations that we believe will make up more than 50% of the market opportunity.
- Finally, as a result of the company's unique technology, expanding menu of tests, leadership in MRSA testing, large cash balance, and built up net operating losses, there is a distinct possibility that the company will be acquired over the next three to five years. We believe this should help support the stock price in the near term and note that in a takeout, we believe the company could fetch a multiple based on current year revenues in the low double digits.

Risks

- Investors seemed fixated on emerging competition in the MRSA market with Gen-Probe (GPRO \$63.88), Roche, and Qiagen (QGEN \$21.68) expected to eventually enter this market. However, we have heard directly from both Gen-Probe and Roche that they will not enter this market in 2008 (and we believe even 2009 could be stretch). In the near term, this could cause shares to remain volatile as rumors about market entry from competitors could knock the name.

- A factor in the company's early success with its test for MRSA was that there was a mandate from the Veteran's Administration to test for this staph infection and a preference toward a molecular method was noted. Without another mandate, either at the state level or from a large hospital group, instrument placements could be more of a "missionary sale" that results in lumpiness from quarter-to-quarter.
- While the company has a broad and impressive product pipeline, actual commercialization of these products is by no means certain and product delays in some areas should be expected.

Valuation

- On the basis of EV to 2008 sales, Cepheid trades at a multiple of 7 times, which represents a 70% premium to the median multiple seen in the overall diagnostics industry (where growth is estimated to be in the midsingle digits). However, when compared to more pure-play molecular diagnostic comparables Gen-Probe and Third Wave (TWTI \$7.78) (6.4 times and 8.0 times, respectively), the multiple for Cepheid is more reasonable, especially when one considers that the roughly \$3 billion molecular diagnostics continues to be the most rapidly growing segment of the overall \$30 billion diagnostics industry.

Allscripts Healthcare Solutions, Inc.

Rationale

- Adoption drivers in the market for electronic medical records (EMR) remain healthy.
- We believe this end-market environment, combined with what we view as Allscripts' favorable competitive position, should result in continued strength in bookings growth.
- We anticipate earnings growth should continue to outpace revenue growth as a mix shift toward software and expense leverage drives margin expansion.

Risks

- Software implementations have extended given a new product release and more complex customer needs; revenue and earnings may continue to be affected if this continues.
- The competitive environment could intensify as vendors continue to penetrate the market.

Valuation

- At a 26-times multiple on our 2008 adjusted EPS expectations, we believe the shares are attractive given the company's long-term earnings growth potential and overall franchise quality, in our opinion.

Exelixis Inc.

Rationale

- In our view, the company's outlook is favorable based on several fundamentals:
 - Diverse and large pipeline: Uncommon breadth and size (14 in clinic) with well-designed focus on new targets or next-generation cancer drugs that generates a high level of visibility.
 - Corporate strategy: Unique business style that combines a collaboration with Glaxo-SmithKline (GSK \$52.54) and other smaller partnerships to manage the cash burn and support the large pipeline.
 - Platform technology: Proprietary discovery engine enables quick identification and characterization of candidate cancer drugs, which has attracted a high quality list of collaborators such as Genentech (DNA \$72.78), Bristol-Myers (BMY \$29.06), GSK, etc.
 - Attractive valuation: Recent levels provide an opportunity for growth performance as the midstage programs continue to advance.

Risks

- Pipeline progression is dependent on cash inflow from collaborations that if terminated would heighten capital risk.
- Therapeutic space for cancer drug development is competitive.

Valuation

- We value EXEL based on its pipeline and rich collaborative stream.
- With 14 clinical candidates, attrition is expected; however, with such a large pipeline, there is lower risk than companies with a more binary position.
- Strong cash position (\$253 million in third quarter 2007) provides support and development flexibility to clinical programs and removes imminent dependence on collaborative cash flow.

The TriZetto Group, Inc.

See description in the “2008 Best One-Year Ideas” section.

NxStage Medical, Inc.

Rationale

- Roughly 350,000 people in the United States have end-stage renal failure, a patient population that is growing in the high single digits annually.
- In our view, the company’s System One represents a breakthrough in the delivering home hemodialysis therapy. NxStage’s agreement with DaVita (DVA \$60.47) (one of the two large dialysis chains in the United States), along with a strong relationship with the independent centers, has allowed the company to add a meaningful number of patients in recent quarters, and we expect this trend to continue going forward.
- The acquisition of Medisystems gives NxStage the human and manufacturing resources it needs to meet growing demand for its System One and eventually should provide a portion of the infrastructure needed to tap the enormous international dialysis market.

Risks

- Higher-than-expected patient churn rates or a product quality problem.
- Several companies are developing technologies that are similar to NxStage’s System One and should be on the market within the next three to four years.

Valuation

- The stock trades at 2.8 times 2008 revenue, which we believe represents an attractive entry point for this compelling technology story with a meaningful annuity value component of the business.

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William Blair & Company's Technology Group published its list of "Best Ideas for 2008" and updated its list of top long-term (three- to five-year) picks. As we exit a year in which the technology sector comfortably outperformed the broader market, we look to identify the most relevant trends in the sector as they relate to expectations for 2008. While several factors underpinning our recommendations for 2007 still persist today, the source of strength in the sector could shift. We believe the uncertain macroeconomic environment will be more conducive to a selective approach, as opposed to last year's broader endorsement of the sector. Certain areas of technology still remain well positioned, in our view, considering the following points.

Macroeconomic Uncertainty

Several data points suggest that the technology sector's broad outperformance is at risk if there is a recession in the United States. First, information technology now represents more than half of overall capital expenditures. Moreover, these expenditures have increasingly shifted to replacement cycles as opposed to adoption, facilitating a delay in IT spending during economic downturns. Consumer spending has also become a more important factor driving the technology sector, and we have already witnessed several companies under our coverage that were negatively affected by this exposure.

We acknowledge these are significant challenges to the broader segment, particularly because of their impact on bellwether industry names. Several of these stocks bolstered technology's strong showing in 2007, as evidenced by the performance of the IT sector in the Russell 1000 (up 11.9% year-to-date through November 28) relative to the Russell 2000 (up 1.2%). While many large-capitalization names have become increasingly cyclical and thus would be less attractive to us should a recession ensue, certain areas of the sector are less correlated to the overall economy and are therefore less cyclical, in our view.

If we do not enter a recession, we believe technology stocks should continue to disproportionately benefit from the forces most likely to keep the economy growing. First, technology can be a relatively strong performer in a decelerating economic growth environment because the sector is more leveraged to the global economy, where we believe a slowdown will be less pronounced than the domestic economy. Second, the sector enjoys relatively stronger balance sheets compared with the broader market, as judged by debt/equity ratios, cash balances, and liquidity ratios.

Product Cycles

While we continue to believe product cycles will not be sufficient to lift the entire sector, as they have in the past, there are numerous smaller cycles that we believe provide good investment opportunities in 2008 and/or beyond. The notable addition for 2008 is High Definition.

Recommendations

We are recommending a shift away from bellwethers to high-growth small- and midcap stocks. We are focused on revenue-generating applications as opposed to cost center support. We also seek companies with recurring revenue models and those driving penetration/adoption versus market growth.

We are encouraged by the prospects for our best picks for 2008, as well as our choices for the next three to five years. In keeping with William Blair's bottom-up approach to investing, there is little in the way of a thread tying together the picks of our five technology analysts.

Our recommendations for 2008 are: Microsoft, QUALCOMM, Fiserv, Jabil Circuit, Euronet Worldwide, EnerSys, InnerWorkings, CyberSource, DTS, Composite Technology, Sonic Solutions, and Constant Contact.

The Technology Group's three- to five-year list continues to reflect the longer-term themes that underpin the type of durable growth franchises we attempt to identify at William Blair.

- The first theme is a changing of the guard, as new business models, such as software as a service, threaten the status quo.
- Second, in more mature segments, market leaders that have diversified from their core business provide opportunity for up-and-coming, focused companies to gain significant market share.
- Lastly, we have looked to include companies that benefit significantly from specific emerging technologies such as 3G, RFID, and High Definition.

We made several changes to our longer-term list. Concur Technologies, DealerTrack Holdings, j2 Global Communications, MICROS Systems, Scientific Games, VistaPrint, and Stratasys are additions for 2008. The remaining names are: QUALCOMM, Zebra Technologies, salesforce.com, Electronic Arts, Trimble Navigation, Heartland Payment Systems, FLIR Systems, and Euronet Worldwide.

2008 Best One-Year Ideas

Table 9
Best Stock Ideas for 2008

Company	Ticker	Rating/ Profile	11/28/07 Price	Current Market Cap (\$mil.)	Current NTM EPS	Current NTM P/E
Microsoft Corporation	MSFT	O / E	33.70	\$315,264	\$1.82	18.5
QUALCOMM Incorporated	QCOM	O / C	41.49	\$68,293	\$1.96	21.1
Fiserv, Inc.	FISV	O / C	52.05	\$8,567	\$3.11	16.7
Jabil Circuit, Inc.	JBL	O / C	17.17	\$3,368	\$1.34	12.8
Euronet Worldwide, Inc.	EEFT	O / A	31.52	\$1,532	\$1.44	21.9
EnerSys	ENS	O / C	24.65	\$1,169	\$0.92	26.8
InnerWorkings, Inc.	INWK	O / A	15.50	\$613	\$0.46	33.8
CyberSource Corporation	CYBS	O / A	15.00	\$917	\$0.58	25.8
DTS, Inc.	DTSI	O / A	23.37	\$411	\$0.64	36.7
Composite Technology Corporation	CPTC	O / A	1.68	\$345	-\$0.11	NA
Sonic Solutions	SNIC	M / A	9.62	\$250	\$0.26	36.8
Constant Contact, Inc.	CTCT	O / A	19.31	\$76	-\$0.03	NA

Note: List sorted by market capitalization
Source: FactSet

Microsoft Corporation

Rationale

- Should continue to benefit from Windows desktop upgrade cycle and upcoming Windows 2008 and SQL products
- Can serve as somewhat of a hedge against a potentially weakening economy, since we believe that Microsoft's Windows products are likely to be a priority for IT departments even if budgets tighten; it will also likely benefit from a weakening dollar, which makes its products less expensive overseas
- Accelerating revenue and earnings growth in 2008 due to product flow
- Continuing to return cash to shareholders; cash generation of \$2 billion to \$7 billion each quarter (historical)
- GAAP operating margin should increase to 39.5% in 2008 from 38.6% in 2007
- Trades at relatively low multiples
- In summary, a more conservative pick, especially if the economy weakens

Risks

- Well-owned stock
- Is product flow already in the stock?
- Will Microsoft continue to deliver upside in profitability?

Valuation

- Stock is trading at 17.9 times earnings and 15.8 times on an EV/FCF basis, below the software group on both metrics

QUALCOMM, Inc.

Rationale

- Accelerating growth in the 3G handset market, which is based on QUALCOMM's intellectual property and technologies
- Stronger-than-expected growth in the mobile chipset market—QUALCOMM has now become the No. 1 seller of chipsets in the space
- New Single Chip and Dual Core chipset solutions expected to drive chipset growth and new design wins in 2008

Risks

- Ongoing litigation worldwide over licensing disputes with Broadcom and Nokia
- Near-term Street expectations still adjusting to the exclusion of Nokia revenue, leading to a lowering of expectations at the analyst day

Valuation

- At 19 times 2008 EPS, we believe that QUALCOMM remains undervalued based on near-term concerns that have overshadowed the company's dominant 3G position

Fiserv, Inc.

Rationale

- The acquisition of CheckFree, in combination with divestitures, should result in higher internal growth, margins, and EPS growth, and in the long term creates the opportunity for a differentiated competitive position through integration of several pieces of technology puzzle; opportunity also exists for significant cost savings and enhanced revenue from ongoing strategic repositioning of the company
- Stock has weakened on concerns over the effect of macroeconomic weakness on bank IT spending; we believe these concerns are excessive

Risks

- Although we believe the combination of Fiserv and CheckFree should be relatively straightforward, and its success has not been predicated on significant revenue or cost synergies, execution risk is always present in large mergers
- Extent of impact of credit crisis on financial institutions is not yet known and likely to be a headwind

Valuation

- Stock is trading at approximately 16 times consensus 2008 EPS estimate, before the impact of CheckFree, and at less than 13 times our preliminary 2009 cash EPS estimate, including CheckFree

Jabil Circuit, Inc.

Rationale

- Share gains and continued trend toward outsourcing enable revenue growth even when end-market conditions are challenging
- Greater exposure to end-markets at an early stage of outsourcing (e.g., automotive, instrumentation and medical, and consumer)
- Fundamental recovery in business over the last three quarters has not translated into improved stock price
- Best-in-class EMS company with record of industry-leading margins and return on capital

Risks

- Early 2007 execution missteps raise concern about ability to achieve consistent profitability at a larger scale
- Negative sentiment surrounding dull end-market conditions

Valuation

- At 11 times consensus fiscal 2008 EPS estimates, the stock is at the low end of its historical valuation range

Euronet Worldwide, Inc.

Rationale

- Opportunity for growth remains exceptional—in each of the company's business lines
- Limited exposure to U.S. consumer or broader economy
- Margins should increase due to both revenue mix and increased operational efficiencies
- Confidence in growth outlook (especially for money transfer) can improve with continued execution driving valuation higher

Risks

- Increased valuation depends in large part on continued execution without significant surprises, and this may be difficult to achieve in view of the company's high growth and inherent volatility of the end-markets
- The company has set the bar for the money transfer business high, and immigration issues are unresolved

Valuation

- Stock is trading at approximately 19.5 times consensus 2008 cash EPS estimates, and approximately 18.5 times our 2008 estimates

EnerSys

Rationale

- Management executing well in tough environment
- Potential for earnings growth acceleration as lead costs drop
- End-markets growing
- Market leader
- Shifting production to low cost facilities

Risks

- Lead prices could increase (again)
- Competitors could cut price to gain share at a loss
- Introduction of new technologies

Valuation

- We see current multiple of 22 times 2008 EPS as attractive, given potential for upward earnings revisions

InnerWorkings, Inc.

Rationale

- InnerWorkings is proving out its business model and value proposition, is achieving high levels of growth, and remains at a very early stage of penetrating its potential market
- The company has the opportunity to continue to make acquisitions that can be accretive to growth and profitability after integration
- Recently issued guidance was above our expectations, even though the company has proved to be conservative in its outlook

Risks

- High level of acquisition activity can introduce some risk of effective integration and of achieving expected revenue and profit contributions
- Significant macroeconomic weakness could affect total print spending, though we believe this also could drive more customers to InnerWorkings as they seek cost savings

Valuation

- Stock is trading at less than 21 times our 2009 EPS estimate, a significant discount to the EPS growth rate

CyberSource Corporation

Rationale

- Acquisition of Authorize.Net creates significant incremental competitive and operational scale, both of which company can leverage—together with continued high growth of e-commerce—to sustain high rates of top- and bottom-line growth
- Commentary and guidance continue to appear conservative, and greater synergies with Authorize.Net than have been conceded by management appear likely
- Greater market capitalization, float, and research coverage all can increase appeal (and valuation)

Risks

- Although combination with Authorize.Net should be relatively straightforward, this is a large acquisition for CyberSource and some execution risk exists
- Has consistently provided conservative guidance, creating risk of disproportionate reaction to guidance or to results that are perceived as “merely” in line

Valuation

- Stock is trading at approximately 24 times consensus 2008 EPS estimate, including the impact of the Authorize.Net acquisition

DTS, Inc.

Rationale

- Increasing visibility and acceleration in HD cycle should have significant impact on DTS as mandatory audio standard
- As HD cycle confidence increases, investors will start to focus on peak EPS potential of \$3-plus around 2011, due to high-margin business model
- Potential for upside from incremental end-markets such as broadcast and portable
- Sell-off following third-quarter results creates an attractive entry point

Risks

- HD adoption could continue to be hard to predict, especially if consumer spending declines
- Very hard to forecast quarters due to royalty-based business model—as seen in third-quarter results
- Failure to sell hardware business on investor psychology

Valuation

- Shares are down around 11% since third-quarter results were released and trade at 32.7 times our 2008 EPS estimate; we believe shares would deserve a multiple of at least 20-25 times on peak EPS of \$3

Composite Technology Corporation

Rationale

- Excellent growth opportunity in the wind market
- Favorable supply/demand dynamics for turbines through 2010 (DeWind subsidiary one of the few companies that still has turbines available)
- Cable gaining traction in the United States and abroad
- Near-term catalyst if turbines attain certification

Risks

- Limited operating/product history
- Failure of products to reach commercial acceptance
- Sarbanes-Oxley/compliance-related issues

Valuation

- At 1.3 times EV/2009 revenue, we believe Composite Technology is attractively valued on a relative basis given our projected growth trajectory.

Sonic Solutions

Rationale

- HD and download and burn (DnB) cycle poised to accelerate growth in calendar 2008
- Many catalysts, including options review completion, CES news flow (early January), more DnB announcements, HD acceleration, and DnB kicking off early to mid-2008
- Sell-off after second quarter 2008 represents attractive entry point—sentiment very low at these levels

Risks

- Lack of visibility into quarterly estimates until new product cycles, such as HD or DnB, begin
- Further delay of the HD cycle or no resolution in 2008
- DnB may not materialize into a long-term opportunity

Valuation

- Shares are down 41% year-to-date and trade at 13 times EV/EBITDA and a 3.2% FCF yield, based on our recent and significantly lowered 2008 estimates.

Constant Contact, Inc.

Rationale

- The company has a 50% market share in its target market, the low end of e-mail marketing
- Large, underpenetrated available market of \$15.8 billion in the United States alone
- Half of its customers are from referrals
- The company excels in customer support
- It recently (June 2007) launched e-mail surveying services—a new opportunity
- There is upside to management's guidance (in our view)
- Constant Contact is recession resistant, because it has low exposure to financial services, low ASP of \$400 per year, and those laid off during recessions often start their own companies

Risks

- Competitors that focus on midsize and enterprise companies could move downstream
- Potential for further multiple compression
- Unproven from the Street's perspective

Valuation

- Expected to reach profitability in 2009
- 2009 price/revenue of 4.3 times and adjusted EV/FCF of 19.3 times, slightly above SaaS median

Best Long-Term Ideas

Table 10
Best Long-Term Stock Ideas for 2008

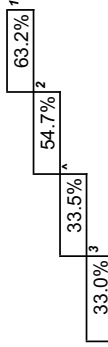
Company	Ticker	Rating/ Profile	Date Added to List	11/28/07 Close	11/28/06 Price	12/16/05 Price	12/2/04 Price	1/14/04 Price	Return Since 11/28/06	Return Since 12/16/05	Return Since 12/2/04	Return Since 1/14/04	Current Market Cap (\$mil.)	Current NTM EPS	Current NTM P/E
QUALCOMM Incorporated	QCOM	O / C	1/14/2004	41.49	35.85	44.74	43.62	30.06	16%	-7%	-0.05	0.38	\$59,224	\$1.96	21.1
Zebra Technologies Corp. (CI A)	ZBRA	O / C	1/14/2004	37.97	34.80	43.80	52.47	44.67	9%	-13%	-0.28	-0.15	\$2,462	\$1.72	22.0
salesforce.com, inc.	CRM	O / A	12/2/2004	54.43	39.35	33.39	16.99	N/A	38%	63%	2.20	N/A	\$4,466	\$0.26	207.7
Electronic Arts, Inc.	ERTS	O / C	12/6/2005	57.29	57.21	56.84	N/A	N/A	0%	1%	N/A	N/A	\$17,621	\$1.51	37.9
Trimble Navigation Limited	TRMB	O / A	12/6/2005	37.17	24.03	17.28	N/A	N/A	55%	115%	N/A	N/A	\$2,670	\$1.28	29.1
Heartland Payment Systems, Inc.	HPY	O / C	12/6/2005	32.25	26.32	22.50	N/A	N/A	23%	43%	N/A	N/A	\$977	\$1.19	27.0
FLIR Systems, Inc.	FLIR	O / A	11/28/2006	69.19	32.29	N/A	N/A	N/A	114%	N/A	N/A	N/A	\$2,118	\$2.09	33.1
Euronet Worldwide, Inc.	EEFT	O / A	11/28/2006	31.52	32.91	N/A	N/A	N/A	-4%	N/A	N/A	N/A	\$1,226	\$1.44	21.9
Scientific Games Corporation	SGMS	O / A	11/29/2007	32.50	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$2,635	\$1.31	24.8
MICROS Systems, Inc.	MCRS	O / A	11/29/2007	71.80	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$1,986	\$2.68	26.8
VistaPrint Limited	VPRT	O / A	11/29/2007	45.70	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$1,365	\$1.03	44.2
j2 Global Communications, Inc.	JCOM	O / A	11/29/2007	24.51	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$1,358	\$1.55	15.8
DealerTrack Holdings, Inc.	TRAK	O / A	11/29/2007	44.75	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$991	\$1.11	40.2
Concur Technologies, Inc.	CNQR	O / A	11/29/2007	36.85	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$557	\$0.42	88.8
Stratays, Inc.	SSYS	O / A	11/29/2007	23.01	NA	N/A	N/A	N/A	NA	N/A	N/A	N/A	\$293	\$0.83	27.7

Tech. Long-Term Picks List's Return Since 1/14/2004

Tech. Long-Term Picks List's Return Since 12/2/2004

Tech. Long-Term Picks List's Return Since 12/16/2005

Tech. Long-Term Picks List's Return Since 11/27/2006



Jan. 14, 2004, Through Last Close

S&P 500 Index (Reported Basis)	SP50	1469.0	1386.7	1263.7	1190.3	1130.5	5.9%	16.2%	23.4%	29.9%
Technology Select Sector SPDR Fund XLK	XLK	26.27	23.32	21.94	21.05	21.18	12.7%	19.7%	24.8%	24.0%
Dow Jones 30 Industrials	DJII	13289.5	12136.5	10856.9	10585.1	10538.4	9.5%	22.4%	25.5%	26.1%
NASDAQ Composite Index	COMP	2662.9	2412.6	2260.8	2143.6	2111.1	10.4%	17.8%	24.2%	26.1%
Russell 2000	RUT	770.0	774.8	687.6	642.5	586.1	-0.6%	12.0%	19.8%	31.4%

^{1,2,3} Returns are adjusted for the recommended CHANGES to the List between 2004 & 2005 (removing CMVT & LXX), adjusted for the recommended CHANGES to the List between 2005 & 2006 (removing SAP, MERO, NVT, VIRL), adjusted for the recommended CHANGES to the List between 2006 & 2007 (removing MXIM, RNOW, INTU), adjusted for the recommended CHANGES to the List between 2007 & 2008 (removing PAYX, ARMHY, LLTC, WEBX, VOCS).

⁴ Returns are time weighted to include Pixar's contribution through May 5, 2006

Note: List sorted by market capitalization, within "date added" groups

Source: FactSet

QUALCOMM, Inc.

See description in the “2008 Best One-Year Ideas” section.

Zebra Technologies Corporation

Rationale

- Opportunity in higher-growth vertical markets (health care, government, and route accounting)
- International growth has maintained a consistent midteens growth rate
- RFID remains long-term opportunity
- Strong balance sheet (about \$4.50 cash per share) and free cash flow generation (about \$30 million/quarter); with new CEO and recent acquisitions out of the way, likelihood of share repurchases is elevated, in our view

Risks

- Integration of sizeable acquisitions: WhereNet (January), Navis Holdings (October), and proveo AG (October)
- Operating margins have suffered as the company invests in demand creation with higher SG&A

Valuation

- Stock reasonably valued at 19 times 2008 EPS, with room for EPS upside if margin recovery continues

salesforce.com, inc.

Rationale

- A core technology holding and the most open-ended growth opportunity on our list (in our opinion)
- One of the best marketing companies we have seen in terms of branding
- It entered an existing market, customer-relationship management, and changed it by altering the business model and the business proposition
- It continues to expand and develop new services: AppExchange/Force.com could further change the way applications are developed and executed, expanding salesforce out of the CRM space and into any application that a developer can imagine
- Its salesforce automation products, which help generate sales, would be less affected than other software products and might still be purchased even if deal sizes shrink (particularly the large ones)
- Because its clients are equally spread between large, midsize, and small businesses, only 30% would be affected by a slowdown
- Customers can simply buy fewer subscriber seats if expenses become a priority

Risks

- Potential multiple compression
- Market “noise” from competitors (e.g., Microsoft, Oracle, SAP)
- Relatively high percentage of revenue from financial services
- Small benefit from weakening dollar, as 75% of its business is U.S.-based

Valuation

- Trading above SaaS and software group medians, but we believe that the premium is warranted given the quality of the company

Electronic Arts, Inc.

Rationale

- Industry-leading video game publisher poised to benefit when cycle accelerates
- New CEO rapidly streamlining company, driving accountability, increasing innovation
- Still has many visible catalysts: conservative guidance, more (smaller) restructuring announcements, first analyst day in February, sentiment still lagging group

Risks

- Struggling to catch up in shifting video game market: caught off guard by Wii's popularity, but has balance sheet to catch up
- Market share still relatively leveraged to core-gamer segment—PS3 and Xbox 360 pricing still need to decline further

Valuation

- Continue to focus on peak EPS power of \$3 to \$5, traditional multiple of 25 to 35 times ahead of peak

Trimble Navigation Limited

Rationale

- Productivity-enhancing solutions with very rapid payback (less than one year)
- Multiyear growth story with very low penetration of point solutions
- Multiple and diversified growth avenues
- Several important partnerships that strengthen market-leading position

Risks

- Results saw pressure in July and August, potentially from overall economic concerns; unclear to what extent continued negative macro headlines and credit environment will have on construction market and Trimble's December results

Valuation

- At 26 times 2008 EPS, we see upside to investors based on the company's earnings growth potential, as well as the growing interest from investors in global infrastructure plays

Heartland Payment Systems, Inc.

Rationale

- Differentiated approach to marketing to merchants is driving growth that is significantly in excess of that of the industry
- Introducing new products and services that can have significant long-term opportunity
- In-house processing creates opportunity for strong leverage of processing volume; initiatives to lower attrition could have significant positive impact on growth and margins
- Industry fundamentals remain solid, with substitution of cash and checks continuing

Risks

- In the absence of an effective alternative, competitors may intensify price competition
- Some economic exposure exists, as evidenced by recent decline in same-store sales growth
- Growth from core business likely to slow somewhat

Valuation

- Stock is trading at less than 25 times 2008 earnings (compared with 25% long-term growth rate) and slightly more than 11 times trailing EBITDA

FLIR Systems, Inc.

Rationale

- Expect continued growth in Government Systems business with several large opportunities set to be awarded near term
- Strong top-line growth visibility due to record backlog coverage
- Underpenetrated commercial opportunity begins to accelerate driven by price elasticity
- Longer-term shift in the military toward procuring lower cost, equivalent commercial off-the-shelf products

Risks

- Lumpy business with significant ties to current U.S. Defense budget
- Sustainability of government segment growth beyond 2008 and 2009
- Working capital management and higher inventories

Valuation

- At 29 times 2008 EPS, we believe the stock will continue to have strong revenue and EPS growth over the next 3-5 years

Euronet Worldwide, Inc.

See description in the “2008 Best One-Year Ideas” section.

Scientific Games Corporation

Rationale

- Well positioned to capitalize on many strong secular trends in global gaming industry in 2008
- International lottery (Germany, Mexico, China, Italy) growth/coming online
- Upgrade cycles in UK bet shops and pubs (slot/VLT-type machines)
- Management team taking cost-reduction steps across business; potential for \$40 million in cost savings through 2008 in instant ticket printing

Risks

- Gaming end-markets can develop slower than anticipated (examples: Germany, Mexico)
- Can be very volatile around quarters—very complicated business, can have quarterly setbacks, but long-term trends are very solid

Valuation

- The stock is trading at 21.8 times price to 2008 EPS and at 9.3 times EV/2008 EBITDA—in line with historical ranges, but with its expanding growth profile, we see potential for an EPS run-rate of \$2.00 by the end of 2008

MICROS Systems, Inc.

Rationale

- Dominant franchise in hotel IT systems, where growth outlook remains favorable
- Restaurant segment also very well positioned, with strong upgrade cycle in the United States and organic growth overseas
- Healthy free cash flows
- Actively buying back stock

Risks

- General economic sensitivity given exposure to restaurant, hotel, and retail end-markets
- Higher domestic restaurant penetration and slower replacement cycle may limit growth outlook

Valuation

- At about 24 times 2008 EPS, the multiple may have limited room for expansion, but we view it as fair given earnings growth and potential for estimates to prove conservative

VistaPrint Limited

Rationale

- Company is in the very early stages of capturing an effectively open-ended opportunity to grow its business in providing marketing support service for 50-plus million SOHO businesses worldwide
- Limited exposure to U.S. consumer; potentially countercyclical to broader economic weakness
- Extremely high rates of top- and bottom-line growth will attract investors in lower-growth environment

Risks

- Growing as fast as VistaPrint is entails significant complexity—the company's ability to manage this complexity and sustain excellent execution will be key to its continued success
- Company's business opportunity and competitive differentiation are not well understood

Valuation

- Stock is trading at less than 29 times consensus fiscal 2009 cash EPS estimates

j2 Global Communications, Inc.

Rationale

- Highly recurring and predictable revenue model, with no customer concentration
- Broadening growth profile, through cross-selling new services (namely voice), greater expansion into the corporate channel, and ramping up international growth
- Strong free cash flow with low asset intensity

Risks

- Disappointing variable revenue contribution
- Exposure to financial firms/credit markets

Valuation

- At 14 times 2008 EPS, we believe the stock valuation is attractive, given the company's consistent growth, strong cash flow, and broadening customer profile

DealerTrack Holdings, Inc.

Rationale

- Company has effectively laid the seeds for sustained high growth through development of an impressive pipeline of new products and services—we expect strong positive news flow regarding new products and markets over next two years; margins should improve and exposure to auto sales decrease over this period
- Stock has weakened on concerns over the effect of macroeconomic weakness on car sales and the knock-on effect for the company; we believe these concerns are excessive

Risks

- Expectations for the contribution of new DMS solution may be unrealistic, although the company should comfortably achieve our targeted growth through other products
- Exposure to auto industry trends creates headline risk

Valuation

- Stock is trading at less than 33.5 times consensus 2008 EPS estimate

Concur Technologies, Inc.

Rationale

- Concur provides an integrated travel and expense offering—to our knowledge, the only one
- It continues to expand and develop new services: Vendor Payment was launched in March and Travel 2.0 was recently launched
- As such, the company has multiple markets and products to support growth, which is in contrast to many SaaS companies that depend on a single product or market
- The Gelco acquisition helps fortify Concur's long-term competitive position and broadens its product portfolio
- Concur should hold up well in a down economy, because it has a consumption-based model, customers do not pay much up-front, its services help customers save money, and no vertical contributes more than 10% to revenue

Risks

- Credible long-term competitive threat from payroll processors, ERP vendors, and travel players
- With penetration rates rising at enterprise companies, it may have to look more to small and midsize segments to expand
- Valuation
- In a tough economy, companies may cut travel expenses; this may be offset by more companies looking to control travel costs

Valuation

- The stock trades at 32.8 times on adjusted EV/FCF basis, in line with the SaaS group, and 7.1 times on price/revenue basis, above the SaaS group

Stratasys, Inc.

Rationale

- Dominant position in the lower-priced 3D printer space
- Rapidly growing installed base should translate to more consistent, recurring revenue from high-margin consumables

- Distribution network would be difficult to replicate
- Best open-ended growth story on our research list; industry is at an early stage of market opportunity penetration

Risks

- Growth of materials in most recent quarter trailed growth in installed base, leading to gross margin shortfall and hesitation regarding the long-term opportunity in consumables
- Equipment sales are still “lumpy” from quarter to quarter

Valuation

- Valuation above average at 27 times 2008 EPS, but recent pullback offers opportunity to own 20%-plus EPS growth story in a nascent industry, in our view

Additional information is available upon request.

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