

# SHAKER INVESTMENTS

A RESEARCH-DRIVEN GROWTH APPROACH TO EQUITY PORTFOLIO MANAGEMENT



## Note From Edward Hemmelgarn

U.S. equity markets have once again started off 2005 with some choppiness. This volatility, especially in a normal return environment (but lower than 1980-2000), continues to cause an above average amount of angst in many individual investors. The effect of the dramatic fall in equity values from 2000-2002 lingers on and will likely continue to do so until investors can be once again reassured by a sustained period of equity outperformance relative to other alternative investments.

Unfortunately for investors, their collective fear creates the conditions for outperformance that currently exist: 1. Equities are very undervalued relative to fixed income securities and 2. Above average profit growth caused by corporate focus on profit growth. At Shaker, we believe that these conditions are perfect for long term value creation even though the road may be volatile. Investor value is created by growing companies. This is certainly occurring in the current environment.

Identifying good, long-term opportunities requires intensive and astute research, and that is always where Shaker seeks to excel. In this issue of our newsletter, analyst Lynn Laws reviews her assessment of Ultralife Batteries (one of our holdings) to demonstrate some attributes that we believe are essential when considering a stock purchase. Complementing Lynn's article is a short interview with Ultralife's John Kavazanjian, which I'm certain you will find informative and compelling. ■



## Case Study: Ultralife Batteries Against Shaker's Key Criteria

By Lynn Laws - Analyst

Volume 6 Issue 1

One of the approaches that we use in researching investments is to evaluate companies against 11 criteria that we believe represent important attributes for superior growth companies. Although it is rare for a company to score high on all of our criteria, those that meet most historically have been more successful investments over time.

We believe it is instructive to show how Ultralife Batteries, Inc. — a leading producer of standard and customized high-energy, non-rechargeable lithium-manganese dioxide batteries and lithium ion and lithium polymer rechargeable batteries — measures up against Shaker's key research criteria.

**Superior growth:** Shaker expects revenues and earnings to grow at a compound annual growth rate of 20% and 50%, respectively, over the next three years. Revenue growth will most likely be driven by increased penetration of lithium-manganese dioxide batteries in the military market as well as new markets and applications for Ultralife's batteries. Margin expansion from operating leverage and productivity improvements should drive even higher earnings growth.

**Sustainable competitive advantage:** Ultralife's competitive advantage stems from its strategy of targeting niche markets with specialized requirements, typically for applications where a reliable battery is critical and customization is expected. Ultralife's patents and trade secrets are also an advantage, and as Ultralife's batteries are designed into its customers applications, it often has long-term contracts. Even with its patents, however, it is difficult to assess whether Ultralife can sustain this competitive advantage indefinitely.

**Strong management team:** John Kavazanjian, the current CEO, engineered a turnaround of Ultralife from an unprofitable company that lacked vision to a profitable company with a differentiated product and service offering. His team has extensive experience in the battery industry.

**Market leadership:** Ultralife is a leader in many of the markets it serves. It dominates the military lithium-manganese dioxide market, and this technology is gaining share in the total military battery market. Additionally, Ultralife is the only manufacturer of the standard 9-volt lithium battery which is sold under the Ultralife and Eveready brands.

**Focused:** Ultralife's sole business is specialty batteries.

**New product development:** Ultralife develops 1-2 new battery designs per week, generally tailored to meet the requirements of its target markets and customers. We believe that Ultralife is the only battery manufacturer organized for cost-efficient customization, which enables it to focus on markets that generally are free from entrenched competition.

**Multiple products and/or customers:** Ultralife has numerous customers and makes different batteries for many different applications. However, the military currently accounts for 50-60% of revenues, which is a potential vulnerability. The company's management recognizes this, and is diversifying its revenue stream as it moves into new markets.

**Known for quality:** Ultralife's batteries typically last at least 50% longer than batteries made from alternative technologies.

**Positive earnings or cash flow:** Earnings and cash flow are positive and growing, and should be sufficient to fund Ultralife's future growth.

**Conservative financial statements:** Ultralife's financial strength at this time is acceptable. The company has approximately \$10 million in debt and a positive net cash position. Ultralife's cash balance and balance sheet should become stronger as the company grows.

**Significant insider ownership:** All directors and executive officers as a group own 8.51% of the company. As investors, this provides us with a reasonable comfort level. ■

## PORTFOLIO AT-A-GLANCE

### TOP 10 HOLDINGS\*

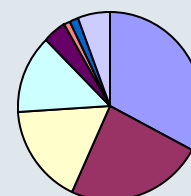
Cell Therapeutics  
Cerner Corporation  
Eclipsys Corporation  
Fair Isaac Corporation  
International Rectifier  
Invitrogen Corp.  
Nordstrom Inc.  
Qiagen, N.V.  
Royal Caribbean Cruises  
Verisign Inc.

### AVERAGE PORTFOLIO CHARACTERISTICS

Number of Holdings	41
Wtd Forward P/E	22.8x
Wtd Sustainable Growth Rate	24.9%
Median Market Cap	1.8 bil
Med Price/Book Value	3.9x

### SECTOR WEIGHTINGS\*

- Technology 32.7%
- Healthcare 24.1%
- Consumer Discret 17.0%
- Financial Services 13.6%
- Producer Durables 4.2%
- Auto & Transport 1.3%
- Materials & Process 1.5%
- Other Energy 5.6%



\*Listed in alphabetical order as of January 31, 2005.

\*based on sector definitions by Frank Russell Co.

Past performance not necessarily predictive of future results.



## Executive Insights

John D. Kavazanjian, Director & CEO  
Ultralife Batteries[NASDAQ: ULBI]

**Q:** What is Ultralife's current market strategy?

**A:** When I joined Ultralife five years ago, we had the only 9-volt lithium battery in the world. At the time, the company's strategy was to manufacture 200-250 million units annually. This might have seemed reasonable, but it also was limiting. The problem was that a lithium 9-volt battery is not advantaged over an alkaline 9-volt battery in every place a 9-volt is sold. We subsequently moved away from a focus on product, and sought instead to find unique markets and applications for our technology. These were in areas like military, medical, automotive and security. Rather than approach niche markets and say "Here's what we have," we asked, "What do you need?" The result is that our customers continually suggest viable applications that we might never have envisioned. Our growth in recent years has been driven by applications, not product.

**Q:** Right now the military is your largest market. Aside from the military, what are some of Ultralife's market opportunities?

**A:** Our most attractive market opportunities outside of the military are in the medical, automotive telematics, and rechargeable markets. Our batteries are currently used in medical instruments in the areas of analysis, monitoring, automated external defibrillators, infusion pumps and other wearable devices. We believe there are further applications for our batteries in the medical market, especially for our thin cell battery – which can be smaller than a postage stamp. We expect that eventually safety systems like OnStar will be in every car, and that the battery back-up market for these systems could be \$500 million per year. The rechargeable market, itself a \$5 billion per year sector, offers numerous opportunities across a wide range of applications, such as PCs, PDAs, and even the web pads employed by UPS and other deliverymen.

**Q:** Has the disappointing performance of U.S. auto manufacturers affected your outlook?

**A:** Actually, we see considerable potential in the emerging market for automotive telematic systems and safety products, such as OnStar. The current flaw in these systems is that if your car battery dies, your mode of communication dies, too. The car battery is essentially a single point of failure. So we created technologically advanced back-up batteries that contain no toxic substances, can sit idle for 10-15 years, and then work when needed in any type of temperature. We initially made these for Volvo, and now with General Motors planning to install OnStar in all of its models, there is renewed interest from the marketplace. We make these batteries better than anyone else, and this could prove to be a significant growth market for us.

**Q:** Were you surprised that Ultralife recently was awarded the entire Next Gen II Phase IV government contract, worth up to \$286 million?

**A:** We received 100% of the contracts for the production of five types of non-rechargeable lithium-manganese dioxide batteries, and that's unusual. It's more common for the U.S. Defense Department to split contracts among various providers. In fact, this is the first time, to my knowledge, that the Defense Department has awarded a contract this large to a single manufacturer.

**Q:** What differentiates Ultralife from its two major competitors in the lithium battery industry?

**A:** Our strategy is fundamentally different from those of our two closest competitors, Saft and Eagle-Picher. As I mentioned before, we focus on applications rather than on product. We don't perceive Ultralife as a manufacturer of lithium batteries or cells. Instead, our company is organized to customize technology to the needs of customers in a number of niche, growth sectors. In terms of creating value

through applications, we really do not have direct competition as yet.

**Q:** Considering that so many U.S. companies have outsourced their manufacturing to low-cost foreign markets, why does Ultralife have a manufacturing facility in the U.S.?

**A:** That question can be answered in a number of ways. One answer is simply that our products for the U.S. military have to be made domestically. A second is that we have made our U.S. operations highly efficient. When I joined Ultralife, we had 250 or more people making 22,000 9-volt batteries a day, with a 25% scrap rate. We now make 27,000 batteries a day with about 63 people, and our scrap rate is under 3%. If you want to manufacture in the U.S., you have to rationalize your labor and find efficiencies wherever you can in your processes. Lastly, we do manufacture some particular individual cells, mostly in rechargeable products, offshore, because that's a high volume, low-margin and sometimes labor-intensive operation.

**Q:** What are your growth expectations for the next five years?

**A:** We expect to double our revenues to \$200 million a year in the next three to five years. We're looking at a marketplace and business that can grow 25%-30% a year on a compounded growth rate basis by exploiting opportunities in our five key markets. Of course, timing is everything: automotive systems may not be rolled out when expected and medical devices may take a little longer to qualify. Our goal is to work closely with these industries, understand their applications, and create products that bring value to the marketplace down the line.

**Q:** Looking ahead, what is Ultralife's greatest challenge?

**A:** Our greatest challenge is balancing all the opportunities we have with a prudent outlook, especially in terms of the internal resources we have in place. We're pretty aggressive about going after markets, but we understand that we have to move carefully and remain within our capital and capacity constraints. ■



One Chagrin Highlands, 2000 Auburn Drive, Suite 300, Cleveland, OH 44122  
Phone: 216/292-2950 Fax: 216/292-2951

1763 East Route, Suite 202, Cherry Hill, NJ 08003  
Phone: 856/761-0540

SHAKER INVESTMENTS IS A SMALL MID-CAP GROWTH MANAGER EMPLOYING A WELL-DEFINED PROCESS  
AND ORIGINAL RESEARCH TO INVEST IN HIGH QUALITY GROWTH COMPANIES.