

**Morning Meeting Note**

**AAON, Inc. (AAON-\$23.36)**

**NEUTRAL**

*Adjust Earnings Estimates; Earnings Preview*

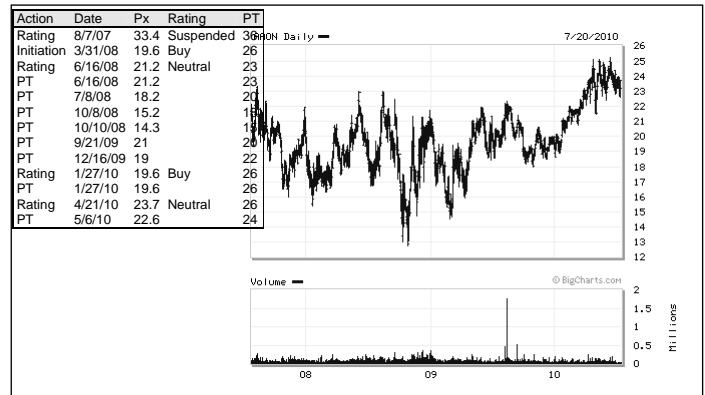
**Target: \$24**

Joseph Mondillo (212) 894-3339 (jmondillo@sidoti.com)

**July 22, 2010**

<b>Market Cap (Mil)</b>	<b>\$400</b>	<b>Price to Book Value</b>	<b>3.8x</b>
<b>Avg. Daily Trading Volume</b>	<b>77,000</b>	<b>Return on Equity (2011E)</b>	<b>19.2%</b>
<b>Shares Out (Mil)</b>	<b>17.121</b>	<b>LT Debt to Total Capital</b>	<b>Nil</b>
<b>Float Shares (Mil)</b>	<b>12.233</b>	<b>5-Year EPS Growth Rate Projection</b>	<b>15%</b>
<b>Institutional Holdings</b>	<b>52%</b>	<b>52-Week Range (NASDAQ)</b>	<b>25-18</b>
<b>Dividend</b>	<b>\$0.32</b>	<b>Russell 2000</b>	<b>613</b>
<b>Dividend Yield</b>	<b>1.4%</b>	<b>Short Interest (Mil)</b>	<b>2.022</b>

	2008	2009	2010E		2011E	
			<u>OLD</u>	<u>NEW</u>	<u>OLD</u>	<u>NEW</u>
Mar.	\$0.35	\$0.39	\$0.30A		\$0.34	
June	0.43	0.43	0.37	0.35	0.42	0.41
Sep.	0.47	0.45	0.38	0.37	0.44	0.43
Dec.	<u>0.35</u>	<u>0.36</u>	<u>0.34</u>	<u>0.32</u>	<u>0.41</u>	<u>0.39</u>
<b>EPS (Cal.)</b>	<b>\$1.60</b>	<b>\$1.62</b>	<b>\$1.38</b>	<b>\$1.33</b>	<b>\$1.62</b>	<b>\$1.57</b>
<b>P/E (Cal.)</b>				<b>17.6x</b>		<b>14.9x</b>



Note: 2009 excludes \$0.02 of one-time charges to close Canadian facility. 2008-2011E include \$0.03 in annual stock-based compensation expense. Sum of quarterly EPS may not equal full-year total due to rounding. The Russell 2000 Index includes AAON.

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010E	2011E
<b>Rev.(Mil.)</b>	\$155.1	\$148.9	\$171.9	\$185.2	\$231.5	\$262.5	\$280.0	\$245.3	\$222.3	\$259.1
<b>GAAP EPS</b>	\$0.71	\$0.72	\$0.39	\$0.60	\$0.90	\$1.22	\$1.60	\$1.60	\$1.33	\$1.57

**Description:** AAON, Inc. (www.aaonnet.com) is a leading domestic manufacturer of standard and custom heating, ventilating and air conditioning (HVAC) units, including unitary rooftops, chillers, air-handling units, make-up air units, heat recovery units, condensing units, coils and boilers. Products target the nonresidential market, specifically planned replacement (55%) and new construction (45%). AAON generates 95% of revenue in the U.S.; the majority of the remaining 5% comes from Canada. Headquarters are in Tulsa, OK.

Release Date	Conference Call	Time (Eastern)	Contact	Co. Guidance	Consensus
August 9	August 9	4:15 p.m.	TBA	N/A	N/A

**Reduce 2010-2011 EPS Estimates On Weak Construction Markets; Look For AAON To Continue To Take Market Share; Weak Markets, Valuation Cause Us To Maintain NEUTRAL, \$24 Target**

- We reduce our 2010 and 2011 EPS estimates to \$1.33 (from \$1.38) and \$1.57 (from \$1.62), respectively.
- We now project 2Q:10 sales of \$57 million (from \$59 million) and EPS of \$0.35 (from \$0.37); the reduction is partially due to the weak construction markets, but also to an estimated \$250,000 loss on the company's copper hedge.
- Yesterday, the Architectural Billings Index (ABI) for June was released and it remained below 50.0 for the 29<sup>th</sup> straight month, indicating further contraction in nonresidential construction.

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- Furthermore, the U.S. Commerce Department announced Tuesday that housing starts, which are a leading indicator to nonresidential construction, declined for the second straight month to 549,000 (a 6% year-over-year change).
  - As a result, we now expect the recovery in the demand for AAON's HVAC products to be slower than we originally forecasted.
  - Nonetheless, AAON manages a strong balance sheet (no debt; \$25 million cash and short-term securities) and we think the company's new products are gaining traction, enabling it to continue to take market share.
  - With the stock trading at nearly 15x our 2011 EPS estimate, we maintain our NEUTRAL rating and \$24 target; we derive our target by applying an unchanged 15x multiple to our new 2011 EPS estimate of \$1.57 (down from \$1.62).
- **We forecast 2Q:10 sales and EPS of \$57 million and \$0.35, respectively.** As a result of a weak nonresidential construction market, we trimmed our sales estimate by about \$2 million (\$0.01 per share). We also trim our gross margin projection by about 45 basis points to 25.6% to account for a loss on the company's copper hedge. The fair value of the futures contract AAON held at the end of 1Q:10 was \$1.67 million; therefore, with copper prices down about 15% in 2Q:10, we estimate a pre-tax loss of \$250,000 (\$0.01 per share). Overall, aside from normal seasonality, we think AAON's business and end-markets remained weak through the quarter. We expect backlog increased from 1Q:10 on seasonality, but that the company's nonresidential markets continued to bounce along the bottom.
- **We reduce our 2010 and 2011 EPS estimates to \$1.33 (from \$1.38) and \$1.57 (from \$1.62), respectively.** Yesterday, the Architectural Billings Index (ABI) for June was released, and it remained below 50.0 for the 29<sup>th</sup> straight month, indicating further contraction in architectural billings and nonresidential construction. Furthermore, the U.S. Commerce Department announced Tuesday that housing starts, which are a leading indicator to nonresidential construction, declined for the second straight month to 549,000 (down 6% year over year and 17% from their recent peak in April). Until the ABI moves above 50.0 or housing starts indicate a sustainable recovery, we estimate there are at least nine-12 months before AAON's nonresidential construction markets begin to recover. Therefore, we remain bearish on the company's end markets.
- **Nonetheless, AAON manages a strong balance sheet, and we think its is positioned to outperform peers.** At the end of 1Q:10, the company had debt of just \$53,000, cash (including short-term securities) of \$25.3 million (\$1.47 per share) and medium-term securities of \$4.6 million. We project solid free cash flow of \$28 million (\$1.63 per share) in 2010 and \$26 million (\$1.53 per share) in 2011. We think the company will begin to use cash to market and sell the new low-tonnage rooftop units, resume stock repurchases and possibly boost the quarterly dividend. In addition, AAON has recently introduced several new products to the market, which we expect to continue to gain traction in 2010 and 2011, allowing the company to gain market share and outperform peers.
- **We maintain our NEUTRAL rating and \$24 price target.** AAON historically traded at an average of 14x forward earnings, and in a range of 10x-18x. As our EPS projections imply, we think 2010 will be a difficult year. However, sales excluding seasonality will likely bottom in 2010 and begin to grow in 2011 as the replacement and new construction sides of the business recover and the company gains market share. In our view, AAON has a superior management team, premium products and a clean balance sheet. Thus, we apply a 15x multiple to our new 2011 EPS estimate of \$1.57 to derive a \$24 target. (Previously, we applied a 15x multiple to our prior 2011 EPS estimate of \$1.62 to derive the \$24 target.)

**Table 1: AAON, Inc. 2Q:10 Variance Analysis**

	<u>2Q:10 Estimate</u>	<u>2Q:09 Actual</u>	<u>YoY Change</u>
Revenue (thou.)	\$56,936	\$68,597	-17.0%
Gross profit	14,547	18,784	-22.6%
<i>Profit margin</i>	25.6%	27.4%	
Operating income	9,537	11,991	-20.5%
<i>Profit margin</i>	16.8%	17.5%	
Pretax income	9,497	11,927	-20.4%
<i>Tax rate</i>	16.7%	17.4%	
Net income	\$5,983	\$7,526	-20.5%
<i>Profit margin</i>	10.5%	11.0%	
Diluted EPS	\$0.35	\$0.43	-19.4%

Source: Sidoti &amp; Co., and Company reports