

INVESTMENT THESIS

LONG: American Reprographics Company (ARP: \$5.74)

Company	American Reprographics Company	FY1 PE (Consensus)	11.0	YTD % Change	-16.2%
Ticker	ARP	FY2 PE (Consensus)	8.8	52 Week High	21.83
Stock Price	\$5.74	FY1 EV/EBITDA (PAA)	4.7x	52 Week Low	2.54
Mkt Cap	245	FY2 EV/EBITDA (PAA)	4.1x	200-Day	10.11
Enterprise Value	560	FCF Yield FY1 (PAA)	23.3%	50-Day	4.25
Net Debt	314	ROE	26.8%	RSI	67.40
Credit Ratings	BB-/Ba3	ROIC	19.0%	Avg. Daily Vol. (000s)	383.4
Cash/Share	\$1.03	Dividend Yield	N/A		

Investment Thesis Overview:

First and foremost, we do not want this recommendation to be misconstrued as a bullish call on construction spending. We have been followers of American Reprographics Company since its IPO in 2005. The company is the unequivocal leader in the \$4.5 billion, highly fragmented reprographics industry. Although this can be stated about a number of companies, we watched with great surprise when the company's stock traded below \$3/share in the depths of March. **Although the stock has more than doubled off of its lows we still see room for substantial upside in the stock even if construction spending remains at depressed levels for the next 12-24 months.** That being said, we always try our best not to chase stocks. ARP is overbought in the short term, but we think the stock could trade higher over the next 6-9 months based on the following:

1. **Simply stated, ARP is an undervalued cash cow.** Even though ARP has been public for more than five years, the company's business model is not well understood. The company has generated FCF in excess of its net income in 16 out of the 20 most recent quarters and every single year this decade. The stock still trades with a substantial valuation discount, which we think reflects investor concerns about the company's leverage levels (56.2% debt/cap, 2.1x debt/EBITDA). Management has established a cash flow target for 2009 of \$75 million (30%+ yield), which we think is achievable if the company can manage working capital effectively and will position the company to repay debt rapidly and acquire companies in the second half of 2009.
2. **Management actions to reduce the number of branches, cut back on G&A spending and lower input costs should enable ARP to sustain near 20% EBITDA margins through the downturn.** In the previous economic recession, ARP was able to average 20% EBITDA margins from 2001-2003. This economic downturn is considerably worse, but we think management has been quick to recognize the severity and potential duration of the decline in overall construction spending.
3. **Our proprietary survey of reprographers suggests that management has set an overly conservative bar for 2009 and that overall industry activity picked up in March and April.** The midpoint of management's guidance implies a 20% decline in revenues and almost 500 bps of EBITDA margin compression. Based on our survey of reprographers across the country, it appears that

management has set an overly conservative bar. More than 40% of firms that we surveyed had witnessed a decline in sales of mid to high single digits, while another 25% have generated flat to positive sales thus far in 2009. More importantly, more than 60% of respondents indicated that sales had increased sequentially in March/April from January/February. Should this trend continue, ARP would be well positioned to deliver earnings upside over the remainder of the year.

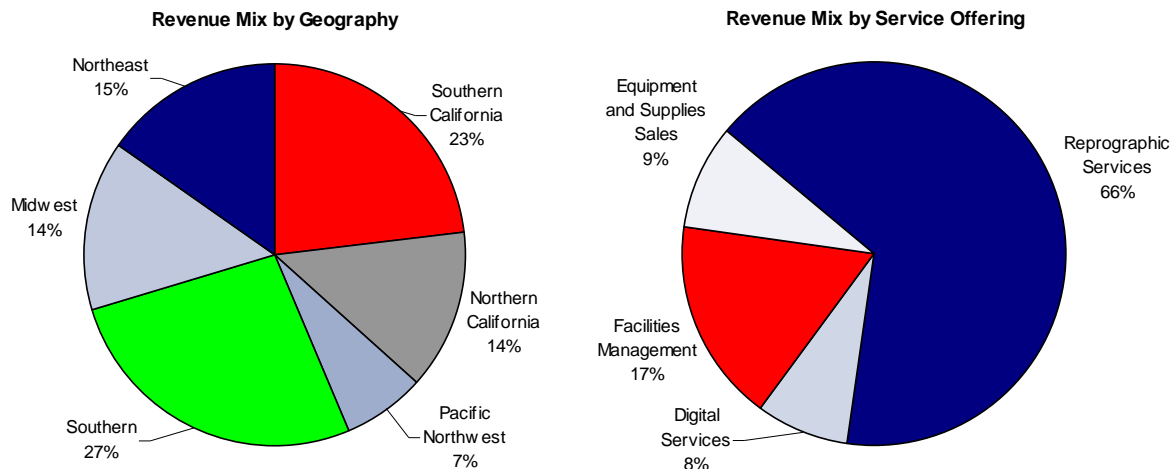
RISKS:

The risks to our investment thesis are the following:

1. The downturn in both commercial and residential real estate worsens from 1Q09 levels. ARP generates approximately 80% of its revenues from Architectural, Engineering and Construction firms targeting non-residential projects.
2. The transition towards digital document management accelerates at a more rapid rate.
3. Construction spending in California lags a nation-wide recovery. ARP generates approximately 36-37% of its revenues from the state of California alone.
4. Receivables quality deteriorates beyond our expectations.

BRIEF COMPANY DESCRIPTION AND TRADING HISTORY

ARP is the leading reprographics company in the US with approximately 299 service centers in 209 cities across the country. The company has four major service offerings: reprographic services, digital document management and planning, facilities management and equipment supplies and sales. ARP has diversified its geographic reach over the past 4-5 years, but project work in California still constitutes approximately 36-37% of sales.



Source: Company reports

Reprographics Services: The "bread and butter" of ARP

One of the most common questions people ask when looking at ARP as an

investment is: what is reprographics? In short, it is a combination of print and distribute and distribute and print. Through its core reprographic services, ARP provides customers with document management, document distribution and logistics, and print on demand services. The vast majority of prints are wide-format, or bigger than 11"x17". PlanWell, the company's digital document management service offering is also included in reprographic services. Customers are generally charged on a per-square foot basis.

Facilities Management: Onsite production, a Way to Own the Client

Through its facilities management offering, ARP installs various output devices in customers' local offices and provides staffing for the equipment and on-site document management services. ARP now has over 5,600 facilities management clients. While not as high margin as some of the companies other service offerings, ARP will typically garner a much higher wallet-share of any reprographics oriented work needed by a facilities management client, if not 100%.

Company History and Trading Background:

The history of American Reprographics dates back to 1960, when Ford Graphics, a sole proprietorship, was established. In 1967, the company changed its name to Micro Device, Inc., but reprographics services were still provided under the Ford Graphics name. In 1989, S. Chandramohan (Mohan) and K. Suriyakumar (Suri) bought Micro Device Inc. Over the past 20-years, Mohan and Suri, through both acquisition and organic growth established ARP as the leading national provider of reprographics services. ARP has been a serial acquirer of smaller players in the space, since 1997 the company has completed 130 acquisitions.

ARP's stock peaked in the first week of May 2006 at roughly \$38/share. At their peak, ARP shares traded at 29x what was then consensus EPS of \$1.31. Take a moment to compare that to today's valuation of roughly 11.0x what might be trough EPS. ARP's stock began to sell-off from its peak as organic growth slowed, which was initially caused by the downturn in residential construction. The stock sold-off further as non-residential construction trends deteriorated. The March lows represented the trough P/E valuation afforded to ARP shares since the company went public.



Short Dynamics and Insider Trading

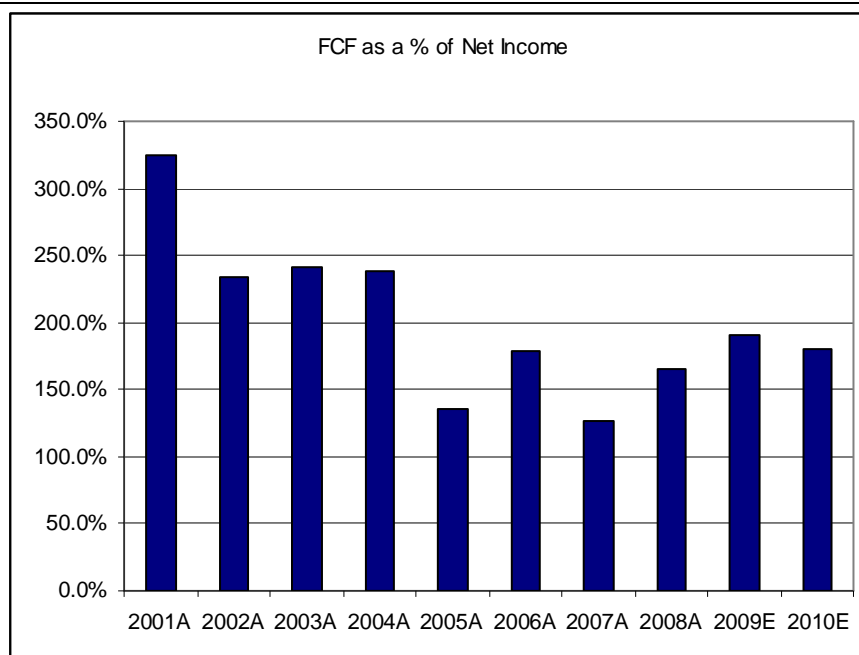
The short interest in ARP stands at a modest 541,800 shares, which represents 1.3% of the float and only 2.1 days to cover. The short interest has been at low levels since the stock declined below \$5/share.

We are encouraged by the recent insider purchases of ARP stock, most notably that by Suri. In March, Suri's family trust purchased 35,000 shares at \$2.96. Suri and his various family trusts now own approximately 17.2% of ARP shares.

INVESTMENT THESIS IN DETAIL

Our investment thesis is predicated on the following:

- 1. Simply stated, ARP is an undervalued cash cow.** As we stated earlier, we were somewhat perplexed by the magnitude of the sell-off in ARP shares in the past 6-months given the strong FCF the company has generated historically. The capital required to build out a branch is relative insignificant and the returns are remarkably high. CAPEX has represented approximately 1-2% of revenues over the past 10-years. In the past 12-months, ARP has done a better job of managing receivables, something which we expect to become increasingly difficult in the coming quarters given the economic stress on their customer base. In the table below, one can see that the company's FCF has averaged approximately 150-200% of net income over the past decade.



Source: Company reports, PAA Research

We think the company's overall leverage levels and its highly cyclical end-market exposure were primary reasons why the stock sold off so sharply during the first quarter. ARP has operated with significant leverage for the past decade. For all of 2002, ARP had leverage (total debt/EBITDA) in excess of 4.0x and interest coverage of less than 2.3x, which put greater financial constraints on the company than today's meager leverage level of 2.1x and strong interest coverage of 4.9x. As the table below demonstrates, we expect ARP to remain well within compliance for its key financial covenants over the course of the next 2-years.

Capital Structure	Pricing	Maturity	12/31/2008	% Cap
Revolving Credit Facility (\$75MM available)	L+150	Dec-12	\$0.0	0.0%
Term Loan A	L+150	Dec-12	\$261.3	40.6%
Seller Notes			\$35.4	5.5%
Capital Leases			\$64.4	10.0%
Total Debt			\$361.0	56.2%
Equity			\$281.8	43.8%
Total Capitalization			\$642.8	

Covenants	2008	2009	2010
Minimum Interest Coverage	>2.25x	>2.5x	>2.75x
Fixed Charge Coverage	>1.1x	>1.1x	>1.1x
Leverage Ratio (Total Debt/LTM EBITDA)	<3.0x	<3.0x	<3.0x

Compliance	2008	2009	2010
Minimum Interest Coverage	6.5x	6.2x	9.2x
Leverage Ratio (Total Debt/LTM EBITDA)	2.1x	2.5x	1.7x

Source: Company reports, PAA Research

2. **Management actions to reduce the number of branches, cut back on G&A spending and lower input costs should enable ARP to sustain near 20% EBITDA margins through the downturn.** Outside of equipment and branch leases, there is very little within the company's cost structure that is fixed. Employee shifts can be managed, equipment purchases deferred and logistics/route infrastructure reduced. ARP has already announced that it has closed 20 locations and reduced headcount by 200. The company operates a "hub and spoke" distribution model for its reprographics branches, which enables ARP to flex capacity based on the market opportunity. Despite the announced branch closures, ARP has not exited any major markets. In addition to the cuts at the branch level, ARP has announced that it has instituted a 5% company-wide pay cut and a 50% reduction in salary for CEO K. Suri. Management has also indicated that it has identified an additional 40 branch locations for potential closure should the environment worsen or the duration of the downturn last longer than current expectations.

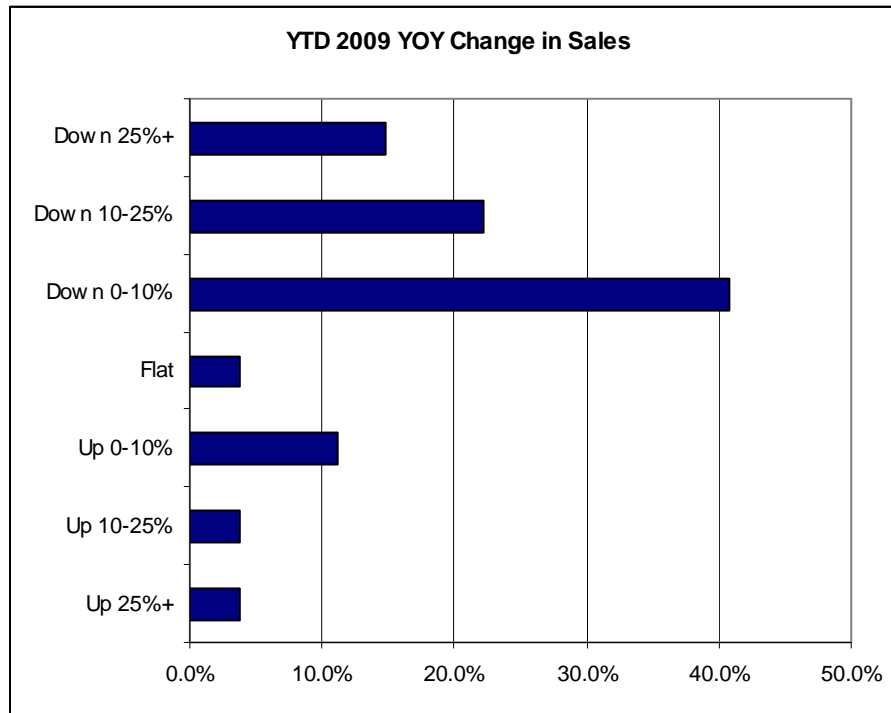
We are confident that management has a firm understanding of the magnitude, severity and potential duration of this downturn. They are clearly committed to maximizing cash flow and financial flexibility. Management has established a cash flow generation goal of \$75 million for 2009. We think the company could fall slightly short of their cash flow targets due to a larger working capital drain from slower receivable collection. Our survey results indicate that clients are paying on slower terms. We are also concerned that the company could witness a sizeable uptick in charge-offs in 2009. However, despite our more conservative assumptions, we have assumed ARP will be able to repay \$50-\$60 million in outstanding debt in 2009.

3. **Our proprietary survey of reprographers suggests that management has set an overly conservative bar for 2009 and that overall industry activity picked up in March and April.** We have conducted a survey of approximately 30 reprographic firms to gain a better understanding of how they view the current economic downturn. Following the recent uptick in the AIA Billing Index for March, we were particularly interested to determine whether or not any of these firms had witnessed an uptick in activity in the March/April time frame as compared to January/February. Overall, we found the results encouraging, particularly as it relates to management guidance for FY09. As a reminder, on its 4Q09 conference call ARP's management established revenue guidance of \$540-\$580 million, which implies a 20%+ decline at the midpoint. Here are some of the key findings of our survey:

- Industry participants overall have made better inroads into non-AEC clients than ARP has. The company still generates approximately 80% of its revenues from AEC clients, while only 41% of respondents indicated they generated more than 75% of revenues from AEC clients.
- Digital document management continues to increase as a source of

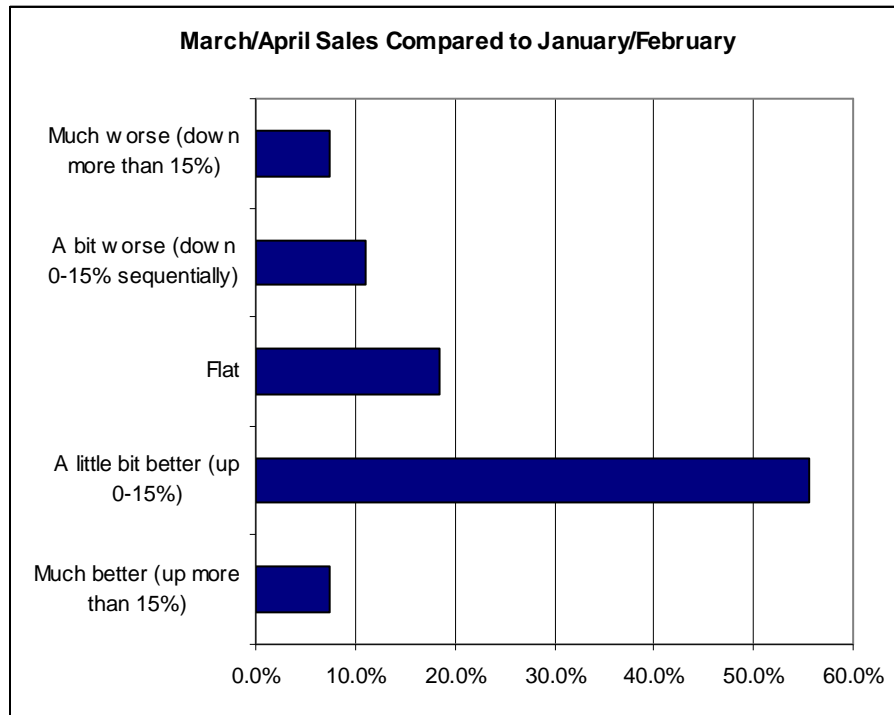
revenues, but it still remains a relatively small piece of the pie. More than 75% of respondents generate less than 15% of revenues from digital document management.

- As one would expect, sales thus far in 2009 have been weak, but maybe not down as much as feared. Overall, a surprising 22% of respondents' sales are flat or up on the year and 41% have only witnessed a single-digit YOY decline.



Source: PAA Research

- There have been several economic data points in the past 4-6 weeks that have suggested the broader macro-economic environment has stabilized, if not improved slightly from the first two months of 2009. The AIA Billings Index for March increased from 35.3 in February to 43.7 in March, the highest levels since September 2008. More than 60% of respondents to our survey indicated they've witnessed a sequential increase in sales in March/April as compared to January/February.



Source: PAA Research

- The outlook for the remainder of 2009 also doesn't appear as dire according to our survey respondents. Almost 30% indicated they expect sales to increase for the remainder of 2009.



Source: PAA Research

- Almost none of the firms we surveyed expect an increase in sales for residential construction oriented projects in 2009, while almost 40% expect to see some increase in non-residential project work.
- More than 90% of respondents have witnessed an increase in the time it takes to collect receivables
- Approximately 85% of respondents have seen some sort of pricing pressure from competitors, although at this stage it does not appear to be intense
- Outside of the overall economic environment, the transition towards digital document solutions remains of paramount concern.

VARIANCE VS. CONSENSUS

The vast majority of our estimates are based on the findings of our survey and our expectation that management's actions thus far will enable the company to sustain 20% EBITDA margins for 2009. For the first quarter, we have assumed that gross margins remain consistent with 4Q08 levels (36.7%) and then increase over the course of the year. We have assumed that the company will use almost all of its FCF to repay bank debt. We have not modeled any acquisitions into our forecasts, although we would not be surprised to see the company pursue acquisitions in the back half of 2009 to the extent the economy stabilizes and ARP's balance sheet improves. As we stated previously we expect working capital to become a drain on FCF this year, as opposed to a source of cash in 2008. We have assumed that DSO's go back to 52-54 days in 2009, despite the company's recent success in managing receivables.

	Consensus			PAA Research			Mgmt. Guidance
	1Q09E	FY09E	FY10E	1Q09E	FY09E	FY10E	FY09
Revenues	\$139.3	\$555.6	\$563.8	\$145.6	\$589.9	\$624.6	\$540-\$580
% Change	-25.7%	-20.7%	1.5%	-22.3%	-15.8%	5.9%	
EPS	\$0.11	\$0.52	\$0.65	\$0.13	\$0.64	\$0.85	\$0.50-\$0.75
EBITDA				\$27.9	\$119.4	\$137.4	
FCF				\$8.5	\$56.8	\$74.3	\$75

Source: Yahoo Finance, PAA Research LLC

CATALYSTS

We recommend scaling into a position in ARP shares. The stock is approaching 70 on an RSI basis; it appears due for a pull-back on a technical basis. There are a few positive catalysts on the horizon over the next 2-3 months, although we think the investment horizon for ARP is longer in duration (6-12 months).

1. **1Q09 Earnings (May 7th)**. The quarter will include a significant number of

charges due to severance and branch closures. Additionally, the first 8 weeks of the quarter were likely the weakest of this recession. However, we do expect the company to express confidence in its guidance, its potential to generate FCF, and perhaps most importantly speak to the sequential improvement in business trends in recent months.

- 2. AIA Billings Index for April (third week of May).** The AIA Billings Index is one of the more current economic indicators for non-residential construction activity. Based on the results of our survey, we would expect the index to show an increase from March levels, although not quite above 50, which would imply overall growth.

PROBABILITY WEIGHTED RETURN

Looking at the return on investment based not only on current valuation, but the probability weighted return given our conviction level

Upside Conviction Level: 80%

A quick look at valuation: ARP shares currently trade at 11x consensus FY1 EPS estimates. The stock trades at 3.3x trailing EBITDA and 4.5x on our 2009 EBITDA estimate. We estimate the FCF yield as 23% (30% on management's guidance for cash flow). Anyway you look at it, ARP shares appear cheap. We do not understand why ARP shares trades at a trough valuation on what is likely to be trough earnings at a time when other cyclical stocks now trade with valuation premiums. We can't help but wonder if investor concerns about the transition to digital based services has depressed valuation. That does seem unlikely given how slowly the transition has evolved and the overall lack of clarity on its ultimate direction.

We think ARP shares could trade to \$9 by the end of the year: At \$9, ARP would trade at 6x our FY09 EBITDA estimate and 14-15X on a P/E basis. Hardly a reach given the historical valuation afforded this company.

Total Probability Weighted Return: In order to better allocate capital from a timing and sizing perspective, we think it is important to look at each position on a probability weighted return basis. Overall, we think there's an 80% chance that ARP shares will trade higher over the next 6-9 months. We expect management to reiterate guidance on its 1Q09 earnings conference call and speak to the strong cash flow potential of the business as it is currently constituted. We anticipated shares could trade as high as \$9 per share in the next six-months as investors gain comfort with the company's balance sheet and revenue growth prospects. Overall the probability adjusted return is 35.9%, which we think is compelling for a 6-9 month trade.

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	\$5.74	\$9.00	60.0%	56.8%	0.5x	113.6%	35.9%
Base	\$5.74	\$7.50	20.0%	30.7%	0.5x	61.3%	
Downside	\$5.74	\$4.50	20.0%	-21.6%	0.5x	-43.2%	

Source: PAA Research LLC

HEDGING STRATEGIES TO CONSIDER

Choice of Hedge: We would consider using Servicepoint (SPSL.MC) and a basket of commercial real estate services firms as hedges to a long position in ARP. Servicepoint is a smaller competitor of ARP's in the reprographics space with operations in the US and Europe. We think firms such as CBG, JLL, CSGP, FSRV, LOOP could represent good hedges, as we do not view their FCF profile as stable as ARP's and they might not benefit from an uptick in activity as soon.

Relevant upcoming events:

April 7 th

1Q09 Results

Relevant upcoming events:

3 rd Week of May

AIA Billings Index for April

Relevant upcoming events:

3 rd Week of June

AIA Billings Index for May
