

## INVESTMENT THESIS

### SHORT: Briggs and Stratton. (BGG: \$16.26)

Company	Briggs and Stratton	FY1 PE (Consensus)	20.5	YTD % Change	-7.6%
Ticker	BGG	FY2 PE (Consensus)	15.8	52 Week High	21.51
Stock Price	\$16.26	FY1 EV/EBITDA	10.3x	52 Week Low	11.13
Mkt Cap	810	FY2 EV/EBITDA	9.5x	200-Day	14.62
Enterprise Value	1,242	FCF Yield (Trailing)	9.3%	50-Day	14.28
Net Debt	433	ROE	2.7%	RSI	67.09
Credit Ratings	BB-/Ba2	ROIC	1.2%	Avg. Daily Vol. (000s)	1001.0
Cash/Share	\$0.38	Dividend Yield	5.3%		

#### Investment Thesis Overview:

BGG's stock has increased 18% over the past month, which we attribute to the following: Increased investor appetite to own cyclicals, growing investor anticipation that a bottom in housing could be forming, and a broad-based rally in the most heavily shorted stocks. More importantly, the rally in BGG has not been sparked by anything company specific. The company will report 3Q09 results on April 16<sup>th</sup>, we anticipate this will be a downside catalyst for shares based on the following:

1. **Proprietary survey suggests management guidance for FY09 (June FYE) appears ambitious and needs to be reduced.** Management has established FY09 EPS guidance of \$0.81-\$1.01 (consensus \$0.86), which is based on a "flat" sales outlook from retailers and independent dealers. We have conducted a survey of approximately 30 independent dealers nationally, the results suggest that sales could be down as much as 10-15% and dealers are particularly cautious in taking on inventory. As a result we expect BGG to miss 3Q09 revenues and EPS and lower guidance for the remainder of the year.
2. **Slower inventory turns, orientation towards FIFO based accounting and longer term aluminum and steel contracts could limit the potential positive impact of lower commodity prices in 3Q09.** The street has factored in a meaningful gross margin benefit in 3Q09 from lower commodity costs. It is our view that the vast majority of these cost benefits will not be realized until 2010 based on BGG's slower inventory turns, greater percentage of FIFO accounting and longer term commodity contracts which have locked in pricing at higher levels.
3. **Leverage coverage could impair operation flexibility and cause the company to consider a dividend reduction.** BGG ended 2Q09 in compliance with its total leverage covenant (3.1x vs. 4.0x covenant). However, a weak spring selling season characterized by low inventory sell through and re-orders could limit the company's operational flexibility and cause the company to consider a dividend reduction. we anticipate this will be the third consecutive year that the company does not earn its dividend, which is a \$43 million use of cash annually.
4. **Disclosure of nationwide class action suit surrounding lawnmower engine horsepower marketing could pressure stock.** BGG has been named in a nationwide class action suit which alleges that lawn mower and engine and

mower manufacturers are misleading consumers by charging higher prices for mowers that are labeled with higher horsepower even though the product has the same engine as lower priced mowers. The company has yet to disclose the suit even though pre-trial conferences have already commenced.

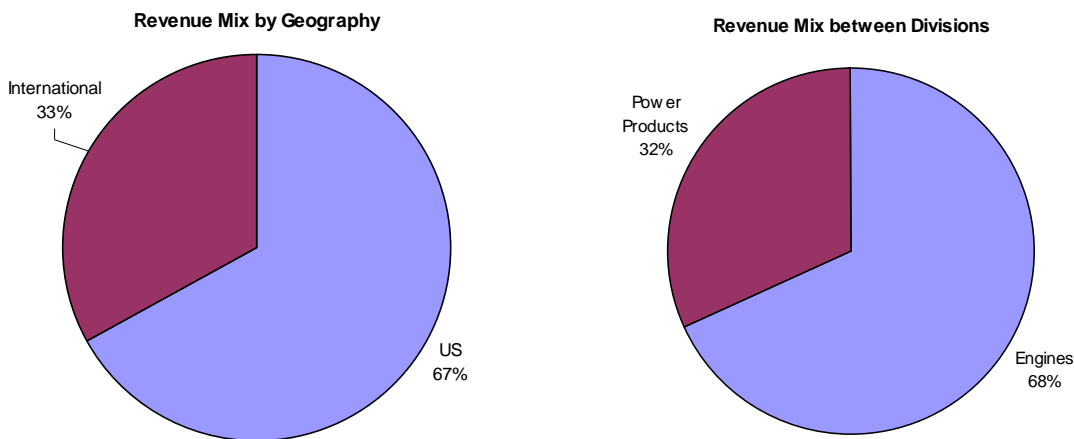
**RISKS:**

The risks to our investment thesis are the following:

1. Investors continue to look past weak results in the near term and place a bid on the stock knowing that in the past peak EPS for the company has approached \$2.50-\$3.00.
2. The benefits of lower commodity costs are realized more quickly than we currently forecast.
3. Continued incrementally positive data (or less negative) surrounding housing creates interest in highly correlated stocks. This is a short term trade and there are no significant economic releases on housing in the next two weeks, so we think that risk is significantly diminished.

**BRIEF COMPANY DESCRIPTION AND TRADING HISTORY**

Briggs and Stratton is the world's largest producer of gasoline engines for the outdoor power equipment market. The company has two primary divisions: Engines and Power Products.



Source: Company reports

**Engines Division: The Leader in Lawn and Garden Equipment**

The company's Engines division has approximately 70-75% market share in powered lawn equipment and produces product under the Briggs and Stratton brand. Final products containing Briggs and Stratton engines include lawn mowers, garden tillers and snow throwers. The top three customers for the Engines division were Husqvarna Outdoor Products Group, MTD Products and Deere and Company, which accounted for 42% of total Engines revenues in FY08. Approximately 80% of all lawn and garden powered equipment sold in the US was sold through large big box retailers such as

Home Depot, Lowe's, Sears and Wal-Mart. For BGG, approximately 25-30% of sales for the Engine division occur at Sears, 18% for both Wal-mart and Home Depot, and 10-12% at Lowe's. BGG competes with Hondo Motor Co., Kawasaki Heavy Industries, Kohler and various Chinese Manufacturers.

**Power Products: Generators and Downstream Products**

BGG's power products division manufactures power generators for home and commercial use, pressure washers, snow throwers and other garden power equipment. The company sells its products under the following brands: Briggs and Stratton, Brute, Craftsman, Murray, Snapper and Troy-Bilt, among others. BGG sells its power products in several channels including big box retailers and through 9,000+ independent dealers.

**Company History and Trading Background:**

Briggs and Stratton was founded in 1908 and developed the first lightweight aluminum engine in 1953. The company has been the leader in the outdoor power equipment market for decades now and typically produces 12 million engines for the outdoor power equipment market globally. In May 2001, Briggs and Stratton entered the portable generator market through its acquisition of Generac. In July 2004, the company made the decision to increase its downstream exposure through the acquisition of Simplicity/Snapper Manufacturing, Inc. Simplicity is a leading designer, manufacturer and marketer of a broad range of outdoor power equipment. BGG further increased its size as an OEM through the acquisition of Murray, Inc. out of bankruptcy in February 2005. At the time, Murray was BGG's third largest customer. BGG has to walk a tightrope in its efforts to increase its downstream exposure in order to avoid alienating its existing OEM customers. The company has not made a significant acquisition since industry volumes started to decline in 2005.

BGG's stock peaked in late 2004/early 2005 in conjunction with the peak in new and existing home sales. At their peak, BGG shares traded at roughly 13-14x what was 12-month forward EPS of approximately \$3.00. Over the past 2-3 years, BGG's stock has been hit by a series of negative estimate revisions relating to lower than expected industry volumes, higher commodity costs and one-time warranty costs. BGG shares are up 56% in the past month based on increased investor anticipation that housing sales have started to form a bottom.



### Short Dynamics and Insider Trading

The short interest in BGG stands at 12.6 million shares, which represents 25.9% of the float and 17.3 days to cover. The short interest has remained at elevated levels for most of this year, although we do think a large part of the recent run-up has been driven in part by significant short covering.

Over the past 12-months a number of high level executives have entered into 10b5-1 plans (Although not the CEO, COO or CFO). For the most part, the level of insider selling has been relatively modest.

## INVESTMENT THESIS IN DETAIL

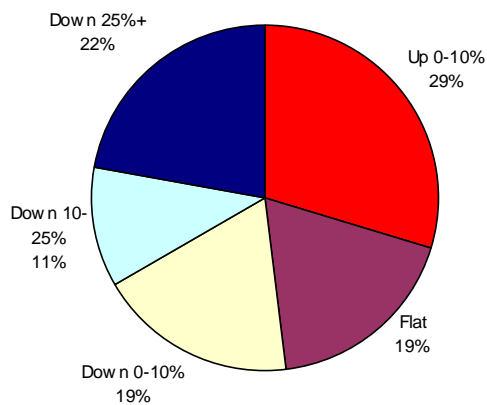
Our investment thesis is predicated on the following:

- 1. Proprietary survey suggests management guidance for FY09 appears ambitious and needs to be reduced.** Management has guided to EPS of \$0.81-\$1.01 for FY09 (consensus \$0.86), which is based on a "flat" sales outlook from retailers and independent dealers. The company generates 35-38% of its sales in 3Q09 and 25-30% in 4Q09. More importantly, BGG generates 80-100% of its operating income in the back half of the year. The spring selling season is absolutely critical for the company. Outside of the overall state of the consumer, weather is a very important factor in driving demand for lawn and garden equipment. Rain is good, drought is bad; it's that simple. BGG will typically start to take orders for inventory in September/October for the following spring. This year the company had shipped approximately 40% of its inventory on a unit basis as of 12/31/08. The company will ship the remainder of its inventory to fulfill initial spring orders in January and February, after which it is dependent on re-orders and inventory de-stocking at retail to generate incremental revenues.

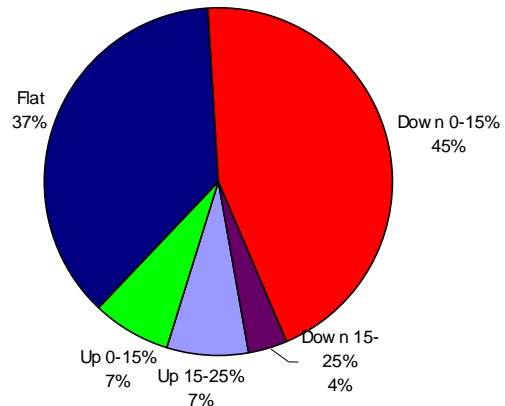
We have conducted a survey of approximately 30 independent dealers nationally, in order to better understand how sell through looks at retail at this point in the spring selling season and better understand how re-orders might shape up. Here are some of the key findings:

- More than 50% of dealers have seen a decline in sales this year, with the average decline being about 15%. Surprisingly, 30% of respondents had witnessed an increase in sales of mid-single digits.
- Dealers have been reluctant to take on additional inventory this year. 44% of respondents had reduced inventory this year versus a year ago, while 37% had the same level of inventory as a year ago.
- Approximately 60% of dealers expect sales to be down YOY for the remainder of 2009
- Interestingly enough, riding mowers have seen the strongest relative sell-through among lawn and garden equipment
- More than 80% of dealers are offering some form of 0% financing
- 70% of dealers have seen customers trade down to lower priced products "a great amount" or "somewhat"
- Only 41% and 59% of respondents plan to make re-orders for walk behind mowers and riding mowers, respectively. 15% of respondents indicated they do not expect to make any re-orders.

YOY Change in Sales Thus Far in 2009



Inventory Thus Far in the Spring Compared to a Year Ago



Source: PAA Research LLC

As previously mentioned, management's guidance for FY09 is predicated on a "flat" YOY outlook at retail. The results of our survey indicate that initial orders are down YOY and re-orders are likely to be weak starting in March and for the remainder of the spring/summer selling season. Our current revenue and EPS forecasts are based on an 8% decline in revenues for both the third and fourth quarters.

## 2. Slower inventory turns, orientation towards FIFO based accounting and longer

**term aluminum and steel contracts could limit the potential positive impact of lower commodity prices in 3Q09.** Embedded in the street's FY09 EPS forecast of \$0.86 is some level of gross margin expansion as a result of lower commodity costs. We do not think the company will witness meaningful gross margin expansion as a result of lower commodity costs until FY10. First, BGG's inventory turns have declined from a peak of 6.0x to 2.5-3.0x thus far in FY09, so it would take several quarters to pass along 4Q08 commodity costs under any circumstance. Second, BGG has a much higher percentage of inventory accounted for under FIFO relative to its peer group (53%), which will also serve to delay the benefit of lower commodity costs.

Finally and most importantly, the company has locked in commodity costs at near peak levels for most of the inventory it has produced for the 2009 spring selling season. Aluminum and steel each account for approximately 8% of COGS for BGG. The company's most recent aluminum contract expired at the end of 2008 for which pricing was set at a price of \$1.25, compared to today's level of \$0.65. Additionally, the company's steel contract was negotiated during the summer of last year and is a year in duration. This would imply that almost all of the inventory shipped in 3Q09 will have peak, or near peak commodity cost inputs.

- 3. Leverage coverage could impair operation flexibility and cause the company to consider a dividend reduction.** BGG ended 2Q09 at 3.1x on a total debt/EBITDA basis, well in compliance with its total leverage covenant of 4.0x. The company will typically draw down its revolver in the first two quarters to fund working capital needs and inventory build for the spring selling season. Typically the company will have a \$150-\$225 million cash need in the first half of the year and then generate \$200-\$300 million in FCF in the second half of the fiscal year. This year BGG did a better job of managing working capital and reduced its level of inventory build for spring, as a result the cash drain was only approximately \$60 million (before dividends). This enabled the company to maintain reasonable flexibility in its covenant compliance. However, just as the company had a smaller inventory build heading into the spring selling season, FCF generation in the second half should be substantially lower compared to FY08 levels. Should the company have a bigger inventory build in 1H10, BGG could violate its leverage covenant in 2Q10, based on our forecasts. Given the limited financial flexibility the company could have over the next 12-months, we think it's a strong possibility management might consider cutting the dividend which is a \$43 million use of cash annually.

<b>Capital Structure</b>	<b>Pricing</b>	<b>Maturity</b>	<b>2Q09</b>	<b>% Cap</b>
R/C (\$500MM w/\$250MM accordion feature)	L+100	Jul-12	\$199.7	16.0%
Senior Notes	8.875%	Mar-11	\$246.8	19.8%
Total Debt			\$451.7	36.2%
Equity			\$797.9	
Total Capitalization			\$1,249.6	
<b>Covenants</b>	<b>2Q-3Q</b>	<b>1Q &amp; 4Q</b>	<b>2Q09</b>	
Total Debt/LTM EBITDA	<4.0x	<3.25	3.1x	
	<b>2009</b>	<b>2010</b>	<b>2Q09</b>	
Interest Coverage	2.75x	3.00x	4.2x	

Source: Company reports

4. **Disclosure of nationwide class action suit surrounding lawnmower engine horsepower marketing could pressure stock.** BGG has been named in a nationwide class action suit against all lawnmower engine manufacturers. The suit alleges lawnmower and engine manufacturers are misleading consumers by charging higher prices for mowers that are labeled with higher horsepower even though the product has the same engine as lower priced mowers. Additionally, the plaintiffs allege that they have testing data from the EPA that proves that actual horsepower on mowers sold is below the advertised level. In a conversation with counsel of one of the plaintiffs we have learned they will seek damages of \$100-\$300 per mower sold all the way back to the mid 1990's. Recently, a total of 39 individual state class-action suits were consolidated and a pre-trial conference was set for late May. BGG has not yet disclosed the suit and we anticipate headlines related to the suit could create pressure or an overhang on shares.

## VARIANCE VS. CONSENSUS

The vast majority of our estimates are based on the findings of our survey and our expectation that gross margin will decline as a result of higher commodity cost inputs and lower capacity utilization. For 3Q09, we have assumed total gross margins of 15.7%, which would be down 110 bps YOY. The company plans to ship approximately 10.0-10.5 million engine units, which is well below its current plant capacity of 12.0-12.5 million units. Additionally, the company's decision to layoff more than 100 workers at its manufacturing plant in Poplar Bluff, MO serves as an indicator of how trends are evolving thus far in the spring selling season and the level of excess capacity at the company.

	Consensus			PAA Research		
	3Q09E	FY09E	FY10E	3Q09E	FY09E	FY10E
Revenues	\$721.8	\$2,230.0	\$2,290.0	\$661.8	\$2,127.7	\$2,200.4
% Change	-0.4%	3.7%	2.7%	-8.7%	-3.1%	4.4%
EPS	\$0.64	\$0.86	\$1.12	\$0.53	\$0.56	\$0.58

Source: Yahoo Finance, PAA Research LLC

## CATALYSTS

We view a short-position in BGG as a near-term trade surrounding its 3Q09 earnings release.

1. **Dividend declaration (April 15<sup>th</sup>).** Historically, BGG has declared its dividend on the day before its earnings release. We believe there is a strong chance that management could elect to cut the dividend in light of weak demand and the prospects of bumping up against its leverage covenant in the next 12-months.
2. **Release of 3Q09 results and FY09 guidance.** Our primary research suggests that initial inventory sell-in and re-orders are likely to be down substantially YOY, which is currently not factored into management guidance or street consensus. BGG has delivered EPS upside in the first half off this year, largely due to strong power generator sales following hurricanes Gustav and Ike and relatively strong snow blower sales. It seems unlikely that weather will help them this spring.
3. **Disclosure or headlines related to the class-action suit.** There is no clear timeline on when the company will choose to disclose the suit or when headlines might appear. Our expectation is that headlines related to the suit could start to appear sometime in the next 3-6 months as pre-trial conferences heat up.

## 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:** BGG shares now trade at 20.5x consensus EPS for FY09. The stock has already started to discount a major earnings recovery. Historically the stock has traded at 9-14x 12-month forward EPS. We recognize that cyclicals will trade at peak multiples on trough earnings, but we think the stock has gotten well ahead of itself and its peer group. The stock has outperformed its peer group by approximately 23% thus far this year and appears overbought on an RSI basis.

Company	Ticker	Price	Shares Out	Mkt Cap	YTD Change	FY1 EPS	FY1 P/E	FY2 EPS	FY2 P/E	5 year Avg. P/E	Mult. Rel to 5-yr	RSI	Price to Sales	Price to Book
Black and Decker	BDK	\$32.00	60.1	\$1,923	-23.5%	\$1.89	16.9x	\$2.63	12.2x	10.7x	1.4x	68.13	0.4x	1.7x
Toro Co.	TTC	\$25.05	35.8	\$897	-24.1%	\$1.59	15.8x	\$1.93	13.0x	11.8x	1.2x	45.03	0.5x	2.5x
Tecumseh Products	TECUA	\$6.25	18.5	\$116	-34.8%	N/A	N/A	N/A	N/A	21.6x	N/A	45.34	0.1x	0.2x
Briggs and Stratton	BGG	\$16.26	49.8	\$810	-7.6%	\$0.86	18.9x	\$1.12	14.5x	14.5x	1.1x	67.09	0.4x	1.0x
				<b>AVG.</b>	<b>-22.5%</b>		<b>17.2x</b>		<b>13.2x</b>	<b>14.4x</b>	<b>1.2x</b>	<b>56.4x</b>	<b>0.3x</b>	

Source: Yahoo finance

**We think BGG could trade south of \$14.00 following 3Q09 results:** At \$14, BGG would trade at 25x our FY09 EPS estimate, which we think is generous given the uncertainty surrounding the duration of the current economic downturn. Overall, we expect a

rebound in earnings power for BGG to be very modest over the next 12-months, which would suggest that a lower multiple could be used.

**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 BGG shares will trade lower after the company's 3Q09 earnings release. Should the company meet street consensus for the quarter and guide inline, we would expect the stock to trade as high as \$20, as investor's try to further discount a pending recovery in housing and unit volumes for BGG. Overall the probability adjusted return is 9.1%, which we think is sufficient for a 2-3 week trade.

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	\$16.26	\$13.50	55.0%	17.0%	0.1x	169.7%	9.1%
Base	\$16.26	\$15.00	25.0%	7.7%	0.1x	77.5%	
Downside	\$16.26	\$18.00	20.0%	-10.7%	0.1x	-107.0%	

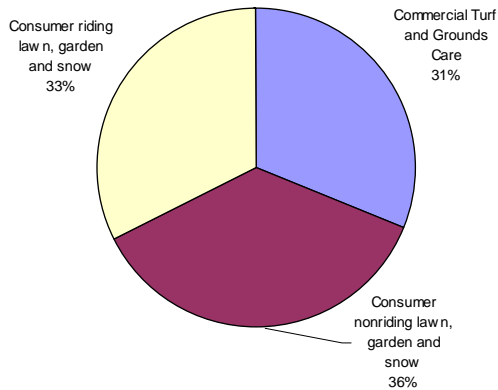
Source: PAA Research LLC

## Industry Overview

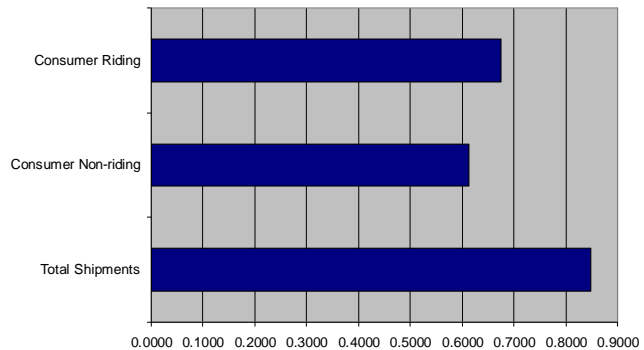
### **Total Industry Size in the US of \$7.7B**

The lawn and garden equipment market in the US was approximately \$7.7 billion in 2007 (the last period for which full year data was available). The US Census divides the industry into three major categories: commercial turf and grounds care, consumer non-riding and consumer riding. Overall the industry experienced approximately 10% cycle-to-cycle growth between the years 2000 and 2007. As one would expect the industry is highly correlated to consumer spending and more importantly housing. Consumer unit volumes of lawn and garden equipment started to show signs of slowing in 2005 in conjunction with the slowdown in housing. Overall the correlation of industry shipments to new and existing homes sales exceeds 0.80. The charts below outline the value of shipments between each of the major industry categories in 2007 and the correlation of industry shipments with new and existing home sales over the past 10 years.

**Lawn and Garden Equipment Value of Shipments 2007**



**Correlation Between Home Sales and Industry Shipments of Lawn and Garden Equipment**

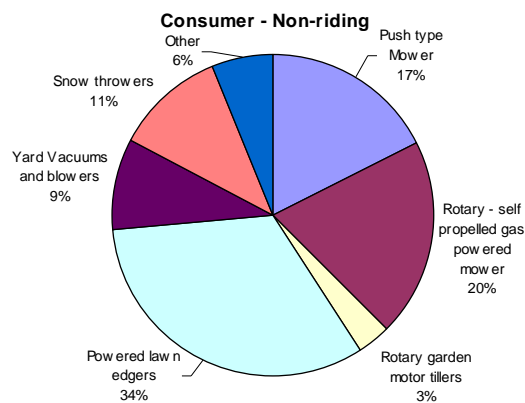


**Commercial Turf and Grounds-care Sub-sector: Later-Cycle Growth**

The commercial sub-sector of lawn and garden equipment approximated \$2.4 billion. Average ASPs for riding commercial mowers are roughly \$17,000. Unlike the consumer oriented segment, unit volumes for the commercial segment continued to increase through 2007 and did not start declining until the second half of 2008.

**Consumer Non-riding Sub-sector – Unit Volumes Still Declining**

The consumer non-riding sub-sector includes push mowers, self-propelled mowers, edgers, blowers and snow throwers. The industry had \$2.8 billion in shipments in 2007. Average ASP's for non-riding mowers average between \$150-\$300 and \$75-\$150 for other lawn equipment. Over the past 2-3 years the industry has been relatively successful in passing along the impact of higher commodity costs to consumers; pricing has been the only source of growth from 2006-2008. The first chart below outlines the value of shipments by product category for the consumer non-riding segment. The second chart compares the value of shipments in 2007 to that in 2002. Given the magnitude of this recession it is not a surprise that unit volumes were down in 2008 and will likely be down in 2009.



**Value of Shipments 2007 vs. 2002**

Consumer - non-riding	Units	Value	ASP
Push type Mower	93.9%	99.8%	106.3%
Rotary - self propelled	130.0%	134.8%	103.7%
Rotary garden motor tillers	83.5%	85.7%	102.6%
Powered lawn edgers	116.7%	155.6%	133.3%
Yard Vacuums and blowers	86.7%	94.3%	108.8%
Snow throwers	112.6%	111.0%	98.6%

**Consumer riding Sub-Sector – Most Dependent on Credit Availability**

The consumer riding segment includes riding mowers and garden tractors and totaled \$2.5B in 2007. It should come as no surprise that overall unit volumes have declined in excess of 10% YOY for each of the past three years. The average ASP for a front engine riding mower is \$1,000-\$2,000. A significant portion of consumers obtain financing in order to purchase a riding mower. In 2007 the number of front engine riding mowers shipped was already 20% below volumes in 2002. Thus far in 2009, volumes have yet to show clear signs of stabilization. During the 2009 spring selling season, many dealers are offering 0% financing or lower rates in order to induce demand.

### HEDGING STRATEGIES TO CONSIDER

Choice of Hedge: Over longer periods of time BGG shares have been highly correlated to the homebuilders and housing related retailers. Over the past 12-months that correlation broke down a bit. However, more recently the correlation has been stronger. We would consider using a basket of homebuilders and HD and LOW as a hedge against a short position in BGG.

Relevant upcoming events:  
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Relevant upcoming events:

April 15
April 16
Late May

BGG Dividend Announcement
BGG 3Q09 Results
Update on status of class-action lawsuit