

INVESTMENT THESIS

LONG: Herman Miller Inc. (MLHR: \$15.33)

SHORT: HNI Corporation (HNI, \$18.92)

Company	HNI Corporation	FY1 PE (Consensus)	99.6	YTD % Change	19.4%
Ticker	HNI	FY2 PE (Consensus)	28.2	52 Week High	34.37
Stock Price	\$18.92	FY1 EV/EBITDA (PAA)	15.0x	52 Week Low	7.70
Mkt Cap	848	FY2 EV/EBITDA (PAA)	9.1x	200-Day	14.96
Enterprise Value	1,132	FCF Yield FY1 (PAA)	1.6%	50-Day	17.35
Net Debt	284	ROE	6.8%	RSI	46.40
Credit Ratings	N/A	Price/Book	1.9x	Avg. Daily Vol. (000s)	358.6
Cash/Share	\$0.49	Dividend Yield	4.7%		

Company	Herman Miller, Inc.	FY1 PE (Consensus)	18.3	YTD % Change	17.7%
Ticker	MLHR	FY2 PE (Consensus)	15.5	52 Week High	30.54
Stock Price	\$15.33	FY1 EV/EBITDA (PAA)	6.7x	52 Week Low	7.91
Mkt Cap	823	FY2 EV/EBITDA (PAA)	5.9x	200-Day	14.60
Enterprise Value	998	FCF Yield FY1 (PAA)	10.3%	50-Day	14.42
Net Debt	173	ROE	394.1%	RSI	55.14
Credit Ratings	N/A	Price/Book	16.0x	Avg. Daily Vol. (000s)	455.4
Cash/Share	\$3.45	Dividend Yield	0.6%		

Investment Thesis Overview:

In the debate over "green shoots" we have directed our attention in large part to the state of the housing market as an indicator as to when the economy actually might improve (as opposed to getting worse at a slower rate). From that perspective, at best there are some encouraging signs and at worst some very mixed signals for economic growth over the next several years. However, we would be remiss if we didn't acknowledge the true devastation ongoing in the labor market. Simply stated: this is the worst labor market in the past 70-years. The US is on pace to hemorrhage close to 7 million jobs this year. Unemployment is likely to remain elevated for several years to come, which will significantly dampen the magnitude of any economic recovery. In this type of environment we think it is reasonable to bid up early cyclicals based on "green shoots" or "second derivative" improvements, but we find ourselves hard pressed to believe how late cyclicals (those stocks are typically more dependent on job gains) should rally.

Outside of staffing, we cannot think of another group of companies that are more dependent on employment trends than office furniture manufacturers. We have been watching the price action of a leading office furniture manufacturer, HNI Corporation (HNI), of late with considerable consternation. The stock is on a roll, up 19% YTD and an amazing 89% since 3/31/09. Even though we are not bullish on the office furniture manufacturers we think investors can generate strong returns through a pair trade – long Herman Miller, Inc. (MLHR) and short HNI Corporation (HNI). Our thesis is based on the following :

1. **This is the worst labor market in the past 70 years, don't forget it.** We recognize that a peak in weekly jobless claims might have formed and that the rate of

decline in non-farm payrolls has lessened. However, even the most optimistic economic forecaster is not looking for meaningful job growth until next year at the earliest. The playbook on the office furniture manufacturers has always been to buy these names in the early stages of an economic recovery (not necessarily at the bottom of a recession), after which gains were tougher to come by. However if this economic downturn has proven anything it's that portfolio management playbooks compiled in the past 25-years are not nearly as effective. We are concerned that the stocks of the leading office furniture manufacturers and HNI in particular have had a false dawn. The Business and Institutional Furniture Manufacturer's Association (BIFMA) currently forecasts a peak to decline trough of approximately 30%, which we think is too low given the magnitude of job losses. Additionally, BIFMA currently forecasts a modest recovery in office furniture production in 2010, which we think might be optimistic. It is important to remember that meaningful job GROWTH is a necessary condition in order for revenues and earnings to recover for this group. We anticipate it could take a few years before there is any real job growth which is currently not reflected in the sell-side outlook.

2. **We think HNI will violate their total leverage covenant within the next quarter or two, which could cause the company to drastically reduce its dividend.** We think HNI shares have been supported in large part by the company's dividend. HNI currently pays out \$0.88/share in dividends annually, implying a yield of approximately 4.7%. The dividend has become an increasingly unwieldy use of cash for the company. The payout ratio exceeds 125% and based on our projections the company will not likely cover the dividend payment with free cash flow generation. Based on our EBITDA forecasts over the next two quarters, we think HNI will violate its total leverage covenant (total debt EBITDA) of 3.0x in the third quarter. Given that the company now spends \$38-\$39 million on its dividend and free cash flow generation prospects are likely to be limited for the next 2-3 years, we think the company's lenders will ask for a large dividend reduction as part of any amendment to HNI's credit agreement.
3. **In a tale of the tape between Herman Miller and HNI, MLHR wins by a knockout There is no rational reason as to why HNI commands a valuation premium relative to MLHR.** Even though there are slight differences in the end-markets they address, MLHR and HNI shares have been highly correlated over the past 15-years. Over the past 12-months and 15 years, HNI and MLHR have had a correlation of 0.874 and 0.809. However, since March 31st of this year, HNI has outperformed MLHR by approximately 44%, which we find truly astonishing. There have only been two other periods this decade during which HNI outperformed MLHR shares by more than 30% on a 3-month basis. In the month following those two periods, MLHR shares outperformed HNI by 20% and 30%. HNI trades at almost twice the multiple of MLHR on a forward P/E basis and EV/EBITDA even though MLHR's as a company is financially superior in almost every way. We think the recent outperformance in HNI shares has created an opportunity to hedge a short position with a long position in MLHR, a company which has superior revenue growth, operating margins, FCF generation and return on equity. We expect a dividend reduction and

potential negative revisions to estimates for HNI to create mean reversion in its valuation relative to MLHR.

RISKS:

The risks to our investment thesis are the following:

1. **HNI's "Cup and Handle" technical formation.** In a market with such economic uncertainty and characterized by the ongoing debate about the formation of green shoots, we have found that investors increasingly rely on technicals to govern their investment decisions. Causality in the stock market is always difficult to peg in an absence of company specific news, but we think HNI shares have been rallying of late based on technical traders buying a "cup and handle" formation. What is a cup and handle formation? In general a cup and handle is a bullish trading pattern that marks a consolidation period followed by a breakout. There are two parts of the pattern, the "cup" and the "handle". The cup should be "U" shaped (as opposed to "V" shaped), with highs that are equal (or close) on both sides. In the chart below, you can see a solid "cup" pattern formed for HNI from January to May. A pull back following the formation of the "cup" is typically viewed as the "handle". As you can see the "handle" in this case looks like it might have been formed in the past month.



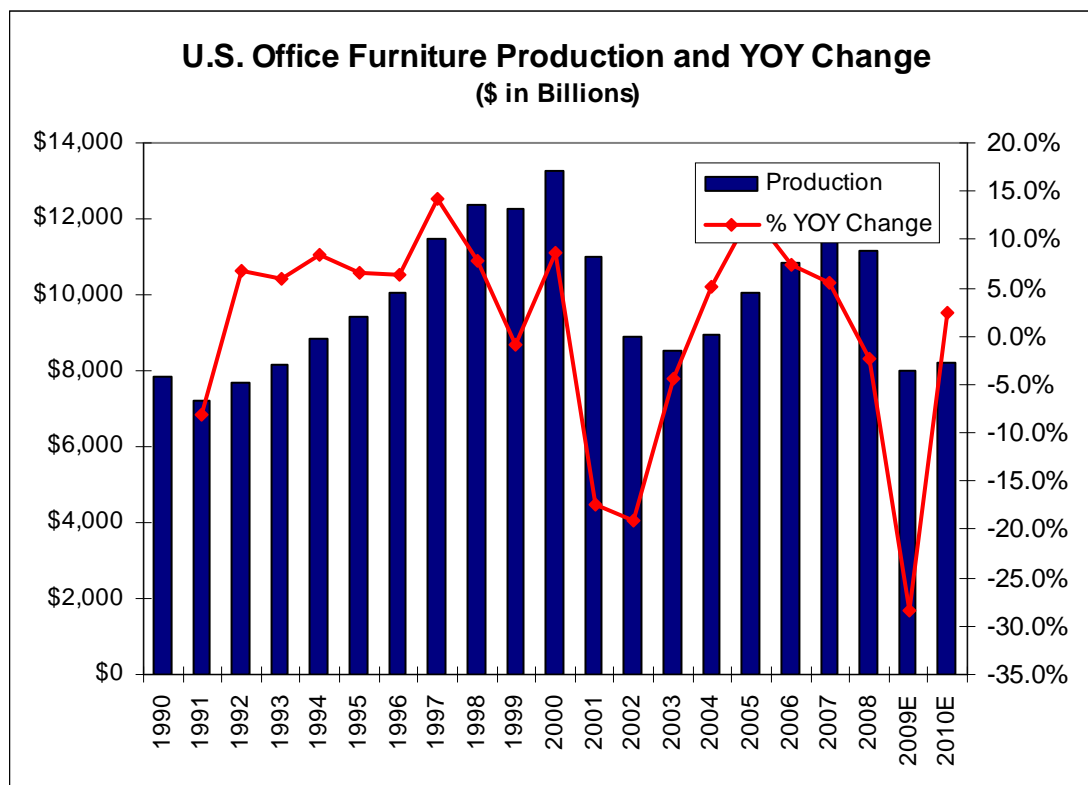
A true cup and handle formation will be characterized by a breakout on significant volume. Last week, HNI broke to new highs for the year, but on very weak volume. Overall trading volumes in the past month have been 50% of normal in the past month. Our expectation is that Wednesday's earnings release will be the test that either confirms a "cup and handle" formation or creates a different technical picture for HNI shares. We're in the latter camp.

2. **HNI is heavily shorted.** Clearly we're not the only ones who think that HNI shares have significant downside. There were approximately 6.7 million shares short as

of last month, representing a short interest ratio of 22.5 days. We think the fundamentals are likely to remain poor for HNI for several years. However that doesn't mean that shares won't rally on the most modest of "second derivative" improvements. We still think the stock will be hard pressed to find incremental buyers given the relative valuation gap to its peers who in many cases have better balance sheets and stronger brands.

BRIEF INDUSTRY AND COMPANY DESCRIPTION AND A LOOK AT THE TRADING HISTORY

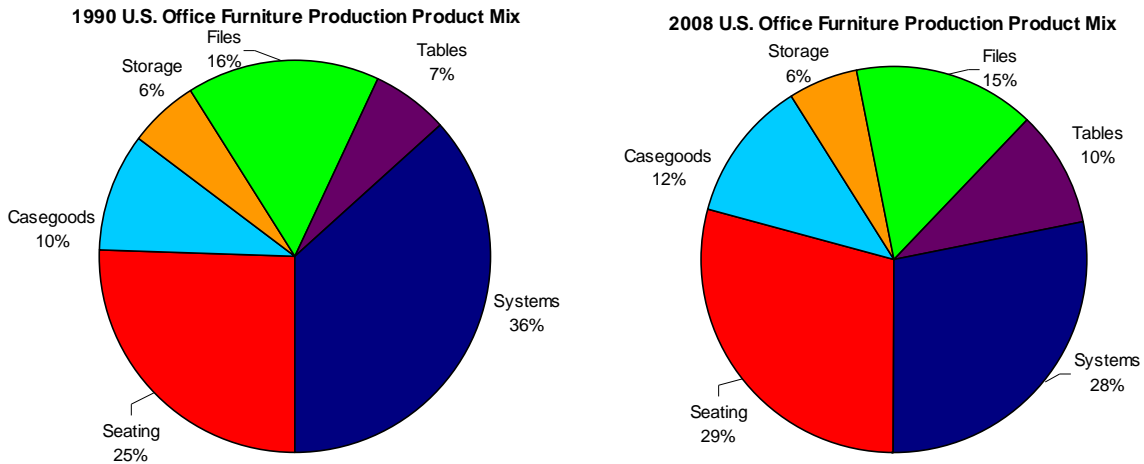
According to the Business and Institutional Furniture Manufacturer's Association (BIFMA), the total amount of office furniture produced in the U.S. declined 3.2% in 2008 to \$11.2 billion. The industry is highly cyclical and largely dependent on employment trends. 2000 was the strongest year for the industry in its history both from a production and consumption perspective due to the extraordinarily tight labor markets. As the chart below indicates, it is not uncommon for the industry to have a peak to trough decline of 25-30% over the course of a recession.



Source: The Business and Institutional Furniture Manufacturer's Association (BIFMA)

BIFMA divides the industry into 6-major product categories: seating, casegoods (storage products, desk sets), storage, files, tables, and systems. Over the past 15-20 years the percentage of industry revenues derived from systems has declined while that generated from the sale of seating and casegoods has increased. We attribute the decline in systems related revenue to a desire among corporations to reduce the

presence of "industrial" cubicles in the work place. Manufacturers have responded with more elegant desk solutions and casegoods. Seating has increased as a percentage of revenue due to the advent of ergonomic chairs such as Herman Miller's Aeron chair. The tables below compare the percentage of production coming from each product line in 1990 to that in 2008.

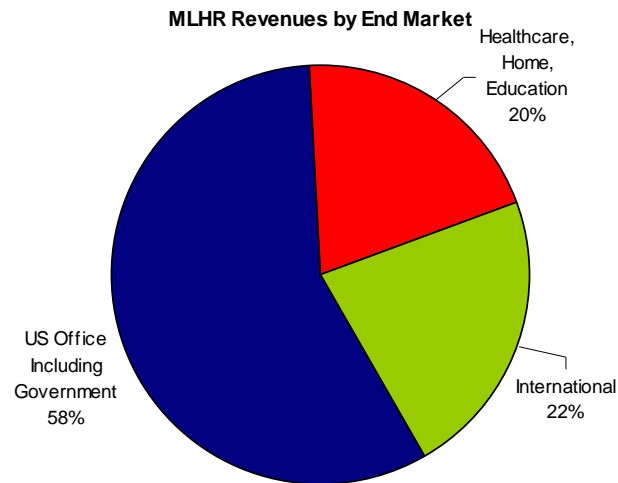


Source: BIFMA

A Quick Look at Herman Miller

Herman Miller Inc. was founded as Star Furniture Company in 1905 and has become one of the largest manufacturer's of office furniture in the world through a series of acquisitions and organic growth. The company is probably best known for its Aeron chair, but Herman Miller also has a full product suite of award winning seating, casegood, furniture systems and storage solutions. In 2008, the company was named to Fortune's "100 Best Companies to Work For", Fortune's "Most Admired", and Fast Company's "Fast 50" most innovative lists. The company has 157 active patents in the U.S. and 52 more design patents pending. The company sells 70% of its product through independent dealers.

Over the past five to ten years, Herman Miller has made a concerted effort to diversify its revenues into new end markets internationally as well as new verticals in the U.S. As a result, the percentage of revenues the company generates from the traditional office furniture channel has declined from 75% in 2001 to 58% in 2008.



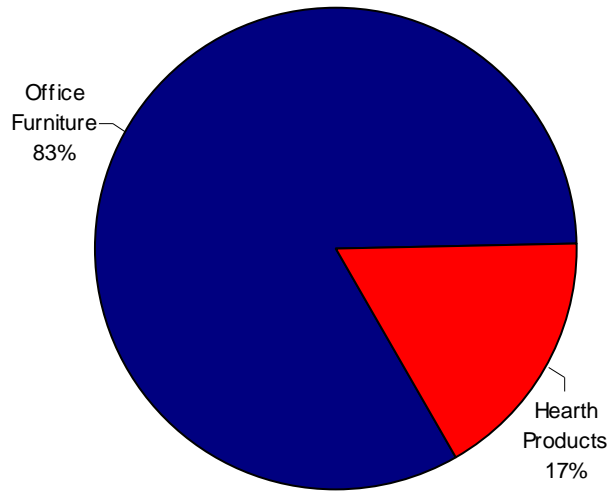
Source: Company reports.

HNI Corporation at a Glance

HNI corporation was founded in 1944 and is now the second largest manufacturer of office furniture in the world. The company has two major operating groups: office furniture and hearth products. Through its office furniture group, HNI has 9 major operating division and brands: Allsteel, Gunlocke, HBF, Paoli, Omni Workspace Company, HON, Maxon, basyx, and Lamex. The company divides its end markets for office furniture into two broad categories: the supplies driven channel and the contract channel. The end buyer in the supplies driven channel is primarily a consumer or small business. The selling model for this channel is a combination of independent dealers, and large office supply stores (Staples, Office Depot, and OfficeMax). The company has a greater percentage of its revenues coming from the supplies driven channel than do most of its publicly traded competitors (KNL, SCS, and MLHR etc.) The contract channel is where HNI has the most overlap with the traditional office furniture manufacturer. Revenue prospects in HNI's supplies driven channel and its contract channel are highly correlated, even though the end-buyer is slightly different.

HNI is North America's largest manufacturer of prefabricated fireplaces and related products. The company's hearth products include a full suite of gas, electric and wood burning fireplaces. Sales for this division are highly correlated to new home sales.

HNI Revenues by Product



Source: Company Reports

Trading Background:

MLHR shares peaked in February 2007 in conjunction with a peak in non-farm payrolls for the previous economic cycle. At its peak, MLHR shares traded at \$40, which represented 15.6x what turned out to be peak earnings for the cycle. MLHR has taken a number of steps to reduce manufacturing capacity and cut costs in order to preserve profitability. In December, the company announced plans to lay off 1,000 employees. On May 14th, MLHR announced that it planned to close a manufacturing facility in Spring Lake, MI and would reduce its dividend by 75% from \$0.088 quarterly to \$0.022. These cost reductions enabled the company to exceed street estimates for 4Q09 (May 31st FYE) and the stock rallied more than 10% on the day earnings were announced.



HNI shares peaked at \$58 in the first quarter of 2006, a full year prior to those for MLHR. We attribute this to the decline in revenues and operating income for the company's hearth products division which tracked the peak in housing. To put this in perspective, the hearth products division generated \$600 million in sales and \$58 million of operating income in 2006, compared to our forecast for 2009 for \$300 million in revenues and an operating loss. As we mentioned previously, HNI shares have closely tracked those of the other leading office furniture manufacturer's up until the last three to four months.



Short Dynamics

As of the end of June there were approximately 2.6 million shares short for MLHR, which represents 4.9 days to cover. We do not think the short interest in MLHR will play a material role in its stock price performance.

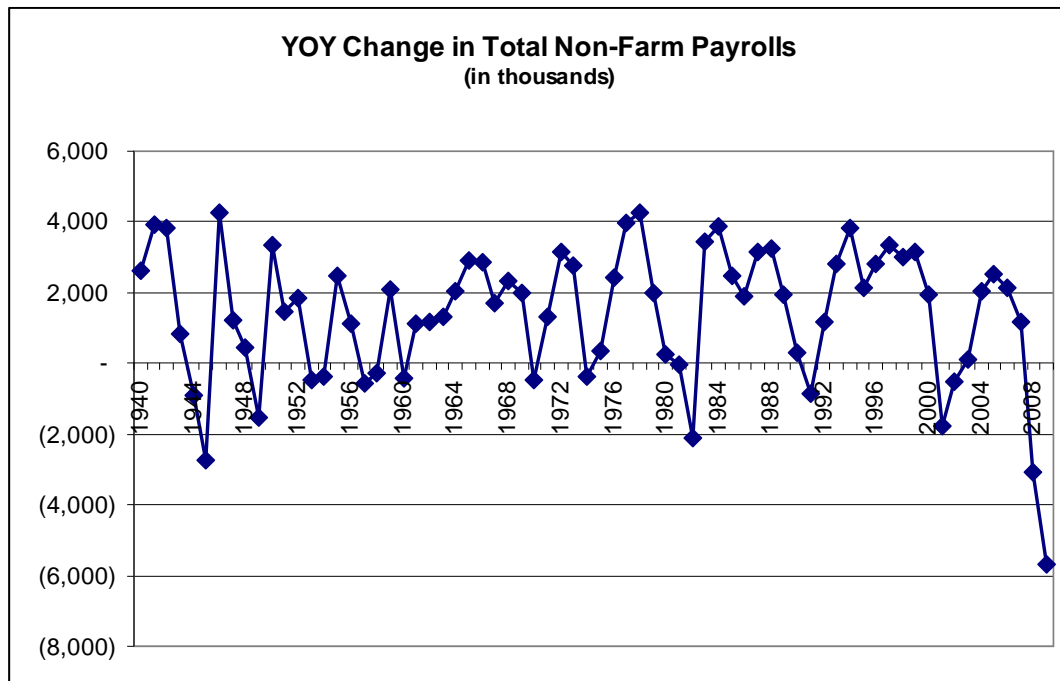
HNI is heavily shorted and investors should always be mindful of a potential short squeeze even on a modestly positive data point. As of the end of June there were approximately 6.7 million shares short, which represents 15.3% of the float and 22.5 days to cover. We think MLHR represents a superior way to play any recovery in the office furniture sector (which we view as doubtful) and continue to see rotation out of HNI given its huge valuation premium.

INVESTMENT THESIS IN DETAIL

Our investment thesis is predicated on the following:

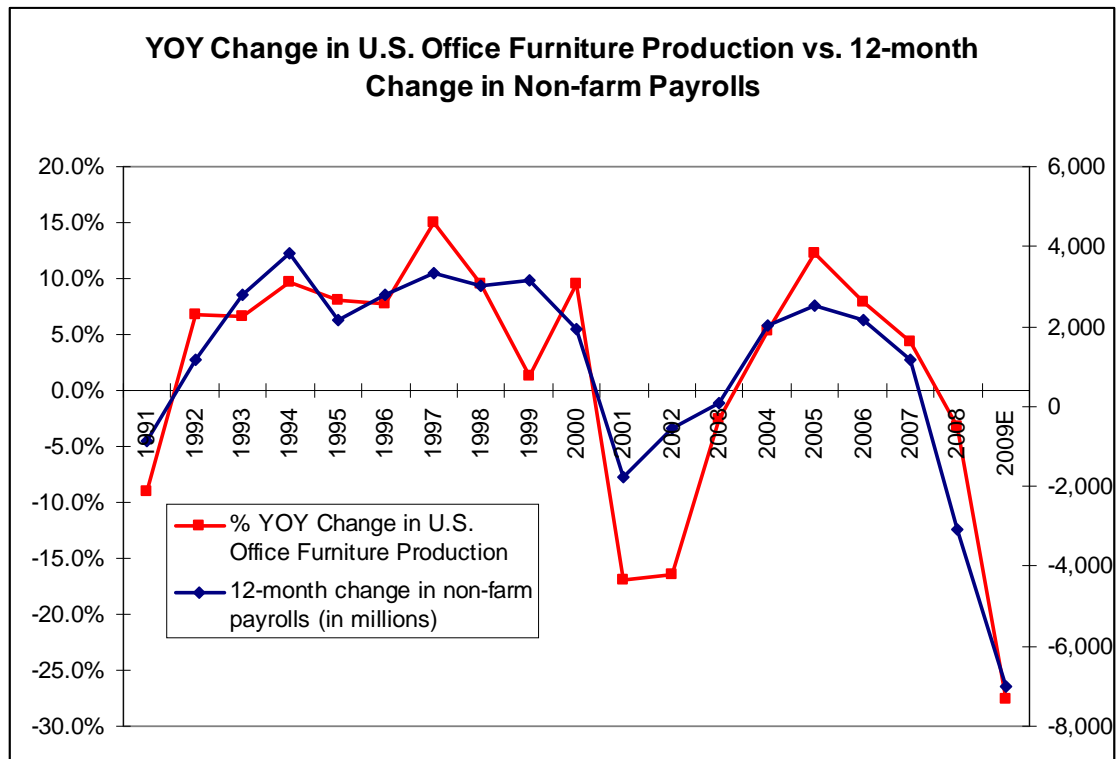
- 1. Employment is the single most important factor that drives demand for office furniture - we're in for a deep freeze.** As investors we constantly search for

parallels when evaluating companies and analyzing the broader economy. Over the past 12-18 months how often have we heard people discuss whether or not this economic downturn resembles that of the early 1980's, the mid 1970's, the post war period, or even the Great Depression. One thing is for certain, this is the worst labor market in the past 70 years. As the chart below demonstrates, the overall YOY decline in non-farm payrolls in the past year is more than twice that of any recession the U.S. economy has experienced since 1940. The magnitude of job losses is truly staggering and almost certainly will be a major impediment to consumer spending and broader economic growth for the next several years. Not only has this recession been the worst from a labor market perspective in the past 70 years, but it was preceded by an economic recovery that was most notable for its lack of job gains. Investors should not forget how "deep in the hole" this could leave many industries that are particularly sensitive to employment growth.



Source: Bureau of Labor Statistics

The U.S. office furniture market is highly correlated to labor market trends. As the chart below demonstrates, the YOY change in office furniture production has closely tracked the 12-month change in non-farm payrolls.



Source: BIFMA and Bureau of Labor Statistics

In its base case projections for 2009 and 2010, BIFMA has forecast a 28% decline in industry-wide production in 2009 and then a slight recovery in production in 2010. Overall this would imply a 30% peak to trough decline in production and consumption for the current economic downturn. This would be less than the 36% decline in production witnessed from the peak in 2000 to the eventual trough in 2003. We recognize that 2000 represented the end of an unusual period of economic growth characterized in part by incredible labor market tightness. However, the sheer magnitude of job losses thus far in this recession would suggest that the downturn from peak to trough will be even greater this time around. We anticipate it could exceed 40% and take more than three years. It appears that consensus estimates for the publicly traded furniture manufacturers are more closely tracking BIFMA forecasts rather than our more sanguine view.

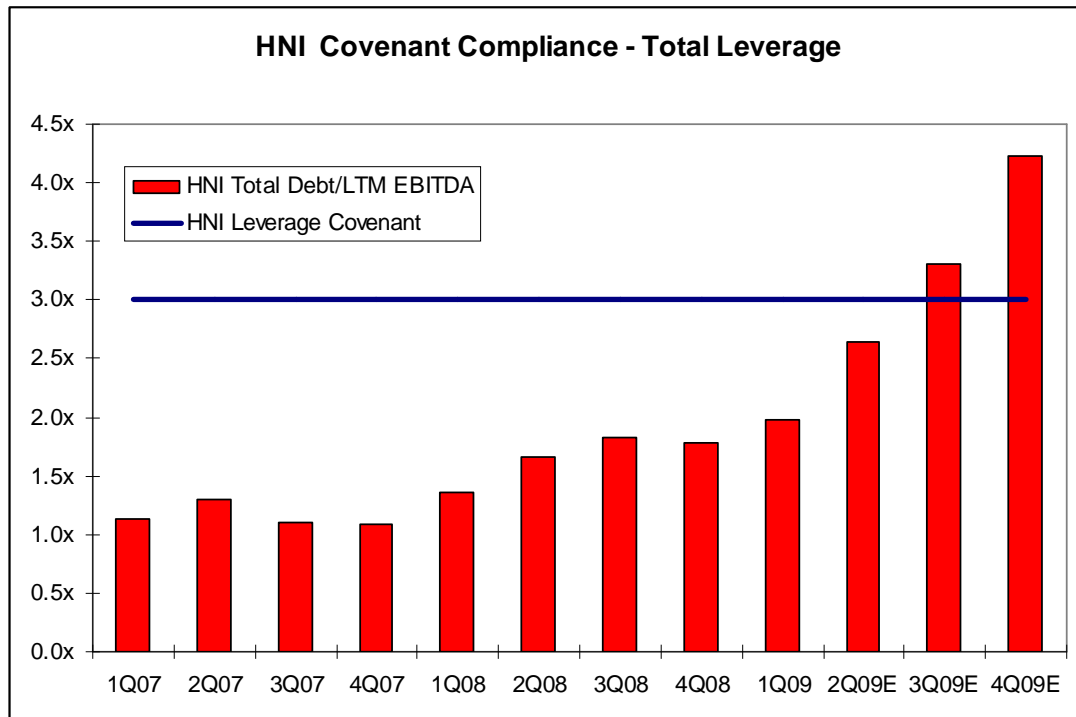
	Peak to Trough	
	Consumption	Production
Current Recession Forecast	-30.0%	-29.9%
2001 Recession	-32.4%	-36.0%

Source: BIFMA

- HNI Corporation will likely violate its total leverage covenant within the next quarter or two, which we think will result in a substantial reduction in the company's dividend.** In our view, HNI's seemingly attractive dividend yield (4.7%) has been one of the key factors supporting the company's valuation

premium relative to its peers. We anticipate the attractiveness of HNI shares from a dividend yield perspective are likely to change within the next 3-6 months. As part of its credit agreement, HNI must maintain total leverage no greater than 3.0x as measured by total debt to LTM EBITDA. Based on our forecast, we think HNI could violate its total leverage covenant as soon as the third quarter of this year. Currently the company's dividend payout ratio exceeds 125% on a TRAILING basis and overall the dividend is a \$38-\$39 million use of cash annually. Historically, HNI has generated ample free cash flow (150%+ of net income). However, given the magnitude of the downturn we do not think HNI will generate enough FCF to pay its dividend for the next 12-18 months. As a result, we think lenders will ask for the company to reduce its dividend meaningfully as part of any amendment to HNI's credit agreement.

In this environment the stigma surrounding a dividend reduction has been reduced. Additionally, we think HNI management and its lending group will look closely at MLHR's decision to reduce its dividend by 75%. Although MLHR never paid out as much as MLHR, the dividend reduction in part has enabled the company to pursue drastic reductions to its leverage levels. We think a dividend reduction would remove the last support that long investors have in HNI. The table below outlines HNI's historical compliance with its total leverage covenant and our forecasts.



Source: Company reports, PAA Research

- MLHR and HNI are highly correlated, but in a tale of the tape between Herman Miller and HNI, MLHR wins in a knockout.** HNI and MLHR shares have been highly correlated for 15-years. On a 12-month basis, the two stocks have had a

correlation of 0.874.

	HNI/MLHR Correlation
1-year	0.87442
2-year	0.83584
3-year	0.90934
5-year	0.76821
10-year	0.70957
15-year	0.80916

Source: Yahoo finance, PAA Research

Since 3/31/09, HNI shares have increased 89.2%, while MLHR shares are up a more modest 45.1%. That's 44% outperformance for two companies that have historically been highly correlated. To put this in perspective, this decade there have only been two other periods during which HNI shares outperformed MLHR shares by more than 30% on a three month basis. There was a 20-day period in the fourth quarter of 2008 and a 10-day period in the third quarter of 2002 and that's it. In 2008, the performance gap was narrowed by 30% within a month and in 2002 the relative performance of MLHR shares increased by 20%.

We find little fundamental justification for the relative outperformance. We think the long MLHR/short HNI pair trade is particularly compelling because MLHR is clearly a fundamentally superior company and a better way to play any recovery in the office furniture market, in our view. To top it off, MLHR trades at a steep discount to HNI shares. Let's take a look at the two companies side-by-side across a variety of fundamental barometers. First from a P&L perspective:

	HNI	MLHR
LTM Revs	\$2,320	\$1,630
YOY Change	-8.0%	-19.0%
Growth Most Recent Q	-28.0%	-38.4%
5-yr CAGR	7.1%	8.5%
FY1 Revs	\$1,770	\$1,330
FY1 Growth Est.	-28.6%	-18.4%
LTM Gross Margin	32.9%	32.4%
LTM EBIT	\$87	\$151
Margin	3.8%	9.3%
LTM EBITDA	\$159.44	\$192.30
Margin	6.9%	11.8%
LTM EPS	\$0.99	\$1.59
FY1 EPS	\$0.19	\$0.84
FY 2 EPS	\$0.67	\$0.99
5-yr EPS growth rate	-9.4%	52.2%

Source: Company reports, Yahoo Finance, PAA Research

Looking at the table above, one can quickly see that MLHR had stronger revenue growth over the past 5-years, has superior margins and generated higher EPS growth in the most recent cycle. One thing that skews the analysis a

little bit is the difference in the fiscal year end for each company. HNI is a standard December 31, FYE, while MLHR has a May 31 fiscal year end. This explains why the LTM revenue decline for MLHR is higher than that for HNI. Based on our forecasts the YOY revenue decline on an LTM basis will jump to 17% when HNI reports 2Q09 results.

From a working capital and CAPEX perspective, both companies appear to be very similar. CAPEX typically approximates 2-3% of total revenues, DSO's are very reasonable at 38-42 days, and inventory turnover is very high. Structurally speaking, both companies have strong free cash flow models. MLHR is better positioned relative to HNI in our view because the company has less leverage (on a net-debt basis) and does not have a huge dividend payout. It should be noted that MLHR's debt to cap has been skewed by the huge amount of share buybacks the company completed over the past 2-3 years. The company now plans to use its excess free cash flow to repay debt and currently has a \$75 million tender offer out for its 7.125% notes expiring in 2011.

	HNI	MLHR
LTM CAPEX	58.5	40.5
As a % of Revenue	2.5%	2.5%
Free Cash Flow	\$117.7	\$173.1
FCF/Net Income	225.0%	113.7%
Annual dividends/share	\$0.88	\$0.09
Dividend Payout Ratio	129.1%	5.5%
DSO	41.3x	33.3x
Inventory Turnover	27.2x	29.6x
Total Debt	316.11	377.4
Net Debt	284.11	173.2
Debt/Cap	39.5%	97.7%
Interest Coverage Ratio	10.8x	8.0x
Leverage Ratio (Total Debt/EBITDA)	2.1x	2.0x
Covenant	3.0x	3.5x

Source: Company reports, PAA Research

Based on the previous two tables, one would be rationale to assume that HNI and MLHR trade at similar valuation multiples, or perhaps MLHR trades at a premium. Of course we know that the opposite is true. From a return on capital perspective, there is no fundamental justification for HNI shares to trade at a premium to those of MLHR. MLHR consistently has had some of the strongest returns on capital employed and equity in the broader market. It is hard to believe that HNI trades at almost twice the multiple of MLHR. Mean reversion in the relative valuation appears inevitable and the downside to HNI shares with a combination of a dividend reduction and downward revisions to estimates could be considerable.

	HNI	MLHR
Stock Price	\$18.92	\$15.33
Market Cap	\$847.62	\$824.60
Enterprise Value	\$1,131.73	\$997.80
FY1 P/E	99.6x	18.3x
FY2 P/E	28.2x	15.5x
P/E Peak EPS	7.4x	6.0x
EV/FY1 EBITDA	15.0x	6.7x
LTM FCF Yield	13.9%	21.0%
Price/Revenue (FY1)	0.5x	0.6x
Price/Book	2.0x	16.0x
Dividend Yield	4.65%	0.57%
ROIC	3.6%	22.4%
ROIC 5-yr. Avg.	13.6%	23.0%
ROE	6.8%	394.1%
ROE 5-yr. Avg.	19.6%	64.2%

Source: Yahoo finance, PAA Research

CATALYSTS

We like pair trades in uncertain trading environments, the S&P 500 has been stuck in a range for the past few months between 880 and 950. We anticipate this could continue through the summer until the debate over "green shoots" is eventually resolved by the back to school and holiday seasons. Even if the office furniture market is in an "ice age" (i.e. it's frozen) we still think there are significant returns to be made. Here are the catalysts we see for the trade over the next several months.

- 1. HNI 2Q09 Results (7/22/09, before market open).** HNI will report 2Q09 results on Wednesday, before the market opens. We think the company will fall short of consensus revenue and EPS estimates and potentially announce a decision to lower its dividend. If the company does not address its dividend policy in conjunction with this earnings release, we almost certainly think a reduction will occur on or before its third quarter earnings release.
- 2. July Non-farm payrolls (8/7/09, 8:30AM).** As we highlighted above, employment trends are the single most important macro-economic factor that drives revenue prospects for office furniture manufacturers. In general the stock prices will only move on the day of a non-farm payrolls release if the result is substantially different from expectations.
- 3. August non-farm payrolls (9/4/09, 8:30AM).** See above.
- 4. MLHR 1Q10 (last September).** We expect MLHR to announce the results of its debt tender offer and progress on its cost reduction efforts. Our call here is not predicted on earnings upside for MLHR as much as it is about the company's ability to generate cash and continue to reduce leverage in this environment.

A Look at Our Estimates vs. Consensus

We see significant downside to estimates for HNI. We think the KNL 2Q09 earnings call provided a preview of what is to come. Management discussed the possibility for a sequential decline in revenues from 2Q to 3Q, which is not factored into HNI estimates. Additionally, KNL management was somewhat tepid about the prospects for a strong sequential improvement in revenues in 4Q. Lastly they highlighted how the low level of revenues will make it difficult to sustain gross margin levels even though input costs have declined a sizeable amount on a YOY basis. Here are our key assumptions for our HNI estimates:

- From a broader perspective, we think the peak to trough downturn in industry-wide U.S. office furniture production will exceed 40%
- A 35% YOY decline in 2Q09 for both office furniture and hearth product revenues
- 2Q09 gross margins of 32% (130 bps improvement from 1Q09) as a result of manufacturing capacity rationalization and lower material costs.
- Overall gross margins of 31.5% for 2009
- A 6.5% YOY decline in revenues for 2010. It is important to note that the decline in revenues for the first half of 2009 was somewhat mitigated by backlog created in 2008.
- Total FCF of \$25 million in 2009 and \$40 million in 2010, assuming CAPEX of \$30 million and \$44 million in those years respectively.

PAA Research for HNI vs. Consensus and Guidance

	Consensus			PAA Research			Mgmt. Guidance 2Q09
	2Q09E	FY09E	FY10E	2Q09E	FY09E	FY10E	
Revenues	\$401.2	\$1,770.0	\$1,700.0	\$392.4	\$1,728.6	\$1,615.5	
% Change	-34.6%	-28.6%	-4.0%	-36.0%	-30.2%	-6.5%	(-32%)-(-38%)
EPS	-\$0.08	\$0.19	\$0.67	-\$0.18	-\$0.23	\$0.52	Operating Loss
EBITDA				\$5.4	\$74.6	\$120.2	
FCF				(\$3.0)	\$11.6	\$20.6	

Source: Yahoo finance, PAA Research

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: 70% MLHR Long, 80% HNI short

We think MLHR shares could trade as high as \$20 and MLHR shares south of \$12: Our call here is not about MLHR shares being hugely undervalued. The stock appears reasonably valued given the uncertain nature and magnitude of any stabilization or recovery in the labor market. In an environment where non-farm payrolls appear to stabilize we think MLHR shares could trade as high as 20x FY11 estimates based on

investors buying in anticipation of a return to peak earnings, which in the most recent cycle were \$2.56. HNI, on the other hand should trade at a valuation consistent with that of MLHR. A 16x multiple on consensus FY10 EPS would put HNI shares \$10.50. If the company cuts its dividend and employment trends do not show any meaningful improvement we think it's possible that shares could trade to those levels.

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. In the case of a pair trade we want to evaluate the relative upside and downside in each stock. We are targeting a 25% net return from this pair trade. We think there's a 70% chance MLHR shares will trade higher in the next 6-9 months. Overall our probability weighted return is a modest 9.9%. In the case of going short HNI, we think the stock could trade as high as \$20.00 in a short squeeze scenario. Outside of that, we see downside below \$11 as previously mentioned. That yields a total probability weighted return of 23.6%.

MLHR - LONG							Total Probability Weighted Return
Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	
Upside	\$15.33	\$20.00	30.0%	30.5%	0.5x	60.9%	9.9%
Base	\$15.33	\$17.00	40.0%	10.9%	0.5x	21.8%	
Downside	\$15.33	\$13.50	30.0%	-11.9%	0.5x	-23.9%	

Source: PAA Research LLC

HNI - SHORT							Total Probability Weighted Return
Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	
Upside	\$18.92	\$11.00	25.0%	41.9%	0.5x	83.7%	23.6%
Base	\$18.92	\$14.00	55.0%	26.0%	0.5x	52.0%	
Downside	\$18.92	\$20.00	20.0%	-5.7%	0.5x	-11.4%	

Source: PAA Research LLC