

AAON, Inc. (NasdaqGS: AAON)

INDUSTRY: CAPITAL GOODS

DISCLOSURES: 6A

See last page for disclosures

RATING: STRONG BUY

RISK: MODERATE

CLOSING PRICE 08/06/08	TRAILING P/E (TTM)	SHARES OUT (MILS.)	MARKET CAP (MILS.)	3 YEAR EPS GROWTH	PRICE TARGET
\$19.58	15.1	18.1	\$354.4	18%	\$25.00

ANNUAL DATA – DECEMBER YEAR END			
	2007A	2008E	2009E
EPS	\$1.22	\$1.51	\$1.64
P/E	16.0	13.0	11.9
REVENUE (MILS.)	\$262.5	\$280.2	\$315.0
P/S	1.35	1.26	1.13

EARNINGS					
	Q1	Q2	Q3	Q4	ANNUAL
2009E	N/A	N/A	N/A	N/A	\$ 1.64
2008E	\$ 0.35	\$ 0.43	\$ 0.42	\$ 0.35	\$ 1.51
2007A	\$ 0.33	\$ 0.36	\$ 0.28	\$ 0.24	\$ 1.22
2006A	\$ 0.20	\$ 0.18	\$ 0.28	\$ 0.35	\$ 0.90

AAON reported a record second quarter with revenue growth of 5.6% to \$74.8 million and an EPS increase of 19.4% to \$0.43 on fewer shares outstanding. Much of the earnings growth came from expansion in gross margin, which came in at 24.1% and better-than-expected; management expects to maintain a gross margin in the 23% plus area. We are maintaining our 12-month price target of \$25 and our **STRONG BUY** rating.

- Second quarter revenue growth was 5.6% to \$74.8 million.
- Operating margins came in at 15.9% and net margin was 10.4%.
- Net income rose 12.8% to \$7.7 million.
- Share repurchase program for the quarter amounted to \$15.4 million, or 697,358 shares.
- Approximately 45% of AAON's revenues come from replacement demand for old HVAC units.
- Backlog at quarter end was approximately \$67 million, down about \$10 million YoY. Almost all of the decline is attributable to the Canadian operations. The order rate is slightly ahead of the price increases.

Revenues were essentially in line with of our estimate of \$74.0 million. Gross margins at 24.1% were higher by 110 bps than our estimate and SG&A at 8.2% was lower than our estimate of 8.7%. The highest gross margin in recent history was last year's Q107 gross margin of 26.8%. The tax rate at 35.2% came in as expected. Net income of \$7.760 million came in higher than our estimate of \$6.947 and EPS of \$0.43 was five cents above our estimate. YoY fully-diluted share count was down by 6%.

	Q208	Q207	%
Revenues, net	\$ 74,781	\$ 70,835	5.57%
Gross Profit	17,990	15,598	15.34%
Gross Margin	24.06%	22.02%	NM
Net Income	7,760	6,877	12.84%
EPS Diluted	\$ 0.43	\$ 0.36	19.44%

The revenue gain for the quarter was a combination of 3/4 price increases and 1/4 volume. The large capital spending program that commenced in 2004 is bearing fruit and has driven cost down, particularly in the sheet metal operations. Gross margins came in higher than we estimated and management continues to implement price

increases. On the call, management mentioned that they thought they would need another price increase of 3% to 5% to cover component cost increases, some of which are expected to run up to 15%. We expect this price increase to be announced in approximately 60 days. Providing that commodity and component costs remain stable we believe that gross margins can be maintained in the 22.5% to 24.5% area.

Highlights for the quarter include:

- Backlog at quarter end was approximately \$67 million compared to \$77 million a year ago and the decline is attributable to the Canadian operations. We believe that due to production efficiencies (shorter lead times) that the company will operate on a lower backlog of perhaps eight weeks.
- Production in the quarter was not constrained by a labor shortage as was discussed on the last conference call. Productivity is rising.
- The company anticipates announcing a 3% to 5% price increase within the next 60 to 90 days.
- Wal Mart Stores (NYSE: WMT: \$60.76 - Not Rated) is currently testing several new high-energy efficient systems.
- Units with the new environmentally-friendly refrigerant R410A are selling well and comprise almost all of larger unit volumes. Because the penetration rate of the newer refrigerant is so high, management expects to cease production of the older models by year end.
- The new foam panel products that increase the R-value and use less steel to construct are selling well. They comprise about 40% of sales and are expected to increase to 60% plus in the next 12 months.
- Capital spending for the quarter was \$0.418 million and is expected to run between \$7 million and \$10 million for the year. Most of the expenditures will be for an additional 100,000 square feet of assembly space. Capital spending for 2009 is not expected to exceed the 2008 amount.
- SG&A increased in the quarter to 8.2% of revenues vs. 7.4% last year. On the call, management indicated that SG&A would run between 8.5% and 9% for the balance of the year and for the first half it came in at 8.6 %.

Canada, which produces high-end custom products, had been plagued with a large backlog without price protection for the weak US dollar. Prices were increased by 30% in April of 2007. For the quarter, Canada had a modest operating loss on revenues of approximately \$2 million. The large backlog has been worked off and now the operation needs additional revenues, as we do not believe that it can become profitable unless revenues approach \$4 million on a quarterly basis. Management now believes that the pricing is adequate and that the prior operating difficulties are behind them. Approximately 80% of Canadian production is for the US market. Annual capacity is approximately \$45 million. We now believe that management wants to wait and see if enough revenue can be generated from Canada to bring it to profitability. If it is not profitable soon we would expect the operation to be shut down or moved to Tulsa. Several quarters ago it was thought that the Canadian operations initially would generate annual revenues of \$12 million and grow from that base.

Over the past six years, AAON has spent \$66 million on new plant and equipment (\$17 million in 2006, \$10.8 million in 2007) automating its production process for sheet metal, adding new equipment for the production of coils and new product development. Norman Asbjornson, President, believes that the re-positioning of the company is complete. The product line is now complete and the factories are now ready to efficiently produce more product. AAON is ready for the next three to five years with current plant capacity of approximately \$400 million and management is ready to go after market share. After the assembly area is increased by 100,000 square feet, capacity should approach \$600 to \$700 million.

Large national account business represents less than 10% of sales. The sales base continues to broaden and so does the opportunity to get better margins. The national account business has always been very competitive and difficult to maintain reasonable margins. AAON has been able to grow its customer base, which consisted of two

major accounts when Norman Asbjornson joined the company in 1989. When the industry contracted in 2002 and 2003 the competitive landscape only got worse. On the last call, management gave out revenue by market segments, which they had not previously provided; Education 25% to 30%, Retail low 20%, Office 15% to 18% and Other approximately 30%. Management indicated that the Education, Medical and Health markets are stable to strong, Office and Manufacturing are stable and the only real soft market is Retail.

As pointed out in the past, the introduction of the new line of residential replacement units has slipped by two years now. The marketing for these products is web-based and management is now prepared to increase marketing efforts, however residential revenues are not expected to have a material impact on 2008 results. From an industry standpoint, approximately 75% of residential unit sales are replacement units and 25% go into new construction. The pricing environment for residential units is difficult at best and is generally viewed as a commodity. Management believes that they can generate the same gross and operating margins from this business as they do on their other business. AAON does have a technological advantage when it comes to dehumidifying when cooling is not required.

New product introductions over the past 36 to 48 months are helping drive revenue growth. All of the product lines can be purchased with R410A, which is the environmentally-friendly refrigerant. This refrigerant is required by 2010 and will replace Refrigerant 22. Buyers of these products include Kroger (NYSE: KR: \$28.74 – Not Rated), Dillard's (NYSE: DDS: \$10.46 – Not Rated) and Wendy's (NYSE: WEN: \$22.45 – Not Rated). It appears that the adoption rate for the new refrigerant is gaining momentum as approximately 75% of shipments in the quarter were with the R410A. Additionally, AAON now offers larger tonnage units, large air handler and water chillers.

Newer energy efficient units are also selling well. New units use 20%-30% less electricity than units installed 10 years ago or so. The energy savings payback in certain areas of the country can be 3-3½ years. New foam composite panels, which increase the R-value or insulation, are available on indoor air handlers and roof top units. These products now account for approximately 45% of revenues and are expected to represent 70% in the next 12 months. These composite panels also reduce the amount of steel required to build the unit. The company is currently promoting the foam products and is hopeful that higher R-values ultimately become required by building codes. AAON believes that they are the only manufacturer offering the foam panels on rooftop units. The company has also gone to direct drive blowers, eliminating belts and the associated maintenance issues with belt drives.

The balance sheet remains in good shape, as there is only \$194,000 of long-term maturities. Annual depreciation of about \$10 million should cover the estimated capital spending for 2008 of \$7 million to \$10 million. Cash at quarter end was \$0.5 million. For the quarter, stock purchases amounted to \$15.4 million or 697,358 shares. There are approximately 330,000 million shares left in the stock buy back plan. To support working capital needs or the buyback AAON drew on its bank line in the amount of \$4 million.

Outlook. Management gave limited guidance, however business looks better to them than the general media outlook for the economy as a whole. The third quarter is expected to be another good quarter and 2008 is shaping up to look like a record year. Primarily because of a significant drop off in the backlog at the Canadian operations and resulting drop in expected revenues coming from these operations we are reducing our Q308 revenue estimate from \$78 million to \$74 million and fourth quarter from \$68 million to \$66 million. We slightly reduced our gross margin assumption by 20 bps and raised SG&A expense by 10 bps. Other changes to our model include a reduction in share count from 18.2 million to 18.0 million fully-diluted for the year. Our second half net income estimate is reduced by \$770,000 while there is virtually no change in our net income figure for the year; however, due to share count assumptions our EPS estimate has been raised by a penny to \$1.51. Net income is estimated to

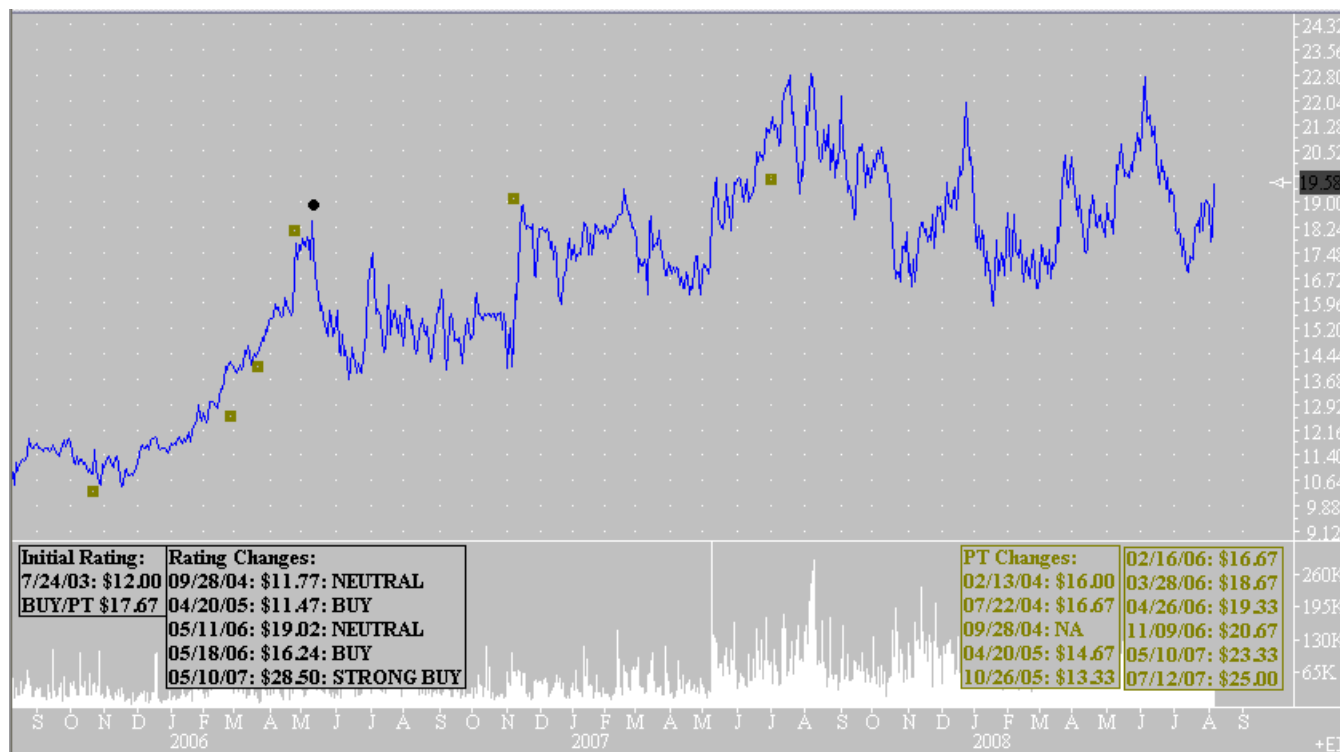
increase by 17.6% for the year. Our estimate for 2009 is for an earnings increase of 8.7% to \$29.6 million and EPS of \$1.64.

The shares are trading at 11.9 times our 2009 estimate and 6.4 times estimated EBITDA. The semi-annual dividend is \$0.32 and the shares have a current yield of 1.6%. We are maintaining our 12-month price target of \$25 and our **STRONG BUY** rating.

Risks include the cyclical nature of the construction market, commodity costs, rising interest rates, start up problems with new equipment and continued operating losses from the Canadian operation.

Company Background

AAON engineers, manufactures and markets air-conditioning and heating equipment, consisting of standardized and custom rooftop unit, chillers, air-handling units, make-up units, heat recovery units, condensing units, coils and boilers. The company has gained market share through its “semi-custom” product lines, which offer the customer value, quality, function, serviceability and efficiency. Custom units are marketed and sold to retail, manufacturing, educational, medical and other commercial industries.



AAON Inc.												
Income Statement												
For the Years Ended December 31												
8/6/2008												
		Mar	Jun	Sept	Dec		Mar	Jun	Sept	Dec		
	2006A	1Q07A	2Q07A	3Q07A	4Q07A	2007 A	1Q08 A	2Q08 A	3Q08 E	4Q08 E	2008 E	2009 E
Total revenues	231,460	58,628	70,835	70,907	62,147	262,517	65,456	74,781	74,000	66,000	280,237	315,000
YoY Change	25.0%	9.3%	19.8%	10.5%	13.9%	13.4%	11.6%	5.6%	4.4%	6.2%	6.8%	12.4%
Cost of Goods Sold	187,570	42,906	55,237	57,267	49,738	205,148	49,804	56,791	56,758	51,282	214,635	242,550
Gross Profit (Loss)	43,890	15,722	15,598	13,640	12,409	57,369	15,652	17,990	17,242	14,718	65,602	72,450
Gross Margin	19.0%	26.8%	22.0%	19.2%	20.0%	21.9%	23.9%	24.1%	23.3%	22.3%	23.4%	23.0%
Selling, general and admin	18,059	5,747	5,270	5,492	5,194	21,703	5,902	6,129	6,475	5,676	24,182	27,090
Total operating expenses	18,059	5,747	5,270	5,492	5,194	21,703	5,902	6,129	6,475	5,676	24,182	27,090
Operating Income	25,831	9,975	10,328	8,148	7,215	35,666	9,750	11,861	10,767	9,042	41,420	45,360
Operating Margin	11.2%	17.0%	14.6%	11.5%	11.6%	13.6%	14.9%	15.9%	14.6%	13.7%	14.8%	14.4%
Other income (expense):												
Interest expense	(81)	(10)	3	(3)	-	(10)	(3)	(16)	(30)	(5)	(54)	(20)
Interest income	24	3	3	1	1	8	21	6	25	25	77	100
Other income	424	188	82	(346)	(245)	(321)	130	117	100	100	447	100
Total other inc. (exp)	367	181	88	(348)	(244)	(323)	148	107	95	120	470	180
Pre-Tax Income (loss)	26,198	10,156	10,416	7,800	6,971	35,343	9,898	11,968	10,862	9,162	41,890	45,540
Taxes (benefit)	9,065	3,839	3,539	2,418	2,391	12,187	3,464	4,208	3,802	3,207	14,680	15,939
Rate	34.6%	37.8%	34.0%	31.0%	34.3%	34.5%	35.0%	35.2%	35.0%	35.0%	35.0%	35.0%
Net Income	17,133	6,317	6,877	5,382	4,580	23,156	6,434	7,760	7,060	5,955	27,210	29,601
Net Income Per Share	\$0.90	\$0.33	\$0.36	\$0.28	\$0.24	\$1.22	\$0.35	\$0.43	\$0.39	\$0.33	\$1.51	\$1.64
Fully diluted shares	18,978	18,902	19,038	19,003	18,767	18,927	18,311	18,145	18,000	18,000	18,000	18,000
Depreciation & Amort.	9,146	2,273	2,387	2,493	2,512	9,665	2,457	2,381	2,375	2,375	9,588	9,500
EBITDA (OPS)	34,977	12,248	12,715	10,641	9,727	45,331	12,207	14,242	13,142	11,417	51,008	54,860
EBITDA margin	15.1%	20.9%	18.0%	15.0%	15.7%	17.3%	18.6%	19.0%	17.8%	17.3%	18.2%	17.4%
EBITDA per share (OPS)	\$ 1.84	\$ 0.65	\$ 0.67	\$ 0.56	\$ 0.52	\$ 2.40	\$ 0.67	\$ 0.78	\$ 0.73	\$ 0.63	\$ 2.83	\$ 3.05
Ratios:												
Selling, general, admin - %	7.8%	9.8%	7.4%	7.7%	8.4%	8.3%	9.0%	8.2%	8.8%	8.6%	8.6%	8.6%
Net margin	7.4%	10.8%	9.7%	7.6%	7.4%	8.8%	9.8%	10.4%	9.5%	9.0%	9.7%	9.4%

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AAON, Inc.														
Balance Sheet														
(\$ thousands, except per share)														
	Mar	Jun	Sept	Dec	Mar	Jun	Sept	Dec	Mar	Jun	Sept	Dec	Mar	Jun
	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Assets:														
Cash	370	236	394	837	3,466	66	467	288	550	326	2,715	879	5,474	505
Certificate of Deposit	3,000	2,500	-	1,000	-	1,000	-	-	-	-	-	-	-	-
Accounts receivable, net	28,698	27,731	33,487	32,487	34,265	37,637	46,350	36,748	37,535	46,177	41,887	38,813	36,502	49,555
Inventories, net	23,496	23,210	23,444	23,708	23,458	23,895	29,721	29,502	32,684	34,444	32,738	31,849	33,003	31,389
Prepaid expenses	583	231	647	1,041	1,202	383	614	267	307	516	409	442	567	725
Deferred tax asset	3,537	4,343	4,984	3,877	4,003	3,670	3,991	3,954	3,783	4,314	4,473	4,312	4,124	4,459
Total Current Assets	59,684	58,251	62,956	62,950	66,394	66,651	81,143	70,759	74,859	85,777	82,222	76,295	79,670	86,633
Property, plant and equipment, net	50,608	50,653	51,661	50,581	54,419	58,440	59,653	59,222	61,490	61,937	61,003	60,770	59,213	57,250
Notes receivable, long-term	75	75	75	75	75	75	75	75	75	75	75	75	75	75
Total assets	110,367	108,979	114,692	113,606	120,888	125,166	140,871	130,056	136,424	147,789	143,300	137,140	138,958	143,958
Liabilities and Stockholder's Equity														
Current liabilities:														
Revolving credit facility	1,347	258	445	-	-	2,225	6,497	-	-	-	-	-	-	4,087
Current Maturates of LTD	108	108	108	108	108	108	86	59	32	5	-	91	91	91
Accounts payable	11,018	11,779	14,112	11,643	12,836	16,481	19,249	15,821	14,870	17,225	12,284	15,059	15,457	18,023
Dividends payable	-	-	-	-	-	-	-	2,465	-	2,497	-	2,943	-	2,848
Accrued liabilities	17,684	15,171	15,874	17,827	19,909	17,518	21,496	16,058	19,413	21,756	20,448	19,414	19,530	24,837
Total current liabilities	30,157	27,316	30,539	29,578	32,853	36,332	47,328	34,403	34,315	41,483	32,732	37,507	35,078	49,886
Long-term debt	140	116	86	59	32	5	-	-	104	72	72	239	216	194
Deferred tax liability	5,630	5,528	5,494	4,474	4,205	3,969	4,016	4,061	3,740	3,592	3,658	3,974	3,433	3,576
Stockholders' equity	74,440	76,019	78,573	79,495	83,798	84,860	89,527	91,592	98,265	102,642	106,838	95,420	100,231	90,302
Total liabilities and equity	110,367	108,979	114,692	113,606	120,888	125,166	140,871	130,056	136,424	147,789	143,300	137,140	138,958	143,958
Shares outstanding	18,572	18,529	18,468	18,409	18,457	18,588	18,513	18,507	18,507	18,711	18,740	18,054	18,061	17,281
Book value / Share	4.01	4.10	4.25	4.32	4.54	4.57	4.84	4.95	5.31	5.49	5.70	5.29	5.55	5.23
Cash / Share	0.02	0.01	0.02	0.05	0.19	0.00	0.03	0.02	0.03	0.02	0.14	0.05	0.30	0.03

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Rating	% of covered companies with this rating	% For which IB services have been provided	Rating Description
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Buy	48.0%	10.0%	Purchase is recommended. The security is expected to outperform the general market over the next 12-18 months.
Neutral	38.0%	0.0%	The share price has moved above the specific 'Buy' range and appreciation potential is less than or equal to the market.
Sell	0.0%	0.0%	The stock has reached the target price and/or conditions have changed sufficiently to alter the outlook for the stock.
N/R	0.0%	0.0%	No investment rating has been assigned at the present time.

NOTE: TRG changed its institutional ratings scale on 10/4/04. Previously, TRG used Buy, Hold, Sell

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- High** The security is more volatile than the market and/or the company is more leveraged than its peer group.
- Moderate** The security has about the same volatility as the market and/or the company carries a level of leverage in line with its peer group.
- Low** The security is less volatile than the market and/or the company is less leveraged than its peer group.

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