

COMMUNICATIONS

October 19, 1981 — Initiation of Coverage

EQUITY RESEARCH

AOE

(NASD: AOE) — RATING: BUY

Current Price (10/18/1981 @ close)	\$27.50
Current Ratio ¹	2.35
Quick Ratio	1.48
Inventory Turnover	12.28
Days to Sell Inventory	30
Net Profit Margin (%)	4.91
Total Debt/Total Assets (%)	4.25
Total Debt/Invested Capital (%)	8.41
Dividend Yield (%)	None
Fiscal Year End	December

Based in Iowa City, Iowa, AOE is an electronic communications provider and a leading designer and manufacturer of cellular and wireless phones. It is also a provider of both landline and wireless network service. It also has significant local, long distance and cellular operations.

- ◆ WE ARE INITIATING COVERAGE OF AOE WITH A BUY RATING BASED UPON PREDICTIONS BY INDUSTRY EXPERTS THAT THE NUMBER OF CELLULAR PHONE USERS WILL INCREASE AT A COMPOUND ANNUAL GROWTH RATE OF NEARLY 50% PER YEAR OVER THE NEXT FIVE YEARS.
- ◆ AOE IS GAINING MARKET SHARE THROUGH AN AGGRESSIVE AND CREATIVE ADVERTISING CAMPAIGN.
- ◆ WE BELIEVE PER SHARE EARNINGS COULD EXCEED 'CONSENSUS' ESTIMATES OVER THE NEXT TWO FISCAL YEARS.
- ◆ AOE IS WELL POSITIONED TO OUTPERFORM ITS INDUSTRY PEERS.

¹ All ratios calculated as of September 1981

Investment Hypothesis

POSITIVES

- The company is experiencing very strong demand in the 15-28 age range market for its improved Mercury product line. Mercury sales increased 50% from the first quarter of 1980. Unit gains translate into a 3 percentage point increase in Mercury's share of the communication device market.
- We expect plans to diversify the product line over the next few quarters.
- AOE has cultivated an important and strategic alliance with SC Communications. The AOE/SC partnership has real potential to meet its objectives: to change the "competitive battle field" from what it is today by setting new technological standards and to gain control of the principle technologies in the cellular phone and network service industry – which is currently controlled by larger rivals, WC Communications and MHC Wireless.
- AOE is faster than its competitors in restructuring. The plan is to reduce operating expenses in order to balance lower gross margins.

NEGATIVES

- AOE is having difficulty filling orders and should continue to do so until next March when new assembly methods are implemented and make production more efficient.
- The general communications industry is facing a slump with little sign of an upswing any time soon due to weak global economies and a strong dollar.
- Short-term sales may also prove sluggish due to the product transition cycle that AOE currently faces.
- In FY 1981, AOE has seen its revenues declining every quarter, gross margins dropping and operating profit falling from year-ago levels.

SUMMARY

AOE is a strong company with serious potential to survive and succeed in this competitive industry. However, it also faces some real challenges. There are growing concerns of an imminent price war in this industry, which would eat away at AOE's earnings. Also, AOE is increasingly having difficulty maintaining its uniqueness and market share with the introduction of the very popular network services provided by AOE's major competitors, WC Communication and MHC Wireless. Another challenge that AOE faces, since the departure of founder Jim Swarthout, is establishing a strong management team with a unified vision for AOE's future.

Background

In 1973, Jim Swarthout started AOE as a local wireline service provider for eastern Iowa. The company went public in 1975, and was a favorite among analysts and investors. As a result, AOE grew rapidly and expanded into the wireless devices and service provider market and is largely responsible for the enormous growth of the cellular industry in the Midwest. Swarthout was determined to design a product line that was relatively easy to use and affordable. The 1979 debut of the Mercury line, which included car phones, cordless phones and the first cellular phones, established the company as a pioneer in cellular design and whose products became known for their innovative technology. In its first few years, AOE's technology and component parts were the fastest and cheapest offered by any communications device manufacturers, which gave AOE a strong market share. Eventually, sales tapered off after a promising start for AOE, and SC Communications quickly caught up and overtook the dominant market share. In the late 1970's, internal problems began to plague AOE, and CEO Swarthout was ousted and replaced by his own second-hand man, Gregor Andrade.

Revenue Sources

AOE's two sources of revenue come from its phone revenue and its network service operations revenue. Its phone revenue comes primarily from its wireless division, with its wireline phones providing 8% of its total revenue. Its network service revenue also comes predominantly from its wireless network services. However, it has maintained a fairly strong share in the local and long distance wireline network service as well.

AOE Communications
Balance Sheet as of September 1981
(\$ Millions)

Assets

Cash and Short-Term Investments	892.7
Receivables	907.2
Inventories - Total	671.7
Other Current Assets	392.1
<i>Total Current Assets</i>	<i>2,863.6</i>
Property, Plant and Equipment - Net	
Other Assets	182.0
Total Assets	3,493.6

Liabilities

Notes Payable	148.6
Accounts Payable	357.1
Income Taxes Payable	14.9
Accrued Expense	418.6
Other Current Liabilities	278.0
<i>Total Current Liabilities</i>	<i>1,217.1</i>
<i>Total Stockholders' Equity</i>	<i>2,276.6</i>
Total Liabilities and Stockholders' Equity	3,493.6

Common Shares Outstanding	118.39
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AOE Communications
Income Statement as of September 1981
(\$ Millions)

Sales	6,309
Cost of Goods Sold	3,110
Selling, General and Administrative Expense	2,323
<i>Operating Income Before Depreciation</i>	<i>876</i>
Depreciation and Amortization	204
Nonoperating Income and Special Items	(172)
<i>Pretax Income</i>	<i>500</i>
Income Taxes - Total	190
Net Income (Loss)	310

Earnings per Share - Excluding Extraordinary Items	1.29
Common Shares Used to Calculate Primary EPS	240.57