

N E W S

L E T T E R

Invest

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Interstate National Dealer Services

(Ticker Symbol: ISTN)

Greetings from LFS

is:



Here is my quarterly newsletter, *Invest*. The goal of *Invest* is to keep you abreast of what is happening in the financial market, inform you about new investments and keep you informed about your current investments. I welcome any questions, comments or suggestions.

Sincerely,
Doug Ruth

Invest

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Summary: Interstate National Dealer Services (ISTN) can be purchased at its tangible book value. The company has developed a successful business model. The stock out-performed the Standard and Poor 500 from October 31, 1995 until January 31, 2002. More recently, however, the stock's performance has been disappointing. There is tangible proof that the company is performing better. Investors who buy the stock at the current level should receive a satisfactory return over a relatively short period of time.

General: Interstate National Dealer Services (ISTN) began operations in November 1991. The company purchased INDS group, which was started under the name Interstate National Dealer Services Group in 1981. The company designs, markets and administers service contracts and warranties for new and used motor and recreational vehicles. They also provide the same products and services for watercraft, motorcycles and other vehicles to a lesser extent.

Marketing: ISTN markets its services and products using its network of independent agents. The company has not disclosed how large this network is currently, but the 1997 *Annual Report* mentioned that the company had 100 active agents at that time. These agents contact dealers, leasing companies, finance companies, and other service contract marketers.

Agents work on straight commission. Every time one of "their" customers, typically a dealer, sells a service contract they receive a commission.

ISTN markets its products to the agents through trade shows and advertising in trade publications. To assure a high level of competence and awareness of current administrative services and products, the company provides initial and on-going training for its agents and dealers.

ISTN also maintains its own third party direct marketing facility. This facility contacts prospects who did not purchase a service contract at their dealer when the vehicle was purchased.

ISTN products are sold under 7 different brand names:

1. **Interstate Auto:** Interstate Auto products are offered through franchised dealers. Coverage is underwritten and insured by Orion Capital, members of the Royal & Sun Alliance USA Group of companies. Royal & Sun USA is part of the London-based Royal and Sun Insurance Group PLC, which operates and transacts business in over 130 countries worldwide, and ranks as one of the 10 largest multi-line companies in the world, with more than \$100 billion in assets and \$17 billion in premiums.
2. **Interstate Star Auto:** Interstate Star Auto products are offered through franchised or independent dealers and are underwritten by National Service Contract (NSC) Insurance Company. NSC is owned by ISTN.
3. **Interstate AutoGuard:** Interstate AutoGuard products are offered through Credit Unions and other financial institutions, and are underwritten by Royal & Sun Alliance USA Group.
4. **Secure Value:** Secure Value contracts are offered through franchised dealers and are underwritten by member companies of the Travelers/Gulf Insurance companies. The Member Companies of Gulf Insurance Group are subsidiaries of Travelers Property Casualty Corporation, which is a member of Citigroup. Citigroup is one of the largest financial service companies in the world.
5. **Interstate Star RV:** Star RV products are offered through NSC.

6. **Interstate Star Sport:** The Interstate Star Sport division provides coverage on motorcycles, ATVs, snowmobiles and personal watercrafts. Coverage is underwritten by NSC. NSC was formed partially to allow ISTN to increase its penetration into these markets.

7. **Interstate Star Marine:** Star Marine products are offered through NSC.

Four levels of coverage are offered to customers:

1. **Power:** "Major medical" type coverage for the power train, including the engine and transmission, the two most expensive components of the vehicle.
2. **Golden:** More extensive than the "Power" coverage, eleven vehicle components are covered by this plan.
3. **Platinum:** Seventeen vehicle components are covered by this plan.
4. **Diamond:** Commonly referred to as "bumper to bumper" coverage, the Diamond Plan covers almost everything. If a component breaks or wears out, and is not among a short list of exclusions, the plan covers it.



A service contract can be sold by one of three different entities:

1. **Seller:** The seller originating the sale of the vehicle; for example, General Motors or Ford, or one of their dealers.
2. **Financial Institution:** The financial institution financing the sale; i.e., a Credit Union.
3. **Other entities:** This includes ISTN, who sells the contract to the owner of the vehicle after purchase.

A vehicle service contract is an agreement between either the seller or administrator of the contract and the vehicle purchaser. Under the service contract the seller or administrator agrees to replace or repair designated vehicle parts for a specific length of time in the event of a failure. A service contract is essentially an insurance policy that offers the purchaser "peace of mind." The purchaser can relax because if a major problem develops with the vehicle, "it will be taken care of" by the contract. Vehicle service contracts are in lieu of manufacturer's warranties and provide a variety of extended coverage options (typically ranging from three months to seven years and/or 3,000 miles to 150,000 miles).



Initially, the company focused its business on extended warranties for new automobiles and to a lesser extent used cars. In the past five years, however, a higher percentage of sales are from warranties for used cars. In addition, the company has expanded into other markets and has realized an increasing portion of revenues from its recreational vehicle programs.

The mechanics of a vehicle service contract start when the customer purchases the contract from the seller. In most cases, the seller of the contract is free to determine the price at which the service contract will be sold to the purchaser.

It is important to understand that a car dealer has the opportunity to profit in several separate transactions that all come together in selling a vehicle:

- The sale of the vehicle itself.
- The sale of add-ons such as undercoating, rust proofing or fabric protection.
- The opportunity to provide financing.
- The sale of a service contract.

Each vehicle sale is unique. The dealer with his or her representatives decide which of these menu opportunities to pursue on each sale. The dealer can raise or lower the price of each of these menu

items depending upon the situation. Understanding this explains why two people could buy the same car and the final price could be dramatically different.

ISTN determines a net rate, in fact, this is the dealer's cost for the contract. The net rate ranges from \$75 to over \$3,000 per contract with a typical average net rate per contract of \$700 for a new or used car, \$650 for a new recreational vehicle, and \$850 for a used recreational vehicle.

After the contract is purchased by a customer, the proceeds are divided as follows:

1. **Administrative fee:** Ranges from \$30 to \$300. ISTN pays the seller of the contract a commission of \$10 to \$150. The agent who signed up a particular dealership to sell ISTN products receives this commission. Please consider this simple example. If there is a dealership named Jones Buick and Debbie Smith is the agent who is able to get the dealership to sell ISTN products, Debbie would receive a commission for every contract sold by Jones Buick.
2. **Insurance premiums and fees:** A fee for the insurance underwriter. This portion represents the amount that is used to pay for the insurance.
3. **Claims reserve:** Money set aside in an interest-bearing account to pay the customer's claims.

Sale of a Service Contract for a Typical New or Used Car: If a customer paid \$1,000 for a service contract, the following list shows how the money would be split:

Dealer Profit	\$300
Commission	\$75
Administrative Fee (retained by ISTN)	\$75
Insurance Costs	\$50
Claims Reserve	\$500

ISTN rewards the sellers of its contracts with increased compensation if they either:

- Achieve stated sales volume goals.
- Sell contracts to customers who have claims that are below a preset level.

Understanding ISTN: ISTN makes money for its investors in two ways:

- 1. Operations:** Historically, the company has generated a profit from its operations. You can see that the operating income margin is trending down and for fiscal 2001 it was negative. More information will be provided about this later.

ISTN Operating Revenues							
(in \$Millions)							
	1995	1996	1997	1998	1999	2000	2001
Revenues	\$13.7	\$21.4	\$37.9	\$49.3	\$56.2	\$61.7	\$59.9
Costs of Services Provided	\$3.4	\$6.4	\$16.8	\$24.0	\$28.1	\$33.7	\$33.8
Cost of Services as a % of Revenues	24.5%	30.2%	44.4%	48.6%	50.1%	54.6%	56.4%
Sales, General & Administrative Expense:							
SG&A Expense	\$10.0	\$13.7	\$18.3	\$21.8	\$24.8	\$26.5	\$26.5
SG&A as a % of Revenues	72.4%	64.4%	48.2%	44.3%	44.2%	43.0%	44.3%
Operating Income:							
Cost of Services Provided	(24.5%)	(30.2%)	(44.4%)	(48.6%)	(50.1%)	(54.6%)	(56.4%)
SG&A	(72.4%)	(64.4%)	(48.2%)	(44.3%)	(44.2%)	(43.0%)	(44.3%)
Operating Income as a % of Revenues	<u>3.1%</u>	<u>5.4%</u>	<u>7.4%</u>	<u>7.1%</u>	<u>5.7%</u>	<u>2.4%</u>	<u>(0.7%)</u>
	100%	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %

- 2. Investments:** ISTN also makes money by investing. The Claims Reserve belongs to the customers who bought service contracts. The company, however, keeps the income generated by these reserves. This is a substantial sum and it is growing.

	Investment Income	Claims Reserve
1995	\$364,502	\$6,723,792
1996	\$499,118	\$12,653,771
1997	\$771,702	\$20,111,223
1998	\$1,483,296	\$28,216,427
1999	\$1,869,802	\$37,262,045
2000	\$3,212,400	\$48,474,194
2001	\$3,842,280	\$56,799,324

The key to understanding the beauty of ISTN's business is the term *float*. Float is the income generated by the Claims Reserve. ISTN does not own this money – the customers do. In the service contract business, float arises because premiums are received before losses are paid. In 1995 through 2000, ISTN produced an operating profit. In effect, it cost the company nothing to have use of the float. Since there was an operating profit, the

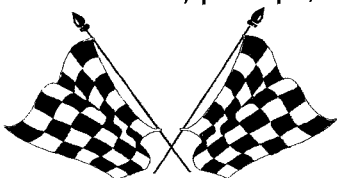
company did not have to use any of the funds in the Claim Reserve to pay its customers' bills.

The year 2001 shows the negative side of float. The company lost money. In 2001, for every dollar of premiums collected, ISTN paid out \$1.01. So the company had to access the Claims Reserve to pay some of the customer bills.

The ability to generate an operating profit and grow the size of the Claims Reserves are the keys to operating a successful service contract business. If a company can generate an operating profit, something ISTN was able to do 1994 through 2000, the company gets to use the float for free. If a company can increase the size of the claims reserve, often more investment income can be generated. Success is being able to repeat this cycle many times over many years.



Understanding some financial concepts can often be difficult. A simple example, however, illustrates float and operating profit very clearly. Essentially, when someone buys insurance or a service contract, there is a winner and a loser. What is cruel, perhaps, is realizing that sometimes



you have to lose to win. If Joe spends \$500 to buy a \$100,000 life insurance policy on January 1, 2001 and he is still alive on

December 31, 2001, he is the loser and the insurance company is the winner. Joe and his family had peace of mind for 2001 knowing that he was insured. If Joe dies in 2001, he is the winner (that's the cruel part) and the insurance company is the loser. The insurance company pays out \$100,000 after collecting only \$500. In theory, the insurance company's book value would go down after paying out the death claim to Joe's family because the insurance company would probably have to access the Claims Reserve. Also, the company would probably have a loss from operations.

According to actuary tables, a male today has an average life expectancy of about 75 years. So if an insurance company sells 1,000 insurance policies, the group, on the average, should live to be about 75. If this is the case, and if the insurance company priced the policies correctly, the company should be profitable consistently.

Measuring Results -- Book Value: The best way to measure the success or failure of a service contract business is to measure an increase or decrease in the book value. ISTN has done a wonderful job at increasing book value.

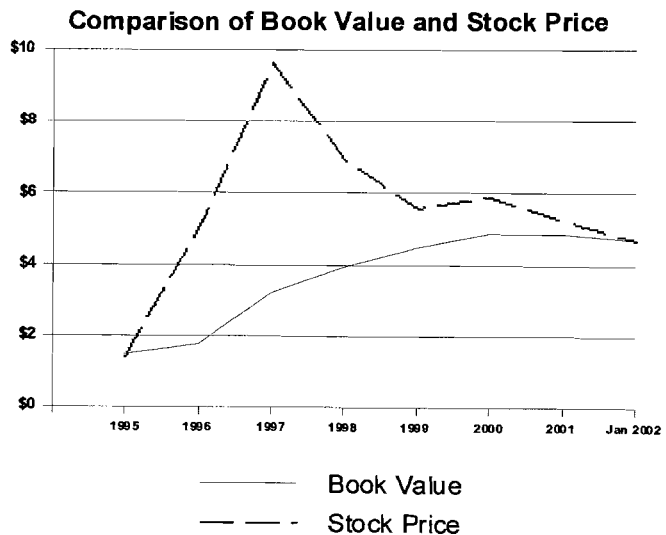
Book Value							
1995	1996	1997	1998	1999	2000	2001	2002*
\$1.48	\$1.74	\$3.19	\$3.90	\$4.48	\$4.89	\$4.88	\$4.92

* January 31.

I have prepared a table that shows how ISTN stock price has tracked the book value:

Year	Comparison of ISTN Book Value and Stock Price			
	Book Value on October 31	Appreciation	Stock Price on October 31	Appreciation
1995	\$1.48		\$1.41	
1996	\$1.74	17.6%	\$5.06	258.9%
1997	\$3.19	83.3%	\$9.69	91.5%
1998	\$3.90	22.3%	\$6.94	(28.4%)
1999	\$4.48	14.9%	\$5.56	(19.9%)
2000	\$4.89	9.2%	\$5.91	6.3%
2001	\$4.88	(0.2%)	\$5.25	(11.2%)
2002*	\$4.92	1.0%	\$4.70	(10.5%)
Total		232.4%		233.3%

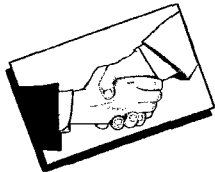
* January 31.



We can look at the book value of ISTN and learn a lot about the company. We can also make some predictions about the future that should be reasonably accurate.

The first item you can see is that the increase in book value has slowed and in 2001 slightly decreased. This decrease is the rate of growth in the book value is what creates an opportunity for the astute investor. I believe the company has paused before growing again. In fact, on March 14, 2002, ISTN released its fiscal 2002 first quarter results and this has happened. More information about this will be provided later.

What Do We Know For Sure? We know that each year from 1994 through 2000, ISTN produced a profit from operations. In 2001, the company had a loss. What happened? In 2001, ISTN was involved in legal proceedings and litigation with Ceco, a Texas-based company, operating under the name *Warranty Gold*. Ceco was selling the *Warranty Gold* contracts and tried to sue ISTN in both Texas and New York (ISTN is based in New York) but was unsuccessful.



Ultimately, ISTN was able to reach a settlement with Ceco on October 12, 2001. The total cost of this event was \$4.4 million. Ouch! I read ISTN's financial reports from 1995 though 2001.

The company does not have a history of this type of litigation. I am somewhat troubled, however, by the fact that the company did not disclose the size of the pending litigation in the 2000 financial report. The company's management explained to me that they were not aware of problems until 2001.

It is common to hear stories from family, friends or associates who have purchased a service contract. Everything is fine until they have a claim. Then, the issuing company refuses to pay the claim. One of the problems companies such as ISTN contend with is the honesty of the dealers who sell the service contract.

When a person purchases life insurance, they complete a health questionnaire and often undergo some sort of medical exam. The underwriter for the insurance looks at the results of both the questionnaire and exam and determines if, and for how much, the insurance should be sold.

In the case of a service contract, the dealer is the underwriter who has to answer the following questions:

- Should a service contract be written?
- Does the vehicle have a pre-existing condition such as a defective engine or transmission?

The integrity of the dealer is challenged constantly. Dealers will have conflicts because when a contract is sold, they make more money. If the dealer does not sell the contract, he or she will make less money but they have followed the Golden Rule: Treat others like you want to be treated.



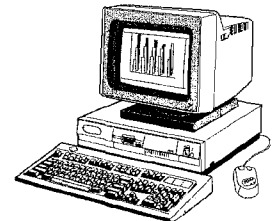
ISTN is a small company. The size of the company's share of the service contract business is insignificant when measured against auto manufacturers or other industry participants. The size is not small, however, when you consider how many contracts the company sells. ISTN does not disclose the number of contracts it sells nor does it separate the contracts by class; e.g., cars versus recreational vehicles. I am able to determine a ballpark figure by doing some simple analysis.

A suggested shortcut method to determine the number of contracts sold by ISTN was offered by a sophisticated investor. I have used the shortcut. I will be studying this method in the future to try to determine its accuracy.

Revenues	\$59,853,318
Cost of Services Provided	<u>(33,752,925)</u>
	\$26,100,393

$$\$26,100,393 \div \$200 = 130,502 \text{ Service Contracts}$$

I checked the Better Business Bureau's website, www.BBB.org, and determined that there were 40 unresolved complaints in the last 12 months and 77 unresolved complaints in the last 36 months against ISTN. In reality, one complaint is one too many.

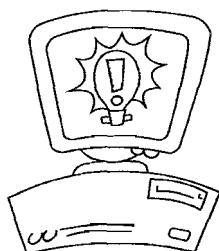


If you consider that in 2001, however, ISTN sold approximately 130,500 service contracts, 36 complaints in a one-year time period is statistically insignificant. For each 10,000 contracts sold, essentially 13 people were unhappy. That is an excellent batting average. It appears that ISTN is treating its customers fairly.

Management Efficiency: I can measure the efficiency of ISTN management by looking at the success of their ability to invest the stockholders' equity. In the time period 1996 through 1998, ISTN was performing very nicely and the management did an excellent job of investing wisely. It is difficult to find fault with anything they did. The company was achieving revenue and earnings growth.

	Return on Equity						
	1995	1996	1997	1998	1999	2000	2001
Earnings per Share							
Continuing Operations	\$0.10	\$0.27	\$0.62	\$0.65 ¹	\$0.66	\$0.63	\$0.53 ²
Discontinued Operations					(0.06)	(0.17)	
Total	\$0.10	\$0.27	\$0.62	\$0.71	\$0.60	\$0.46	\$0.53
Book Value	\$1.48	\$1.74	\$3.19	\$3.90	\$4.48	\$4.89	\$4.88
Return on Equity		18.2%	35.6%	14.5%	20.7%	14.1%	10.8%

1. Excludes one-time gain.
2. Without one-time charge.



In February 1999, ISTN decided to form a subsidiary, Uautobid.com, on the Internet. On this website, a car buyer could purchase a new or used vehicle on-line directly from a participating dealer. Uautobid allowed a perspective buyer to review a broad selection of in-stock vehicles, search by price, make, model and location and other criteria and choose the price he or she wants to bid for the vehicle. If the bid met or exceeded the dealer minimum, the consumer was assured of owning the vehicle at his or her own price. Additionally, each vehicle came with a comprehensive warranty supplied by ISTN.

The idea did not work. In July of 2000, after extensive review and evaluation, the company decided to abandon the operations of its Uautobid.com subsidiary. The company determined that further investment in this operation was not prudent due to the higher level of risk associated with the rapidly changing and increasingly competitive Internet car-buying market.

The company lost \$803,246 after tax in 2000 and \$273,753 after tax in 1999 from the Uautobid.com venture. You can see that the return on equity in 1999 and 2000 was still high (generally a 12% rate is considered acceptable), but not as high as the 1996 to 1998 time period.

We can make two observations from the 1999 and 2000 results. First, in hindsight, the management made a poor decision with the Uautobid.com subsidiary. The management, however, can be applauded for making the proper decision to quickly exit this business.

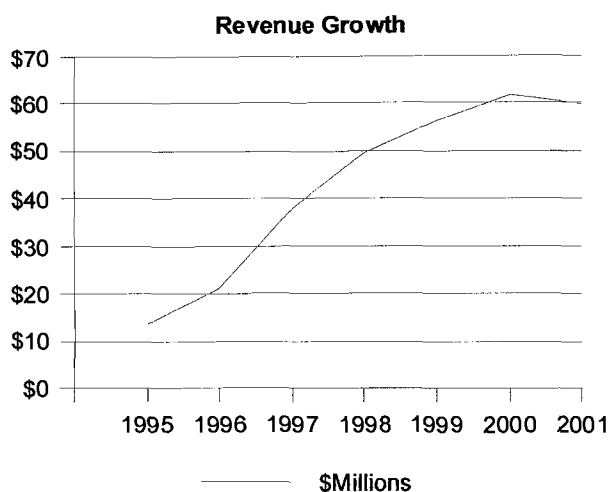


Second, the core business is really profitable. After suffering losses with the Uautobid.com subsidiary the company earned less than the 1996-1998 time period, but still produced an acceptable return on equity.

In 2001, the results produced by management were unsatisfactory. As explained earlier, the company produced a loss from operations. Even excluding the one-time loss the return on equity drops to an unacceptable 10.8% below the benchmark 12%.

Revenue Growth: One of the concerns with ISTN is that the revenue growth started slowing in 1999.

Revenue Growth in \$Millions						
1995	1996	1997	1998	1999	2000	2001
\$13.7	\$21.4	\$37.9	\$49.3	\$56.2	\$61.7	\$59.9



In January 2001, ISTN announced that it had engaged the investment banking firm of Legg Mason Wood Walker Inc. as its advisor to assist the company in creating strategic opportunities. These include but are not limited to, the development and evaluation of possible acquisitions, joint ventures, or other strategic relationship or transactions. So far, there has been nothing further announced.

There is tangible evidence from the first quarter 2002 results released on March 14, 2002, that things are improving. For the first time since the fourth quarter of 2000, the company generated revenue growth. This is significant.

Revenue by Quarter (in \$Millions)				
	Quarter			
	1	2	3	4
2000	\$13.2	\$15.3	\$16.8	\$16.2
2001	\$12.9	\$14.7	\$16.8	\$15.4
2002	\$14.0			

A second concern has been a decline in the operating margin.

Operating Income as a Percentage of Revenue						
1995	1996	1997	1998	1999	2000	2001
3.1%	5.4%	7.5%	7.1%	5.7%	2.4%	(0.7%)

For the first time since the fourth quarter of 1998, the operating margin was higher in the first quarter of 2002. Even though there was a loss, the deficiency was less than last year's. This is also significant.

Operating Margin by Quarter (in \$Millions)				
	1	2	3	4
1997			19.7%	5.9%
1998			16.7%	7.2%
1999	3.3%	5.9%	7.4%	5.5%
2000	3.1%	3.3%	2.9%	0%
2001	(3.5%)	1.4%	1.0%	(2.3%)

ISTN must continue to work to get the operating income higher. This could be achieved by either continuing to increase revenues, lowering the costs of services provided, or lowering Selling, General and Administrative (SG&A) expenses.



If ISTN could achieve a return of equity of 12% for fiscal 2002, this would be a marked improvement over the 2001 results. In my opinion, the market could reward ISTN with a higher stock price.

The Luby Family: The senior executives of ISTN are a father and daughter team:

- Chester J. Luby, age 70, has been the Chairman, Chief Executive Officer, a Director and a principal stockholder of the company since its inception in 1991. Mr. Luby is a graduate of the University of Chicago and Yale Law School, and a member of the New York and Florida bars. Mr. Luby owned and operated several automotive dealerships, marketed credit life insurance and service contract programs to dealerships and financial institutions, and owned two credit life reinsurance companies prior to forming ISTN.

- Cindy H. Luby, age 47, was elected President and Chief Operating Officer of the company in December 1995 and has been a Director of the company since its inception in 1991. Ms. Luby was Vice President, Chief Financial Officer, Treasurer and Secretary of the company from its inception in 1991 until December 1995.

The Luby family has been good for ISTN stockholders. The stock appreciated 233% from October 31, 1995 until January 31, 2002. ISTN has been good for the Luby family. You can see that the Luby's salaries have appreciated nicely during this same time period.

Year	Salary, Bonus and Other Compensation					
	Salary		Bonus		All Other Compensation	
	Chester Luby	Cindy Luby	Chester Luby	Cindy Luby	Chester Luby	Cindy Luby
1994	\$143,500	\$ 73,266				--
1995	\$150,000	\$ 73,980	\$ 37,484	\$ 24,990	\$60,000	--
1996	\$153,975	\$106,184	\$ 72,815	\$ 48,543	\$62,920	--
1997	\$154,167	\$100,961	\$137,829	\$ 98,450	\$62,919	--
1998	\$200,000	\$125,000	\$181,500	\$141,000	\$62,865	--
1999	\$250,000	\$175,000	\$208,313	\$162,125	\$62,865	--
2000	\$250,000	\$175,000	\$165,367	\$128,000	\$62,865	--
2001	\$250,000	\$175,000	\$150,000	\$100,000	\$62,865	--



Target Insurance Ltd: As explained on page 1, some of ISTN products are offered through the Orion Capital members of the Royal & Sun Alliance USA Group of Companies. Royal sometimes reinsures these policies. In effect, buying insurance on

insurance. Orion buys its reinsurance from Target Insurance Ltd. Mr. Chester Luby is the principal stockholder of Target Insurance Ltd. Target received modest amounts of premiums for reinsurance from Orion.

Premiums Paid to Target Insurance Ltd.

1998	\$ 2,100
1999	\$15,000
2000	\$52,600
2001	\$58,100

So, in addition to nice salaries and stock options, the Luby family makes a little extra from this transaction. None of these activities is illegal or are of great concern. The Luby family has done a very good job managing this business.

