

## Security & Technology

### Update on Trends in Security from ISC West 2007

**Conclusion.** This past week we attended the International Security Conference and Exposition in Las Vegas. The event was focused on physical security, including surveillance, access controls, alarms, and screening, and consisted of roughly 20,000 attendees and 1100 exhibitors. Based on the level of activity and conversations with attendees and exhibitors, the industry appears healthy with a number of key trends emerging in the security space.

#### Key Takeaways

- **Lots of Digital, Lots of Networking.** The biggest themes at ISC West this year were the move from analog to digital technologies and the emergence of network enabled devices (cameras, locks, etc.). The adoption of digital technology has opened the door for innovation both with new and transitional solutions. In addition, the move to digital and IP-based offerings has created an interesting competitive picture as traditional IT players such as Cisco (CSCO-\$25.53-NR) and IBM (IBM-\$94.26-NR) have entered the market to compete/partner with the physical security firms.
- **Industry Reps Speak on Port Security.** During the conference we met with industry reps from airports and seaports. Budgets are expected to be up significantly from 2006 in 2007 and 2008. Domestic seaports are focused on surveillance and credentialing (TWIC) programs, while DHS moves to expand the amount of screening at international ports. In airports, the backscatter pilot appears to be doing well, while broader focus is on the bump in funding for hold baggage screening deployments, perimeter security, and frustration with Congress over air cargo screening.
- **Industry Spending Expectations Remain Healthy.** Out of 22 attendees we spoke with, 80% expected spending to be up in 2007 over 2006, 15% thought spending would be flat, and 5% expected it to be down.

#### Reason for Report:

Industry Update

#### Roth Covered Companies Mentioned in this Report:

<b>ASEI</b>	\$52.67	Buy
<b>OSIS</b>	\$26.44	Buy
<b>NSSC</b>	\$5.30	Buy
<b>ID</b>	\$16.51	Buy
<b>TWLL</b>	\$12.47	Buy
<b>CSCT</b>	\$16.35	Not Rated

*Stock prices are as of previous day's close, if not otherwise specified*

## SUMMARY

### SUMMARY OF THE SEGMENTS

#### Surveillance

Video surveillance remains one of the fastest growing areas in security. As with last year, trends in the video surveillance market include the transition from legacy analog CCTV to digital video and the addition of analytics. Also, the impact of the U.S. Department of Homeland Security's \$2B SBInet award was apparent at the show, with a number of vendors displaying high-end, ruggedized solutions targeted at border security.

**Camera Systems / CCTV.** We expect camera manufacturers such as Vicon (VII-\$9.95-NR), Extreme CCTV (EXC.TO-\$2.82CDN-NR), Honeywell (HON-\$46.46-NR), GE Security (GE-\$35.36-NR), Stanley (SWK-\$55.36-NR), Pelco (private), and FLIR (FLIR-\$35.67-NR) to see continued benefit from both new deployments and perimeter upgrades. However, the number of camera and digital/network video recorder (DVR/NVR) manufacturers exhibiting at the conference, especially from Asia, was overwhelming. Given that a majority of these offerings were targeted at the low end of the market, we would expect significant pricing pressure on entry level offerings over the next few years. That said, a number of Asian competitors, including China Security & Surveillance (CSCT-\$16.35-NR) and Hikvision are gaining experience with enterprise scale systems as a result of large deployments in China.

**Video Management and Analytics.** The consolidation that took place in the video analytics market over the past two years was apparent at this year's show; Siemens (SI-\$107.20-NR) acquired VistaScape, Honeywell acquired ActivEye, and Stanley acquired Intivid. IBM has also entered the video management and analytics market with a solution developed in-house. Still, ObjectVideo (private) remains the dominant player in the space with strong OEM relationships with March Networks (MN.TO-\$10.99CDN-NR), Verint (VRNT-\$32.15-NR), Vicon, Texas Instruments (TXN-\$30.10-NR), and Tyco (TYC-\$31.55-NR). Cernium and 3VR both grabbed attention at ISC West with 3VR announcing a partnership with BioScript (BYT.TO-\$0.87CDN-NR) and Cernium's continued success in the airport vertical.

**Analog to Digital Conversion and IP Distribution.** The desire to apply analytics to video and centralize distribution infrastructure continues to drive the industry from legacy analog capture and distribution toward digital imaging and IP based-distribution. Given 90%+ of installed surveillance cameras and 70% of video recorders use analog technology, we expect this transition to create opportunity on two fronts. First, customers are likely to continue to look for analog to digital conversion capabilities, which should benefit companies like Techwell (TWLL-\$12.47-Buy). Second, newer IP-enabled cameras will likely begin to make up a larger share of new deployments. Notable releases during ISC West in this segment included Cisco's release of its *Video Surveillance IP Camera* and *Cisco Stream Manager Video Surveillance Software*, ioimage (private), with its intelligent IP camera, and Steelbox with its digital video distribution offering.

#### Screening

We believe the market for non-intrusive screening of people, parcels, cargo and vehicles has gained momentum over the past 12 months and will continue to benefit both from the Democratic shift in Congress and improvements in technology. Leading up to and during the conference we had discussions with a number of representatives from the ports. Our key takeaways include:

- While domestic budgets were up roughly 20% in FY07, a significant portion of these funds remain unspent and will likely be put on contract over the next two quarters. Additionally, assuming no major changes as they work their way through the legislative process, the FY07 supplemental and FY08 budgets both contribute meaningful funds on the screening front.
- Feedback has been largely positive on TSA's initial rollout of backscatter technology for secondary screening at airport checkpoints and we would expect new airports to be included in this pilot in CY07. In respect to air cargo, while Congress remains focused on increasing the percentage of air cargo that gets screened, due to technical limitations we don't expect efforts to move beyond the pilot stage in the near-term.
- Internationally, we expect DHS to expand the Secure Freight Initiative in FY08. We expect DHS to work with currently available solutions while investing R&D dollars in current solutions (e.g. last week's

award to nine vendors) and in advanced solutions via the CAARS and ASP programs.

Finally, with Brijot's (private) release of an update to its millimeter wave screening solution and comments made recently by AS&E (ASEI-\$52.67-Buy), it appears that more attention is being paid to the stand-off screening market. We view this as a natural extension to the current screening space and look positively on this emerging opportunity.

In conclusion, we believe the outlook for the screening market has improved, which is likely to benefit AS&E and OSI (OSIS-\$26.44-Buy).

### **Identity and Access Management**

The access control market has diverged into two markets. For stand-alone solutions the focus is on electronic locks, which combine PIN, card, and biometric readers. The market has consolidated significantly over the past five years, with consolidated manufacturers such as Ingersoll Rand (IR-\$43.37), Stanley, and Napco (NSSC-\$5.30-Buy) having the broadest offerings in the space. On the high end of the market, these stand-alone offerings are being networked and combined with robust access control software, smart-card technology, and unified security management software which provides a single point of management for security and building control. The convergence of technology at this level has opened the door to innovation with notable announcements leading up to and during ISC West by Cisco, HID Global via ASSA ABLOY (ASSAB.ST-160.50-NR), On Track Innovations (OTIV-\$7.07-NR), and GE Security. As with video products, Asian suppliers have increased their footprint in this market, which will likely create both opportunity and challenges for international competitors in this market as the solutions mature.

**Biometrics.** Based on this year's exhibits and conversation with a number of providers, it appears that the biometrics market has entered a new phase. The number of stand-alone vendors in the space has been reduced, most likely as a result of slow adoption over the past decade. However, the use of biometrics has gained considerable acceptance both in the commercial and government sectors. On the commercial side, nearly every access control, time and attendance, and locking vendor has partnered to incorporate biometrics into their solutions. The most widely displayed solutions incorporated fingerprint technology, though some of the most innovative solutions utilize iris, face, and vein recognition. On the commercial side, access control solutions utilizing fingerprint and facial recognition solutions from BioScript garnered significant attention at the event. Additionally, due to improved interoperability and performance, it appears likely that solutions based on the U.S. government's FIPS 201 standard will see adoption at the high-end of the market. This should benefit the access control vendors as these solutions replace legacy solutions based on proprietary technology as well as Cogent (COGT-\$13.45-NR) and L-1 Identity Solutions (ID-\$16.51-Buy).

### **Perimeter Security / Intrusion Prevention**

At ISC West, the focus in the SMB and residential side of the intrusion prevention market was on the rising number of municipal regulations regarding law enforcement response to false alarms. Over the past few years there has been a growing trend of municipalities passing laws which fine either the alarm monitoring company or home/business owner for false alarms. While suppliers have made incremental improvements in these systems, the most innovative product in the space came from Napco when it released the Freedom 64 line of codeless alarms in December. While still early in the release cycle, based on activity at the exhibit and an overwhelming turnout at a special event held by Napco during the conference, we believe this product is likely to see traction over the next year.

For larger facilities, commercial and government users are consolidating intrusion alarms with surveillance systems, access controls, smart fences, and perimeter sensors. In addition to the systems and vendors previously discussed, Magal Security Systems (MAGS-\$11.01-NR) displayed a number of innovative smart fence, pipeline security, and perimeter protection products.

### **MENTIONED COMPANIES**

Cisco (CSCO-\$25.53-NR)  
IBM (IBM-\$94.26-NR)  
Vicon (VII-\$9.95-NR)  
Extreme CCTV (EXC.TO-\$2.82CDN-NR)  
Honeywell (HON-\$46.46-NR)  
GE Security (GE-\$35.36-NR)

Stanley (SWK-\$55.36-NR)  
 Pelco (private)  
 FLIR (FLIR-\$35.67-NR)  
 China Security & Surveillance (CSCT-\$16.35-NR)  
 Siemens (SI-\$107.20-NR)  
 ObjectVideo (private)  
 March Networks (MN.TO-\$10.99CDN-NR)  
 Verint (VRNT-\$32.15-NR)  
 Texas Instruments (TXN-\$30.10-NR)  
 Tyco (TYC-\$31.55-NR)  
 3VR (private)  
 BioScript (BYT.TO-\$0.87CDN-NR)  
 Cernium (private)  
 Techwell (TWLL-\$12.47-Buy)  
 ioimage (private)  
 Brijot (private)  
 Ingersoll Rand (IR-\$43.37)  
 HID Global via ASSA ABLOY (ASSAB.ST-160.50-NR)  
 On Track Innovations (OTIV-\$7.07-NR)  
 Cogent (COGT-\$13.45-NR)  
 Magal Security Systems (MAGS-\$11.01-NR)

## COVERED COMPANY RISKS AND VALUATIONS

### American Science and Engineering

#### Valuation

Our \$70 price target is based on 3.3x CY07E EV/Sales of \$165m, which is just ahead of the group at 3.0x and also reflects 20x CY07E EPS of \$3.45 versus the group at 20x and 11x CY07E EV/EBITDA of \$39m versus the group at 13x. AS&E continues to demonstrate strong performance in the face of tough comps and is seeing traction in its new products lines.

#### Risks

**Growth at What Price.** While cash flows are likely to remain impressive in the near-term, top-line growth is expected to be muted. The company is expected to look externally for additional growth. While we believe depressed multiples in the sector should allow the company to find an acquisition that isn't meaningfully dilutive, pressure to add to top-line growth could push the company to make an overly aggressive move. However, we continue to believe that AS&E has one of the stronger management teams in the sector and will invest its cash flows accordingly.

**Models Assume Steady Growth, Investors Should Not.** While current estimates assume growth will occur on a steady quarter-over-quarter basis, we remind investors that a) order size compared to overall revenue remains high and that b) government orders tend to be lumpy. Short-term results could create volatility in shares of ASEI.

**Timing of Cargo Business Uncertain.** Large orders for cargo inspection equipment remain elusive and there is little indication as to when/if this market will ramp. Additionally, there are a large number of competitors in the space. While our expectations for this market remain low in the near-term, we believe the market plays a key role in investor expectations regarding AS&E longer-term growth.

**Concerns Over Privacy Could Hinder Sales.** With recent advancements in its filtering technology AS&E is attempting to overcome privacy concerns regarding its people search offerings. While we believe the changes are sufficient, the implementation of these filters remains optional which could negatively impact consumer opinion and prevent wide-scale adoption of this technology.

**Technologies Still Competing.** Companies advancing new technology to the marketplace have inherently higher risks of taking on costs associated with lawsuits over IP, both as a defendant and plaintiff. Additionally, in presenting new technologies to the marketplace, AS&E stands the chance of being displaced by substitute technologies or processes.

**Guidance.** The company does not provide forward metrics or expectations. As such, our ability to project accurately the financial performance of the company is diminished.

### Napco

#### Valuation

Our \$6.25 price target reflects 10.5x CY07E EBITDA of \$12.5 and equates to 1.8x CY07E sales of \$71.8m and 19x CY07E EPS of \$0.33. On a historical basis the EBITDA and earnings multiples fall on the low side of the NSSC four year average, while the sales multiple would fall on the high side. Given the large cap and diverse nature of its competitors, comparables for Napco are limited. However, our analysis of 11 recent acquisitions in the space put typical valuations in the range of 1x-4x TTM sales and 10x-13x TTM cash flows.

### Risks

**No guarantees new products will see adoption.** Over the past few years Napco has made significant investments in its new offerings. The market is competitive and given some of its most significant new products, including the Freedom line, require changes in underlying customer behavior, adoption rates of these products could fail to meet expectations.

**Large competitors.** Napco's primary competitors all have revenues in excess of a \$1B annually. Given the diversified nature of these companies, they may be able to invest more significant resources in their offerings, especially during downturns in the market.

**International Markets.** Napco maintains operations in international markets, some of which are still developing. These investments carry elevated political and economic risk.

**Customer Concentration.** While no customer has contributed more than 10% to revenues during any quarter in the last two years, two customers combine for roughly 35% of account receivable. While Napco believes these customers are creditworthy there is no guarantee that they will be able to meet their commitments.

**Rising Inventories.** Inventories have been rising over the past several quarters. While we expect sales growth and internal changes to manufacturing to reduce inventories going forward, there is no certainty that either of these will happen.

### L-1 Identity Solutions

#### Valuation

For valuation purposes we've compared L-1 Identity Solutions against publicly held secure identification, biometrics, and next generation surveillance companies. Recently we've seen compression in the space, which now trades at 3.5x CY07E EV/sales, and we've reduced our price target to \$19 from \$20 to account for this compression. Our \$19 price target is based on 4.4x CY07E EV/sales of \$334m. We believe this premium is justified given L-1 holds the premier position in the rapidly emerging identity solutions space and note that it is below the recent range of 5x-10x NTM sales for market leaders in this space.

#### Risks

**Delayed Government Decisions.** Issuance of government contracts, both federal and state, tend to get delayed in the bureaucratic process. Given the large size of these contracts relative to L-1's overall revenue, this can result in difficulty predicting quarterly results. With a number of state contracts, including California, up for renewal, headline risk is significant.

**Sarbanes Oxley.** While the company was able to meet the NASDAQ deadlines for filing its delayed 2004 10K and 1Q05 10Q and has continued to invest in its internal processes, L-1 continues to have material weaknesses in its internal controls. This could result in higher than expected expenses and/or restatements.

**Competition.** The company continues to face fierce competition from secure credential companies such as Digimarc, integrators such as Lockheed and Northrop and biometrics companies Cognitec, Cogent and Crossmatch. Each of these companies has had success in its own markets. Also, should the company see better margins based on marketing its offerings as end-to-end solutions, the market may become more attractive to large integrators.

**Acquisition Integration.** While we believe L-1 has improved its financial processes following higher than expected acquisition related expenses in 2004 and early 2005, an accelerated acquisition schedule could lead to continued integration challenges and elevated expenses

### OSI Systems

#### Valuation

Based on our sum-of-the-parts valuation, our price target is \$34 based on 0.8x FY08E sales of \$267m for Spacelabs and 1.4x FY07E sales of \$333m for the combined security and optoelectronics business.

We believe this valuation may prove to be conservative, given the significant discount of its security business versus the comp group currently trading at roughly 3.0x. We note that the company has been running accelerated rates of R&D and SG&A and we expect a near-term dropoff in SG&A with a drop-off in R&D longer-term. Additionally, this valuation doesn't include the \$2.89 per share to \$7.23 per share OSI is likely to receive from the L-3 verdict.

### Risks

**Government Funding Remains Lumpy.** Growth prospects for OSI's security business rely heavily on government funding. Government spending tends to be lumpy and programs are often delayed. Additionally, there is no guarantee OSI's technology will be adopted by the government or that programs, especially for cargo inspection, will gain the political support required to receive funding.

**Cargo and HBS Business Uncertain.** Large orders for cargo inspection equipment remain elusive and there is little indication as to when/if this market will ramp. Additionally, there are a large number of competitors in the space. While our expectations for this market remain low in the near-term, we believe the market plays a key role in investor expectations regarding OSI's business longer-term.

**Concerns Over Privacy Could Hinder Sales.** OSI faces significant privacy concerns regarding its people search offerings. While we believe there exists processes sufficient to reduce these concerns, consumer opinion could prevent wide-scale adoption of this technology.

**Spacelabs May Not Stabilize in the Near-term.** While OSI is investing resources into its Spacelabs technology, years of neglect have put its technology behind that of competitors. Additionally, these companies tend to have more resources available for marketing and research than OSI, which may make stabilization of market share difficult.

**Technologies Still Early.** Companies advancing new technology to the marketplace have inherently higher risks of taking on costs associated with lawsuits over IP, both as a defendant and plaintiff. Additionally, in presenting new technologies to the marketplace, OSI stands the chance of being displaced by substitute technologies or processes.

**Disclosures:**

Roth makes a market in shares of American Science & Engineering, Inc. and as such, buys and sells from customers on a principal basis.

Roth makes a market in shares of OSI Systems, Inc. and as such, buys and sells from customers on a principal basis.

Roth and/or its employees, officers, directors and owners own options, rights or warrants to purchase shares of OSI Systems, Inc. stock.

Roth makes a market in shares of Napco Security Systems, Inc. and as such, buys and sells from customers on a principal basis.

Roth makes a market in shares of Techwell, Inc. and as such, buys and sells from customers on a principal basis.

Within the last twelve months, Roth has received compensation for investment banking services from China Security & Surveillance Technology.

Roth makes a market in shares of China Security & Surveillance Technology and as such, buys and sells from customers on a principal basis.

Roth and/or its employees, officers, directors and owners own options, rights or warrants to purchase shares of China Security & Surveillance Technology stock.

**Distribution of IB Services Firmwide**

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
<b>BUY [B]</b>	<b>114</b>	<b>62.30</b>	<b>21</b>	<b>18.42</b>
<b>HOLD [H]</b>	<b>50</b>	<b>27.32</b>	<b>6</b>	<b>12.00</b>
<b>SELL [S]</b>	<b>5</b>	<b>2.73</b>	<b>0</b>	<b>0</b>
<b>NOT RATED [NR]</b>	<b>11</b>	<b>6.01</b>	<b>2</b>	<b>18.18</b>

Our rating system attempts to incorporate industry, company and/or overall market risk and volatility. Consequently, at any given point in time, our investment rating on a stock and its implied price movement may not correspond to the stated 12-month price target.

Ratings System Definitions - Roth employs a rating system based on the following:

**Buy:** A security, which at the time the rating is instituted and or reiterated, indicates an expectation of a total return of at least 10% over the next 12 months. (Effective 04/03/06 Equity Research eliminated the SB rating)

**Hold:** A security, which at the time the rating is instituted and or reiterated, indicates an expectation of a total return between negative 10% and 10% over the next 12 months. (Prior to 04/03/06 Hold stocks were rated "Neutral")

**Sell:** A security, which at the time the rating is instituted and or reiterated, indicates an expectation that the price will depreciate by more than 10% over the next 12 months.

**Not Rated:** A security which at the time the rating is instituted and or reiterated, indicates that we have no opinion or expectations as to the price of the security over the next 12 months.

For important disclosure information regarding the companies in this industry note, please contact: The Director of Research at (800) 678-9147 or write to: Roth Capital Partners, LLC, Attention: Director of Research, 24 Corporate Plaza, Newport Beach, CA 92660.

Roth Capital Partners, LLC expects to receive or intends to seek compensation for investment banking or other business relationships with the covered companies mentioned in this report in the next three months. The material, information and facts discussed in this report other than the information regarding Roth Capital Partners, LLC and its affiliates, are from sources believed to be reliable, but are in no way guaranteed to be complete or accurate. This report should not be used as a complete analysis of the company, industry or security discussed in the report. Additional information is available upon request. This is not, however, an offer or solicitation of the securities discussed. Any opinions or estimates in this report are subject to change without notice. An investment in the stock may involve risks and uncertainties that could cause actual results to differ materially from the forward-looking statements. Additionally, an investment in the stock may involve a high degree of risk and may not be suitable for all investors. No part of this report may be reproduced in any form without the express written permission of Roth. Copyright 2007. Member: NASD/SIPC.