

Security Finance Newsletter

February 2006

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Volume II, Issue 1

Tracking the Security Industry

It's always illuminating to look back after a year-end and see where the industry has been. In this newsletter we'll take a look at some of the important trends which defined 2005 and peer into the crystal ball to see what may be ahead in 2006.

We are very pleased in this issue to tap as a resource, four industry CEOs who kindly agreed to share some thoughts about 2005 and 2006 with Sokoloff & Co.'s Director of Research, **Clarissa Jacobson**. Turn the page and read commentary from **Honeywell Security** president **Ben Cornett**, **Greg Jendreas**, CEO of **Master Halco**, CEO Gary Holland of **Fargo Electronics** and **Dan Mocerri**, CEO of **Convergint Technologies**.

Industry Growth Numbers

While Q4 results are not yet available, the Security industry continued to see good growth in 2005. According to **Sokoloff & Co.**'s research, *revenue growth in 2003*



over 2002 was 10.9%, accelerating to 12.3% in 2004. Revenue for the last four quarters ending September 30th is up 5.2% over calendar year 2004.

A bit of a slowdown in 2005 was not unexpected. The ramp up in 2003 and 2004 was primarily the result of increased government spending, driven by long awaited post 911 federal budget funding for enhanced security. In 2005 and 2006 Congress continues to increase spending for security, but not at the same growth rates as previously budgeted.

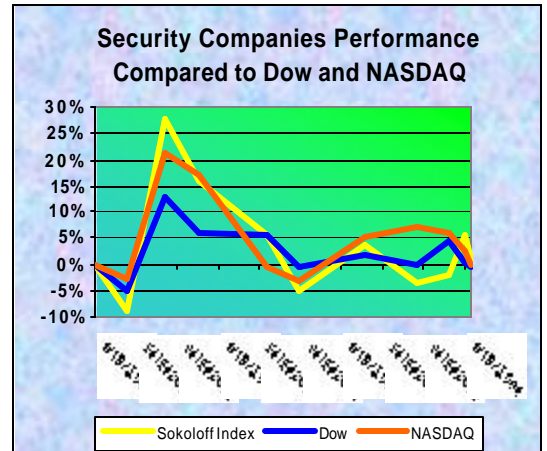
We may see additional rounds of sharp budget increases as the war on terror continues to unfold, but this was not the case in 2005.

On the horizon, corporate spending on security is on the increase, as new advances (IP, digital video, biometrics, etc.), now very much proven technologies, are embraced.

Another great boost to the industry is anticipated as Congress and the President adopt legislation which will mandate that sensitive private enterprises like chemical and petroleum installations add security to provide higher levels of protection.

The Back Page

The chart on the back page of this newsletter is entitled, "**Sokoloff & Co. Valuation Rankings of Public Security Companies.**" Many of the observations and conclusions stated in these pages are gleaned from this data.



Sokoloff & Co. also regularly compiles a stock index which compares the performance of the public security companies historically and in relation to the Dow Jones and NASDAQ indexes.

The **Sokoloff Security Index** was flat in 2005, showing no appreciation at year-end. The performance of the Dow and

What is a Stock Index?

The share prices of a representative group of stocks are added together. This total is then compared on different days so as to measure and report value changes for the group.

NASDAQ indices were virtually identical.

Valuation Indicators

While the process of valuing a company can be quite complex, certain quick rules of thumb have been generated by analysts who study public companies.

The Security companies on the back page trade at a median multiple of earnings that has ranged from a low of about 17x in

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Ben Cornett, President, Honeywell Security

Ben Cornett has been in leadership positions in the security industry for nearly 25 years. Prior to Honeywell's acquisition of Pittway Corporation, he was President of ADEMCO Group and Ademco Sensor Company. Before joining Ademco Group in 1995, Cornett founded and served as president and CEO of IntelliSense, Vice President of Blue Grass Electronics and worked for Solfan Systems which later became C&K Systems.

printer security; **Master Halco** is a fencing company with a concentration in perimeter security; **Convergent** is a systems integrator that designs, installs, and services building systems. **Honeywell Security** is a distributor of security products and a developer of residential and commercial security systems.

CEO ROUNDTABLE: 2005 REVIEW AND A LOOK FORWARD TO 2006

By **Clarissa Jacobson**, Director of Research and Administration, **Peter A. Sokoloff & Co.**

2005 was a year of meeting increasing global demand, seeing new technologies gain ground and solid growth for U.S. Security firms. According to the Security Growth Conference "the industry eclipsed the \$150 billion mark and will continue to be one of the strongest long-term growth industries in the global market." Overall growth was 8%-9% and certain areas experienced growth rates well beyond the general market.

Companies who succeed in riding the tide of change do so by analyzing and constantly revamping their vision, and keeping current with trends so that they thrive in the years to come. **Fargo Electronics, Master Halco, Convergent, and Honeywell Security** are four diverse businesses that are at the forefront of the Security

Industry. Sokoloff & Co. had the pleasure of interviewing the CEOs of each firm; getting their opinions on the pulse of the industry, where it's heading,

and where its been.

Fargo is a manufacturer of ID card personalization systems and a leader in

August 31, 2005
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A subsidiary of
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Has made a strategic investment in



Smart Products for Perimeter Defense

The undersigned advised Safeguards Technology.



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Global Market

The shift to serve a global market was a major driver in 2005 and will continue to be a factor in staying viable in 2006.

Ben Cornett, President of Honeywell Security believes that the future of his company depends on continuing to expand its hold overseas: "We've experienced unprecedented growth internationally. China is huge. You could just show up and still get 20% growth. India, Korea and the Middle East are all developing by leaps and bounds. We expect explosive growth there over the next 20 years."

Gary Holland, CEO of Fargo, says they have established a strong business in the U.S. but will continue to pursue more business internationally. "We do 40% of our business overseas and are a global supplier to over 80 countries."

Greg Jendreas, CEO of Master Halco, also pointed out that "There's a lot of work

from American companies that have huge investments all over the world. These multi-nationals are calling up, wanting American companies to complete projects for them."

Dan Mocerri, CEO of Convergent said they were successful in growing their national account base, and secured one of the largest security projects in Canada. He also mentioned that America is able to compete because of their strength in security: "With so many products

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Dan Mocerri, CEO, Convergent Technologies LLC

Dan Mocerri has 25 plus years in the building infrastructure industry. Prior to starting Convergent Technologies, he was the President of Siemens Building Technologies Security Division for North America. During the span of his career, Mocerri has held positions in sales, engineering, and executive management focused on integrated building management systems throughout the United States and Canada.

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early 2003, to its most recent number of 22.52 at the end of January 2006. This means that, of 39 companies listed, the companies in the middle (the mean or median) have a value equal to 22.52x their earnings.

Instead of using earnings, some analysts prefer to use **EBITDA** (Earnings Before Interest, Taxes, Depreciation and Amortization). *Median EBITDA multiples have shown a little growth, moving from about 10x in early 2003 to 11.33x at the end of January.* No doubt reflecting the 2005 market, the median EBITDA multiples stayed in a narrow range, not changing much over the course of last year.

Another rule of thumb analysts sometimes use is a **multiple of revenue**, also called "Price to Sales (P/S)" or the similar "Enterprise Value to Sales or EVS" (see sidebar on this page). We saw the median EVS trend upward in early 2003, followed by a flattening in 2004 and 2005. Beginning 2003, the median EVS was about 1x. *By mid-2004 the multiple had moved up to its current range of 1.3x-1.5x.*

Enterprise Value to Sales (EVS)

"A valuation measure that compares the enterprise value of a company (computed as the market capitalization plus debt and preferred shares less cash and cash equivalents) to the company's sales. EV/sales gives investors an idea of how much it costs to buy the company's sales. This measure is an expansion of the price-to-sales valuation, which uses market capitalization instead of enterprise value. EV/sales is seen as more accurate because market capitalization does not take into account the amount of debt a company has, which needs to be paid back at some point. Generally the lower the EV/sales the more attractive or undervalued the company is seen.

The EV/sales measure can be slightly deceiving: a high EV/Sales is not always a bad thing as it can be a sign that investors believe the future sales will greatly increase. And a lower EV/sales can signal that the future sales prospects are not very attractive. It is important to compare the measure to that of other companies in the industry, and look deeper into the company you are analyzing."

From: www.investopedia.com

Investors Believe in Biometrics—a Tale of Three Companies

Looking at our back page chart we can't help but notice that three of the top 5 companies are biometric vendors. The top rated companies are ranked according to the multiple gotten by dividing their annual sales into their enterprise value (See sidebar on this page for an explanation of this).

| | TTM Rev | Last Q Rev Growth | Trailing P/E | Forward P/E | Market Cap | EVS | EVM |
|-------------|---------|-------------------|--------------|-------------|------------|-------|-------|
| COGT | 145.4 | 64% | 65 | 27 | 2.15B | 12.95 | 25.39 |
| IDNX | 83.44 | 20% | Loss | 136 | 725.8 | 8.36 | NA |
| VISG | 70.3 | -28% | Loss | NA | 365.9 | 4.91 | 49.2 |

Top dog on the Back Page is Pasadena-based **Cogent, Inc.** In third and fifth place are **Identix Inc.** and **Viisage Technology Inc.**

As a privately held company, **Cogent** was a well kept secret before its IPO in 2004. CEO and founder Ming Hsieh had quietly built a finger print systems powerhouse with rapidly growing revenues and earnings while its higher profile competitor in the finger print systems arena, **Identix** was believed to be the clear cut leader in the market.

COGT's 2004 IPO was the beginning of a rocket ride, as the stock opened at about \$16 in September and soared to over \$35 in December. During 2005, the stock bounced around in a mid-\$20s range. **Cogent** deserves kudos for sustaining rapid growth while not losing sight of the bottom line. The company is quite profitable.

In contrast, **Identix** has had a rocky ride. It pioneered the fingerprint market and has had mixed success in growing its revenues. After a tumble in 2003, **IDNX** grew again in 2004 and continued to enjoy modest growth in 2005. The slow down in revenue growth, combined with the fact it has not been able to find the magic formula to profitability, threatened share value.

Before losing investor interest, help has arrived in the form of facial recognition leader **Viisage Technology**. On January 12th the companies announced a merger. Curiously, despite being the smaller of the

two, **Viisage** management and board members will control the combined company.

This is a creative and optimistic deal for **IDNX's** shareholders, who received a paper premium of 45% on the day the stock-for-stock merger was announced. **IDNX's** shareholders will own 59% of the com-

bined entity.

In the press announcement, **IDNX** and **VISG** said that "combined operations are expected to have about \$220 million in revenue and at least \$40 million in EBITDA (earnings before interest, taxes, depreciation and amortization) in 2006."

The current combined Enterprise Value is about \$1.043 billion. If they were doing \$40 million in EBITDA today, the EVM would be about 26, which is almost exactly what **COGT** is trading at.

The strategic coupling of fingerprint and facial recognition technology certainly makes sense from a business perspective. **VISG** management's challenge is to deliver on EBITDA and earnings while executing well on future sales growth.

For timely financial information, including an archive of M&A Transaction Case Histories, visit: www.sokoloffco.com

Contact Sokoloff & Co.

Please contact **Mark Schwartz**, Managing Director of New Business Development for a confidential consultation about your company's merger and acquisition needs.
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"Always do right. This will gratify some people and astonish the rest."

- Mark Twain (1901)

that have been set forth by the Bush administration amid a desire to fix the mistakes of 9/11. Since going public in 2000, Fargo has consistently manufactured state-of-the-art ID card

“The security industry continues to shift towards IP technology. Customers are requiring a provider with stronger network skills....”

systems, but has expanded by concentrating on the bigger picture: issuance of these cards. Holland explained: “It doesn’t matter how secure your card is if it can be duplicated easily. The terrorists of 9/11 were able to get access to printers (not Fargo’s) and that’s how they got their IDs. So we’ve been concentrating on developing unparalleled printer security.”

Bush’s mandate that all federal agencies as well as employees of government contractors be required to use smart cards, has also given the company an added boost. **Fargo** occupies the enviable position of being only one of three companies in the world that has pioneered the technology (Reverse Image Technology) recommended to print on these cards.

Convergint believes the most important aspect to keeping customers is in training their people. Mocerri stressed Convergint’s dedication to keeping their employee’s skills current: “The security industry

continues to shift towards IP technology. Customers are requiring a provider with stronger network skills. Integrators that understand this will be best prepared to compete as the technology and buying influences continue to evolve.”

Even though technologies change, Mocerri believes that customer’s expectations never really change. “Bottom line: they’re always looking to lower the total cost of ownership and they always expect reliable technology

“We’re looking forward to the future. We know the security industry is stable, long term, and a good field to be in.”

that delivers and is backed by a strong service provider.”

2006 Growth Expectations

A dedication to making the customer first priority, keeping on top of current trends, thinking creatively, knowing

which technologies are important, keeping up to date on governmental policy and playing in a global marketplace yet being responsive to the needs of North America are what keep these companies on top.

Master Halco expects to double their revenue in their security systems segment in 2006, **Convergint** anticipates robust growth in the industry in excess of 15%, and **Honeywell Security** is predicting 10% growth in the industry. Gary Holland from **Fargo** summed it up perfectly: “We’re looking forward to the future. We know the security industry is stable, long term, and a good field to be in.” With these positive outlooks *there seems little doubt that 2006 will be a year of growth and excitement.*



December 30, 2005
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Has been acquired by



RED HAWK
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The undersigned advised National Network Services.



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Tip for Good Business: “They Didn’t Return My Call” Is a Poor Excuse

It’s hard sometimes to be sympathetic to our employees’ excuses for not getting the job done. Perhaps the most often heard excuse is, “He didn’t return my call.” Around my shop, this excuse has been deemed completely unacceptable. The speed of business today is blistering fast. If we don’t reach our customers in short order, someone else will. So, just how do you get someone to return a call?

Persistence. Don’t be afraid to call someone even several times per day (if urgent) until you reach them.

Manners. Be courteous and business like in tone and content for voice mails and e-mails requesting a call back.

Get help. Cultivate a warm relationship with an associate who works with or answers Mr. or Ms. Smith’s phone. Usually, just asking for their help to make sure their boss returns the call is all it takes.

Gather a little intelligence. Just don’t go on blindly leaving messages. Find out if your target is on the road, on vacation, in a meeting, etc. Ask when the best time to call might be; try and set up a telephonic appointment.

---Pete Sokoloff

(Continued from page 2)

becoming homogeneous (having comparable capabilities and reliability), service and support become the main differentiators. In the end, those companies that compete on service and solutions will not be as dependent on the US dollar to win.”

The security industry appears to be relatively sheltered from the declining American dollar. Holland simply states “When you’re dealing with people’s lives, they want what’s best and what works, even if it costs more.”

Technology

The changing landscape of globalization and homeland security has paved the path for new technologies. One technology was mentioned more than any other: that of

One technology was mentioned more than any other: that of video analytics.

video analytics. Video analytics refers to computer-based video surveillance that is able to track and classify an intrusion based on pixel changes. Major technology shifts of the past few years will continue to gain traction in 2006. This includes the progression into IP technology, the merger of physical security and IT, network based storage and video management, intelligent home products, and smart cards (ID cards that are implanted with computer chips or radio frequency identification (RFID) antennas).

Both Holland and Cornett point out that there’s a lot of hype around new technologies and lots of good ones but there’s not enough room for everyone. As Cornett put it “Engineers are always bringing out their newest toys, but a lot of them don’t have a real market or the price is out of reach.”

Business Strategies for 2006 and Beyond

We asked each CEO to describe the vision that will drive their business forward into 2006 and beyond.

Greg Jendreas, President and CEO, Master Halco

For over 30 years, Greg Jendreas has been a leader in industrial manufacturing and distribution operations. As President and CEO of Master Halco, Greg was responsible for creating a new business segment, the successful Security Solutions Group. Prior to his work at Master Halco, Greg served as vice president of operations at MGF Industries, and as vice president of manufacturing at Mark Controls Corporation.



According to Jendreas, his fencing business is moving toward a more creative and integrated solution. “We are seeing technology driven fencing systems linking multiple sites into a centralized control hub. Integrated perimeter security for petroleum and chemical plants has become a necessity. They face the challenge of upgrading protection to meet anti-terrorism ‘deter and delay’ requirements.” And with the strong profits many of these companies reaped in 2005, Jendreas anticipates that if not voluntarily, the government will force them to update their perimeter protection. “The hurricanes and the fire in London were accidents, but they served as a reminder of how vulnerable these industries are and the damage a disruption can do. They simply can’t afford to be unprotected.”

Master Halco is dedicated to their partnership program as well as their unique vision on perimeter security. Jendreas says that their “Partners in Excellence” program is essential to the company’s growth. Through decisive training and certification, Master Halco is effectively helping their fence contractor customers respond to new perimeter protection challenges. For over 40 years Master Halco has manufactured and distributed fencing. Seeing a market for perimeter security they moved into this sector just 18 months ago and have experienced phenomenal growth. “We have people

calling us, telling us they’ve heard of our distinct perspective on perimeter security. We’ve even had calls asking us to do budgetary and design estimates by companies hoping to secure the bid with the US government for the possible Mexican border fence.”

Like Master Halco, **Honeywell Security** relies on partnership to keep in touch with their customers. Cornett believes a big part of Honeywell Security’s current and steady growth has come from their “Partners of Choice” program. “In order to be successful in the long term, you need to be in a position where your partners are a part of your business and they have confidence that you are there to help their business thrive. We give them the training, tools, access to research, and clout to be successful.” They’ve also combined their three businesses: **Honeywell Security and Custom Electronics** (intrusion alarms), **ADI** (the distribution arm), and their **Systems** business (Access and Video) which gives their customers the ability to get everything they need in one stop.

Cornett also expects strong growth for Honeywell Security in 2006 in the residential market. “People are getting much more involved than just security. They want home systems that control everything from a single point, not just alarm systems.”

Fargo has taken a different approach. They have their eyes and ears on policies

Gary R. Holland, President and CEO, Fargo Electronics, Inc.

Gary R. Holland has over 35 years of experience in the security industry. Before working for Fargo he owned and operated two business and strategy consulting firms, Decision Process International of Minnesota, Inc. and Holland & Associates. Prior to this he held top positions at Datacard Corporation, CPT Corporation, The Toro Company, and The Coleman Company. He serves on the board of directors at Delfax Technologies, Inc.



