

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

NAPCO Security Technologies, Inc. (NASDAQ:NSSC)



RICHARD L. SOLOWAY is Chairman of the board of directors of NAPCO Security Technologies, Inc. since October 1981, and President and CEO since 1998. He was awarded Ernst & Young's "Entrepreneur of the Year" in 2001 and awarded Guardian Angels "Champions for Safety through Education" in 2006. He has over three decades of security industry experience — pioneering in U.S. and international markets. He also holds numerous electronic design and manufacturing patents for security technology.

SECTOR — MULTIMEDIA SOFTWARE

TWST: Could you please identify yourself?

Mr. Soloway: I am Richard Soloway, Founder and CEO of NAPCO Security Technologies, Inc.

TWST: Could you tell me a little bit about the company and provide a brief history?

Mr. Soloway: The company is a manufacturer of security products, and we sell our products business to business. Our customer base is a group of security dealers, and right now there are approximately 12,000 of them, and we supply them our units that they install in homes and businesses, hospitals, schools, airports, every type of building and site.

TWST: Can you tell me a little bit about the founding of the company and how it's changed over the years or grown?

Mr. Soloway: Originally when I started out in business, I was manufacturing and installing electric garage door operators, and that company was sold. Then went into manufacturing guitar amplifiers, wah-wah pedals and fuzzboxes, and that company was sold. Then invented a security communicating device which communicated fires and burglaries on-premises using a tape deck, and it would call the police, the fire and family members, or whoever it was programmed to call, and that was the beginning of NAPCO.

The company went public and came out with subsequent products like electronic sirens, control panels, motion detectors, keypads, whole series of the building blocks that security dealers need to install in all kinds of premises. Then the company started acquiring other companies in the field that the dealers could install on their various jobs. As an example, we acquired Alarm Lock Corporation, which makes electronic locking

devices. It was manufacturer of mechanical devices, but we converted a lot of those devices to electronics because our background is electronics. Then we bought Continental Access Control, which is an access control manufacturer and supplies access control systems to buildings of all types, where a security guard is sitting at a desk, he issues visitors badges, temporary codes, barcodes, and can watch everything going on in the building, lock doors and control elevators. We acquired a company that made those products, and then we branched it out to make them enterprise class, which is an important aspect of access control.

The last company we acquired was Marks USA. Marks USA makes architectural locking products used in high-rise buildings with beautiful cosmetics and electronics now incorporated into those so you can open your condo doors with a smartphone. It can also lock down the whole network of locks throughout the entire building from the security desk. It's the new trend in locking, and it's because of our electronics background that we're able to expand from mechanical locks to electronic radio-controlled locks.

TWST: Do you have any products that are involved with defense and protection against terrorist threats and those kinds of things?

Mr. Soloway: Our products are used in all kinds of airports, used on military bases, airplanes, all kinds of places. We manufacture a thousand different products, and the dealers and integrators that install them put them on all types of facilities and vehicles, so our products are seen everywhere. So we like to say that we are a big part of keeping the bad guys out and protecting the citizens, and that's how our products are used both in the consumer market as well as into the military defense space.

TWST: When we're talking about military bases and those kind of things, did you want to maybe mention an example of how one of your products might be used?

Mr. Soloway: The products could be our line of radio-controlled locking products, which can lock down all doors on a base or buildings without going to the door, so they're radio-controlled doors. Our products are used to control access to prevent unauthorized people from coming into defense and military buildings without the right credential. So you need a special credential to enter into those buildings. It's a multitude of things. It's because we make all these different electronic and electromechanical products, the number of applications is unlimited, and we've even seen them on military boats. So they're used everywhere.

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TWST: Do you think that more and more organizations, be it schools or hospitals, wherever there might be a concern for safety of the people inside the building, are using more of these kinds of products?

Mr. Soloway: Yes. There's a couple of major paradigm changes to our business that have happened in the last couple years. I'll tell you about the first one, and that is school lockdown systems. You know we have a lot of problems with unauthorized people coming into buildings, shooters coming in and situations like that. So we make a whole line of K-through-12 security locks, and we make a whole line of college and university security locks. They are used for lockdown. They are programmed by the administration so the doors can be locked from one door to a wing to a whole floor in the different buildings, and they can go campus-wide because they work on radio, and they install very easily and no wiring to run, and they're very, very reliable.

We're doing all kinds of colleges and universities all over the country, and they're very good margins for us, and we sell them through our integrated network to the colleges and universities as well as the K-through-12 schools. So we make them at every price point. That's a big paradigm change because if you think about it, when I went to school and probably when you went to school, we didn't have all these active shooters entering into the schools, entering into hospitals. But now we do, and every day we read about this, and it's a terrible tragedy. So in today's world it's necessary to arm all these facilities with good technology, and NAPCO manufactures these types of products.

TWST: That would be true for military bases and even like a recruiting station or something like that, right?

Mr. Soloway: That's correct. If you go through the airports and you go through any type of building, you're going to see in a lot of cases where one of the NAPCO family of products or all the NAPCO family of products in these different buildings keep the bad guys out and allow the good people that are properly authorized to come in, and that's what we strive to do. So it's a big paradigm change in our business, and it's driving the business forward.

TWST: Talking more about the company, did you want to talk about some of the current priorities and maybe what was the reasoning behind those acquisitions you did make a few years back?

Mr. Soloway: So I gave you the first paradigm change in our business; now I'm going to tell you the second paradigm change, and that is the company is now getting recurring monthly revenue from our new radio products. So the dealers who buy these products and install them in all types of buildings and the communications aspect of those products communicate to our NOC, and so basically you can describe it as a cloud. The products communicate through that cloud, and then they're transferred to the central stations of security dealers for monitoring the input into those central stations to call the police and fire and medical help. We've developed this line of radios in the last two years.

These communicating devices generate fees for us that are called recurring monthly revenue, which is also called SAAS revenue. In the last two years our run rate is about \$10 million in SAAS income. SAAS income has a 90% gross profit. This is a nice acceleration in the growth of that business. So we sell the hardware, and then that hardware is enrolled on our back-end cloud that we built, and then the dealers pay us SAAS revenue every month. So that's an exciting change to our business.

A lot of this came about through the acquisitions of the companies we're talking about. We wanted to have the widest platform of security products in the security industry, and we do now. We have burglar alarms, fire alarms, we have locking products, and we have access control products. There's no company in America that has those three key legs of the security stool. Companies that are our competitors, manufacture alarms; other companies might manufacture locking products; some manufacture access products; some do two, some companies do alarms and access; but nobody does all three. All three are very important today because a dealer can make an integrated system.

With all three of our product lines, we're about 80% commercial as far as where our products go, and we're 20% residential. So the commercial area where we do commercial buildings, commercial fire, we get SAAS revenue from the commercial side of the business. It's very very profitable, and I think I mentioned 90% profit on the SAAS revenue, and it's a very exciting time for us. On the residential side of our business, which is 20%, that's growing very nicely with both selling the hardware and also the SAAS services of our NOC cloud. That's exciting because now we've added besides the communications, which is done with cellular, internet communications on these devices to enhance control panels. It's called the new connected home functionality. Connected home is a very very up-and-coming area where you as a consumer can now control your lights, your heat, your door locks, watch live video — all on your smartphone.

So with the acquisitions of our companies, now we put together a line of SaaS-operated devices which is also connected home

technology, and it's a very important and growing area for the company. Over the next 10 years the market is expected to be in the billions and billions of dollars. It's already accelerating a lot because everybody wants to see what's going on in their home and control everything in their home, but they don't necessarily want to be home. They can do it remotely from their smartphone.

TWST: Do you foresee a time when not just the high-end homes, but the average houses that people might buy, that they'll have this kind of internet-of-things technology in the house, and when do you think you might start seeing that?

Mr. Soloway: We're seeing it now because we brought it to a price point where it's not that expensive to install in a home. An exciting aspect of this whole thing is that we make the StarLink Radio Communicators with a combination of cellular as well as a connected home hub inside the same housing. It's a small box; it's attached on to an existing alarm system that's been in your house. The alarm system could be 25 years old. Once you attach this box on to the alarm system, now you have apps, and now you can control your alarm system remotely, and it's really an exciting product line. So you can have an alarm system that's already paid for, and the dealer can easily upgrade it.

Some dealers charge only a few hundred dollars for this box; some of the dealers don't charge anything for the box because it's very reasonably priced, and they ask you to sign up a contract for monitoring, and then you have control of all your electronic devices around your home on your smartphone. So it's popularly priced now, and there's probably about 30 million alarm systems that are functioning out there which were installed over the last 25 years. These all can be upgraded with this invention.

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It's exciting because in the past if you wanted this type of service, it was expensive, as you were saying, because you had to rip out the old system and put in a brand-new expensive security system. But with our box, you don't have to do that; you can upgrade. The dealers then enroll this box on to our cloud. They pay us a fee every month for using it. The monthly fees run anywhere from \$6 for residential installations to \$30 if it's a commercial installation, where it has more stringent requirements in commercial buildings than residential, and then the consumer can operate the system remotely as well as keep the existing system he's had before.

So that's a major paradigm change for our company and a very exciting change. If you saw our financials that came out this week, we had record sales, and it's been like that for last two years, and I say we're just in the first inning of the ball game of communications, of SaaS revenue and school lockdown safety products. All this is using the newest technology of wireless, cellular and internet.

TWST: Anything else noteworthy you want to mention about those earnings from the most recent quarter?

Mr. Soloway: So our record annual sales of \$87.4 million.

Quarterly sales increase fourth quarter or June 30 year of 7% to a record \$25.7 million. Recurring revenues or SaaS grew 59% for the quarter and 65% for the year. Income before taxes increased 2.5% for the fiscal year to \$6.3 million from \$6.1 million a year ago. The earnings per share dilutive for the fiscal year was \$0.30 as compared to \$0.31 for the same period a year ago, and earnings per share dilutive for the fourth quarter was \$0.17 compared to \$0.18 a year ago. Net debt was reduced to zero as of June 30, 2017.

An interesting thing to point out in this is that we had extra spending both in engineering this year and in sales and marketing, and we did that because we wanted to get our products seeded into the dealer base strongly this year. So we had all these products, the lockdown products and the communications products and the connected home products. So we spent more money promoting it to our dealers, advertising it, training the dealers, and we spent more engineering to get the products to market faster. While it affected our profit a little bit, it was a great thing to do because it sets us up for the future, because the dealers will adopt these products faster because we've trained and educated them. So this was something that was pre-thought, and it will be very good for the future.

We expect that in the 2018 fiscal year the spending rate for both sales and marketing and for engineering will be about the same as in 2017, because we did the job of the marketing and engineering in the 2017 fiscal year. We'll keep it at about the same spend level for the 2018 fiscal year, which should drive our profitability up nicely for the 2018 fiscal year. We're thinking that probably in the 2018 fiscal year, the SaaS revenue will grow from the \$10 million to \$15 million, which is about a 50% increase, and we think in the 2019 fiscal year, it will be also a 50% increase. It's more a conservative number

we believe because it has grown 59% last year, and the products are accelerating and catching on more and more with the dealers. So that was a conscious decision we made: Let's spend more money and get the product embedded and get the products out faster. So that's how we've managed our company for the June 30, 2017 year, and it should reap strong results for the 2018 fiscal year and beyond.

TWST: Looking ahead, what do you think might be one or two challenges that you could highlight?

Mr. Soloway: The challenges are how fast the adoption rate is going to be by the dealers because the technology is such that it's new, but it's exciting technology, and the consumers want it. So when the consumers want these type of products, the dealers will respond and supply the products, so it's just the adoption rate. I keep saying that in all the paradigm-changing product lines, we're in the early, early innings. We are in the first, second inning of the introduction of all this, but we're already seeing from our results a very nice continuity. In fact, the SaaS amount of \$10 million is a year ahead of where we thought it was going to be. We thought it will be at the \$10 million in the 2018 fiscal year, but we did it in the 2017 fiscal year.

So when the wind is at your back and you have new strong product lines, promote them, let the industry know about it, and that will make a nice springboard for the future years, 2018, 2019, 2020. We like to look out in the future and identify the trends and then design products that are to meet those trends as they're coming in. So that's our direction. We brought in lot of new engineering talent into the company in the last two years, and we've developed a lot of new software and apps and communications, and now we're taking the platform of products that we've been selling and electrifying with communications and software, and now it's making a big difference to our company.

TWST: Was it a challenge to get some of those engineers into your company? Did you have to compete with other industries and other fields to get them over to your company?

Mr. Soloway: Yes. Because what happens is we're in a very competitive area here in New York; a lot of the banks have a lot of software developers working for them. But we happen to be 30 minutes east of JFK Airport on the South Shore in the village of Amityville on Long Island, and we have a very big plant there that we own. In that plant, we have about 200 workers, 250 people in total with our salespeople working out of that plant, and engineering is there, and sales and marketing and shipping and startup manufacturing are there.

So a lot of the engineers live on Long Island, and they don't want to commute on the Long Island Railroad into New York City. It takes hours each day, an hour and a half, two hours each way. So being on Route 110, which runs right between Nassau and Suffolk Counties, we're in a very good place for working because the commute is better, the money is very good, and we can attract a lot of very, very good people. So that's an advantage for us. But typically it is a challenge

because you want very high-level engineers that work in today's world with all the modern technology, which keeps changing very quickly, so you have to have a good team. We have more than 40 engineers; we do everything in-house.

TWST: When you look at the next decade, where would you like the company to be as you look to the future?

Mr. Soloway: We believe that in two years, we will be about \$100 million in hardware sales, and we'll be about \$20 million in recurring revenue/SaaS, and at that rate we estimate approximately \$1 a share in profitability. We believe that our stock right now is undervalued, because it's selling for \$9 today. At a little more than \$1 a share, with the 18.8M shares outstanding, our stock could be about \$20 a share. Inside ownership is 38%. We are aligned with our shareholders.

The word has to get out. We hired our own investor relations person in-house instead of using agencies, and we want people to hear about our story. It's an exciting story. It's a story of protection and security, which is very top of mind today, and with all the engineering and all the changes that we've done to bring the product line to the latest level of technology, there's going to be very exciting years ahead.

TWST: Thank you. (ES)

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