

November 17, 2010

Market Outperform / Speculative Risk

Searching for a bottom

#### MARKET DATA Intraday - 11/17/2010

Price	1.66
Exchange	NASDAQ
Target Price	\$2.15
52 Wk Hi - Low	3.02 - 1.50
EV(MM)	56.3
Market Cap(MM)	32.1
Shares Out (MM)	19.1
Public Mkt Float (MM)	12.1
Avg. Daily Vol	9,947.0

#### BALANCE SHEET METRICS

Cash (MM)	5.5
LTD (MM)	\$0.0
Total Debt/Total Equity	163.91%
Debt/Capital	NA
Price/Book Value	1.0x
Book Value/Share	1.74

#### EARNINGS DATA (\$)

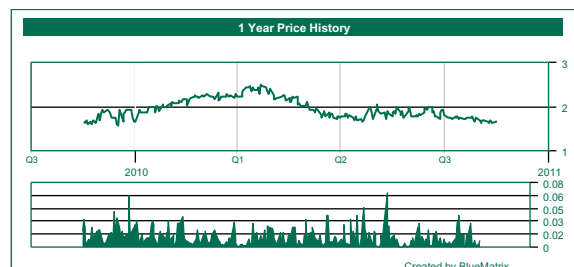
FY - Jun	2008A	2009A	2010A
Q1 (Sep)	0.02	0.02	(0.10)
Q2 (Dec)	0.06	0.02	(0.05)
Q3 (Mar)	0.17	(0.26)	(0.10)
Q4 (Jun)	(0.06)	(0.48)	(0.10)
Full Year EPS	0.18	(0.71)	(0.34)

#### VALUATION METRICS

Price/Earnings	9.2x	NM	NM
Y/Y EPS Growth	NM	NM	NM

#### INDICES

DJIA	11,017.9
SP-500	1,179.6
NASDAQ	2,099.9
Russell 2000	706.5



**Seasonal weakness:** During 1QFY11, Napco Security (NSSC, Market Outperform) reported revenues of \$15.3 million, up 6%yoy and net loss of \$1.1 million (EPS \$0.06) as compared to a net loss of \$1.8 million during the same quarter last year.

The September quarter is a seasonally weak quarter for the company as compared to the June quarter with revenues down 26% sequentially. The 6% year-on-year revenue growth was driven by growth in door locking products by \$1.1 million partially offsetting a \$0.2 million decline in revenues from intrusion and access control products. European revenues at \$0.4 million were down 27% Y/Y, a disappointment this quarter. Overall International sales at \$1.6 million were down 13% Y/Y. The company's new combination control panel for commercial fire has seen strong orders and opens up opportunities in the \$1 billion fire industry. However, management mentioned this product line may take a few more quarters before contributing to revenues. NAPCO recently launched a wireless version of the IC Video product line, a major strategic initiative intended to drive incremental recurring service revenues.

**Cost containment:** Gross margins declined to 22.3% during the quarter from 23.1% last year. However, operating loss narrowed to \$0.7 million from \$1.4 million last year primarily due to lower SG&A expenses resulting from the consolidation of the Marks operations and European and Middle East warehouses into NSSC's headquarters in Amityville, NY. This restructuring was largely completed during the previous fiscal year (Jun-10) during which the company took a charge of \$1.3 million.

**Continued restructuring:** During the quarter, the company repaid debt of \$0.9 million. It has also amended its credit terms with lenders which now include a term loan of \$16 million and \$11.1 million in revolving credit facility. In addition to easing of certain financial covenants, the amendment provides for a LIBOR + 4.5% interest rate option in addition to the current prime + 4% option. The interest expenses of the company are expected to be lower by \$0.5 million annually based on current LIBOR rates.

Accounts receivables dropped from \$17.7 million from last quarter to \$14.7 million primarily due to the seasonal market weakness during this quarter. However, two customers cumulatively accounted for 21% of the outstanding receivables (~\$3 million) which presents a significant credit risk to the company. NSSC has made a \$0.5 million provision for doubtful accounts.

**Bottom Line:** Revenue recovery coupled with expense control should enable the company to reach profitability by fiscal year end.

Our DCF valuation methodology assumes a terminal revenue growth rate of 10%. Our EBITDA assumptions are that operating margins stabilize in the high single digits. For WACC, or cost of equity, we assume a conservative 12%. These assumptions yield a DCF fair value of \$2.15.

**Napco Security Technologies, Inc.**

## Income Statement

FYE: Jun (\$ in million, except per share data)	Sep-08 <b>1Q09</b>	Dec-08 <b>2Q09</b>	Mar-09 <b>3Q09</b>	Jun-09 <b>4Q09</b>	<b>FY2009</b>	Sep-09 <b>1Q10</b>	Dec-09 <b>2Q10</b>	Mar-10 <b>3Q10</b>	Jun-10 <b>4Q10</b>	<b>FY2010</b>	Sep-10 <b>1Q11</b>	Dec-10 <b>2Q11E</b>	Mar-11 <b>3Q11E</b>	Jun-11 <b>4Q11E</b>	<b>FY2011E</b>
<b>Total Revenue</b>	<b>17.5</b>	<b>19.1</b>	<b>14.0</b>	<b>19.0</b>	<b>69.6</b>	<b>14.5</b>	<b>16.6</b>	<b>16.0</b>	<b>20.6</b>	<b>67.8</b>	<b>15.3</b>	<b>16.8</b>	<b>17.0</b>	<b>20.0</b>	<b>69.1</b>
Cost of Goods Sold	11.9	12.9	13.1	15.5	53.4	11.1	12.6	11.9	17.6	53.2	11.9	12.6	12.8	15.0	52.2
SG&A	4.8	5.4	4.9	5.0	20.2	4.7	4.4	5.0	4.7	18.8	4.1	4.3	4.4	4.5	17.3
Restructuring & Impairment	-	-	1.3	9.7	11.0	-	-	0.9	-	0.9	-	-	-	-	-
Operating Income	0.8	0.8	(5.3)	(11.3)	(14.9)	(1.4)	(0.4)	(1.8)	(1.7)	(5.2)	(0.7)	(0.1)	(0.2)	0.5	(0.5)
Interest Income (Expense)	0.3	0.4	0.4	0.5	1.6	0.6	0.6	0.6	0.6	2.4	0.6	0.3	0.3	0.3	1.5
Other income (Expense)	0.1	(0.1)	0.1	0.0	0.1	0.0	(0.0)	0.0	0.0	0.0	0.0	-	-	-	0.0
Minority Interest	0.0	0.1	(0.1)	-	0.0	-	-	-	-	-	-	-	-	-	-
Pretax Income	0.5	0.5	(5.9)	(11.7)	(16.7)	(1.9)	(1.0)	(2.4)	(2.3)	(7.6)	(1.3)	(0.4)	(0.5)	0.2	(2.0)
Provision for Income Taxes	0.2	0.1	(0.9)	(2.7)	(3.3)	(0.1)	(0.1)	(0.5)	(0.4)	(1.1)	(0.2)	0.1	0.1	0.4	0.4
Net Income	0.3	0.3	(5.0)	(9.0)	(13.4)	(1.8)	(0.9)	(1.9)	(1.9)	(6.5)	(1.1)	(0.5)	(0.6)	(0.2)	(2.4)
<b>EPS</b>	<b>\$ 0.02</b>	<b>\$ 0.02</b>	<b>\$ (0.26)</b>	<b>\$ (0.48)</b>	<b>\$ (0.71)</b>	<b>\$ (0.10)</b>	<b>\$ (0.05)</b>	<b>\$ (0.10)</b>	<b>\$ (0.10)</b>	<b>\$ (0.34)</b>	<b>\$ (0.06)</b>	<b>\$ (0.03)</b>	<b>\$ (0.03)</b>	<b>\$ (0.01)</b>	<b>\$ (0.13)</b>
Shares Outstanding	19.5	19.1	19.1	18.7	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1	19.1
<b>Margin Analysis</b>															
Gross Margin	32.1%	32.6%	6.5%	18.3%	23.3%	23.1%	24.0%	25.9%	14.7%	21.4%	22.3%	25.0%	25.0%	25.0%	24.4%
R&D	0.0%	0.0%	8.9%	51.1%	15.8%	0.0%	0.0%	5.8%	0.0%	1.4%	0.0%	0.0%	0.0%	0.0%	0.0%
SG&A	27.3%	28.6%	35.1%	26.5%	29.0%	32.4%	26.5%	31.1%	23.0%	27.8%	27.0%	25.7%	25.9%	22.5%	25.1%
Operating Margin	4.7%	4.0%	-37.5%	-59.3%	-21.4%	-9.4%	-2.5%	-10.9%	-8.2%	-7.7%	-4.7%	-0.7%	-0.9%	2.5%	-0.7%
Pretax Margin	2.7%	2.4%	-41.9%	-61.9%	-24.0%	-13.4%	-5.8%	-14.7%	-11.2%	-11.2%	-8.6%	-2.5%	-2.6%	1.0%	-2.9%
Tax Rate	32.6%	28.0%	14.6%	23.2%	19.8%	6.2%	6.3%	20.8%	17.8%	14.3%	14.4%	-27.4%	-22.2%	200.0%	-21.2%
Net Margin	1.8%	1.7%	-35.8%	-47.5%	-19.2%	-12.6%	-5.5%	-11.6%	-9.2%	-9.6%	-7.4%	-3.1%	-3.2%	-1.0%	-3.5%
<b>Ann. Growth Analysis</b>															
Revenues	26%	18%	-14%	-14%	2%	-17%	-13%	14%	9%	-3%	-12%	-12%	21%	5%	2%
Gross Profit	-15%	-3%	-81%	0%	-21%	-28%	-26%	298%	-19%	-8%	-30%	-23%	284%	37%	14%
Operating Income	3%	-40%	-435%	2068%	-576%	-263%	-154%	-67%	-85%	-65%	-186%	-115%	-97%	-104%	-91%
Net Income	-14%	-72%	-253%	716%	-460%	-665%	-375%	-63%	-79%	-51%	-452%	-258%	-89%	-98%	-63%
<b>Seq. Growth Analysis</b>															
Revenues	-21%	9%	-26%	35%		-24%	15%	-4%	29%		-26%	9%	1%	18%	
Gross Profit	76%	2%	-80%	181%		26%	4%	8%	-43%		22%	12%	0%	0%	
Operating Income	-260%	-8%	-787%	114%		-88%	-70%	327%	-3%		-94%	-84%	33%	-433%	
Net Income	-129%	3%	-1611%	80%		-80%	-50%	104%	2%		-87%	-54%	5%	-64%	

Source: Company Reports and Rodman &amp; Renshaw Estimates

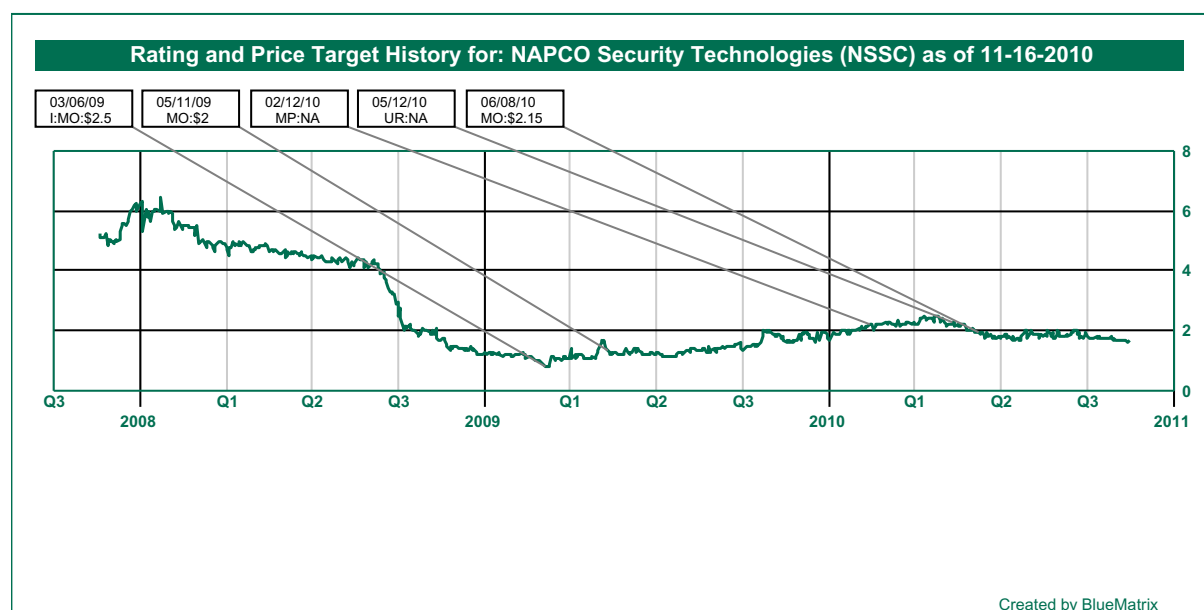
**RODMAN & RENSHAW RATING SYSTEM:** Rodman & Renshaw employs a three tier rating system for evaluating both the potential return and risk associated with owning common equity shares of rated firms. The expected return of any given equity is measured on a RELATIVE basis of other companies in the same sector, as defined by First Call. The price objective is calculated to estimate the potential movement in price a given equity could achieve given certain targets are met over a defined time horizon. Price objectives are subject to exogenous factors including industry events and market volatility. The risk assessment evaluates the company specific risk and accounts for the following factors, maturity of market, maturity of technology, maturity of firm, cash utilization, and valuation considerations. Potential factors contributing to risk: relatively undefined market, new technologies, immature firm, high cash burn rates, intrinsic value weighted toward future earnings or events.

## RETURN ASSESSMENT

- **Market Outperform (Buy):** The common stock of the company is expected to outperform a passive index comprised of all the common stock of companies within the same sector, as defined by First Call.
- **Market Perform (Hold):** The common stock of the company is expected to mimic the performance of a passive index comprised of all the common stock of companies within the same sector, as defined by First Call.
- **Market Underperform (Sell):** The common stock of the company is expected to underperform a passive index comprised of all the common stock of companies within the same sector, as defined by First Call.

## RISK ASSESSMENT

- **Speculative -** The common stock risk level is significantly greater than market risk. The stock price of these equities is exceptionally volatile.
- **Aggressive -** The common stock risk level is materially higher than market level risk. The stock price is typically more volatile than the general market.
- **Moderate -** The common stock is moderately risky, or equivalent to stock market risk. The stock price volatility is typically in-line with movements in the general market.



## RATING SUMMARY

Distribution of Ratings Table				
Rating	Count	Percent	IB Serv./Past 12 Mos	
			Count	Percent
Market Outperform(MO)	169	74.40%	47	27.81%
Market Perform(MP)	46	20.30%	4	8.70%
Market Underperform(MU)	5	2.20%	0	0.00%
Under Review(UR)	7	3.10%	2	28.57%
Total	227	100%	53	100%

Investment Banking Services include, but are not limited to, acting as a manager/co-manager in the underwriting or placement of securities, acting as financial advisor, and/or providing corporate finance or capital markets-related services to a company or one of its affiliates or subsidiaries within the past 12 months.

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