Zacks Small-Cap Research

October 30, 2012
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Sierra Monitor Corporation SRMC-OB

SRMC: – Orders Ramping; OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (10/29/12)	$1.50
Six- Month Target Price	**$2.50**

OUTLOOK

Sierra Monitor Corporation designs and develops hazardous gas monitoring devices for the protection of personnel and facilities in industrial work places. Through its subsidiary FieldServer Technologies the firm has branched into protocol translation technology, which enables machine to machine (M2M) communication in energy and building automation applications. This high growth business should complement the gas detection business, while not sacrificing market or margins. FieldServer should see a tailwind as a result of the push toward zero net energy building designs. We see value in the shares of SRMC.

SUMMARY DATA

52-Week High	**$2.35**
52-Week Low	**$1.10**
One-Year Return (%)	**3.45**
Beta	**0.32**
Average Daily Volume (sh)	**630**
Shares Outstanding (mil)	**10**
Market Capitalization ($mil)	**$15**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**63**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**10.7**
P/E using 2012 Estimate	**8.8**
Zacks Rank	**3**

Risk Level	**Moderate**
Type of Stock	**Small-Blend**
Industry	**Industrial Services**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	3.2 A	2.9 A	3.3 A	3.2 A	12.6 A
2010	2.9 A	3.5 A	3.7 A	4.2 A	14.3 A
2011	4.2 A	4.0 A	3.8 A	3.5 A	15.5 A
2012	6.2 A	4.7 A	4.0 A	4.6 E	19.5 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	$0.00 A	$0.00 A	$0.01 A	$0.01 A	$0.02 A
2010	$0.00 A	$0.03 A	$0.03 A	$0.03 A	$0.09 A
2011	$0.04 A	$0.03 A	$0.03 A	$0.01 A	$0.11 A
2012	$0.07 A	$0.04 A	$0.02 A	$0.04 E	$0.17 E

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WHATS NEW

On October 30, 2012, Sierra Monitor Corporation reported financial results for its third quarter and nine months ended September 30, 2012.

Sierra Monitor reported mixed results with year over year third quarter revenues increasing $237,070 or over 6 percent to $4.040 million from $3.803 million for the comparable quarter of 2011. The Company's third quarter 2012 GAAP net income declined $29,341 to net income of $152,395 from $181,736 during the three months ended September 30, 2011.

The year over year decline in net income was a primarily a result of lower gross margin and slightly higher total operating expenses.

Gross margin dropped slightly year over year from 58.9 percent to 57.9 percent for the three months ended September 30, 2012 while total operating expense increased year over year by $149,242 to $2.086 million.

Based on a weighted average number of basic common shares of 9.905 million, basic net income per share resulted in $0.02 per share during the third quarter fiscal 2012. This compared to basic net income per share of $0.02 on a weighted average number of basic shares of 9.901 million during the three months ended September 30, 2011.

Non-GAAP net income for the third quarter of 2012 decreased year over year by $19,389 to 274,322 while non-GAAP earnings per basic share for the third quarter of 2011 remained steady at $0.03.

For the nine months ended June 30, 2012, year over year revenues improved by nearly 25 percent or $2.951 million to $14.907 million from $11.956 million for fiscal 2011.

GAAP Net income for the nine months jumped by $334,766 year over year to $1.060 million for the nine months ended September 30, 2012. This compares to $725,560 for the comparable nine months ended June 30, 2011.

The year over year jump in net income was a primarily a result of a drop in total operating expenses as a percentage of revenues.

While total operating expenses increased by $541,166 year over year, they fell as a percentage of revenues to 43.1 percent from 49.3 percent of revenues for the nine months ended September 30, 2011.

However, gross margin for the nine months fell to 55 percent compared to gross margin of 59.4 percent for the nine months ended September 30, 2011.

Based on a weighted average number of basic common shares of 9.902 million, basic net income per share resulted in $0.11 per share for the nine months ended September 30, 2012. This compared to basic net income per share of $0.07 on a weighted average number of basic shares of 9.898 million during the six months ended September 30, 2011.

Non-GAAP net income for the first nine months of 2012 increased year over year by over 34 percent to $1.403 million and non-GAAP earnings per basic share for the first nine months of 2012 jumped to $0.14 compared to $0.011 for the nine months ended September 30, 2011.

Sierra Monitor's balance sheet remained strong with cash and equivalents of $2.408 million, net accounts receivables of $2.089 million and no bank debt. This compares to cash and equivalents of $2.132 million and net accounts receivables of $2.455 million for the three months ended June 30, 2012.

Likewise, the Company had a Days Sales Outstanding in Accounts Receivable of 43 days.

Similarly, working capital for the quarter improved sequentially to $6.849 million from $6.639 million for the period ended June 30, 2012.

It should further be noted that the Company's FieldServer sales team has continued to produce higher bookings through more focus on OEM and repeat customer accounts.

Sierra Monitor recently received a follow-on order to supply FieldServer gateways for integration of smoke and flame detectors in a LonWorks network aboard Zumwalt-class U. S. Navy destroyers.

Likewise, the Company received a design/build order from a major international instrument company to supply a custom FieldServer gateway platform for ultra-sonic flow meters used in a broad range of industrial applications.

Furthermore, Sierra Monitor's domestic gas detection sales team has increased its focus on clean energy projects such as alternate fuel fleet maintenance facilities while its international team continues to focus on oil and gas projects

The Company was recently selected by an international company specializing in the reduction of sulfur content in transport fuels, such as diesel and jet fuel, to supply gas and flame detection systems on their skid mounted process equipment.

Seeds of this Stepping Stone Contract Were Sown Long Ago

With their primary gas detection products Sierra Monitor Corporation [SRMC] has established a reputation of supplying high quality instrumentation and control systems for domestic industrial markets. Several years ago the company began releasing new products that further satisfy domestic requirements while also meeting specifications for international projects including the Middle East. With the products released and various third party approvals underway SMC ventured to open a sales office in Dubai beginning the sometimes arduous task of obtaining specific approvals from the key Middle East Companies including Aramco, ADCO (Abu Dhabi Oil), Kuwait Oil and others.

The strategy began paying off in 2010 when several project sales were complete, each in the area of $150K to $250K. The recent announcement that the company has now received an order for delivery in 2011 of $2.5 million of gas and fire detection equipment certainly reinforces that the company has established itself as a player in the large scale project market. The company has the strength of products, size of facility and the strength of balance sheet to undertake this order and continue the Middle East successes. We feel this will become a stepping stone contract.

The World Onshore Pipelines Report 2011-2015 forecasted US$193 billion will be spent on onshore pipeline projects worldwide through to 2015. Many countries, especially in Asia and the Middle East, have specific national priorities for pursuing refining projects. China is going ahead with its refining projects to meet its surging domestic demand for refined products and to reduce dependence on imports. The Middle East is investing heavily to become a major petroleum products export hub by utilizing its domestic heavy and sour crude as well as satisfying its increasing domestic light distillate demand. (Oil and Gas Chronicle)

Cisco EnergyWise

According to Cisco, in response to energy costs, environmental concerns, and government directives, there is an increased need for sustainable and "green" business IT operations. More than 70 percent of electricity consumed in the United States is used in office buildings. However, inefficient use is leading to energy wastage. For example, Department of Energy (DoE) estimates suggest that PCs left on are in use only 9 to 15 percent of the time. Consequently, there is renewed focus in making sure of not only the procurement of energy-efficient equipment, but also judicious usage and proactive monitoring. Enter Cisco EnergyWise Architecture. This is technology architecture added to existing switching and routing portfolios that is able to,

- Measure power consumption consumed by each device in the network.
- Analyze this data in order to make decisions on cost saving policy actions.
- Enact policies to optimize the power consumption of the building.

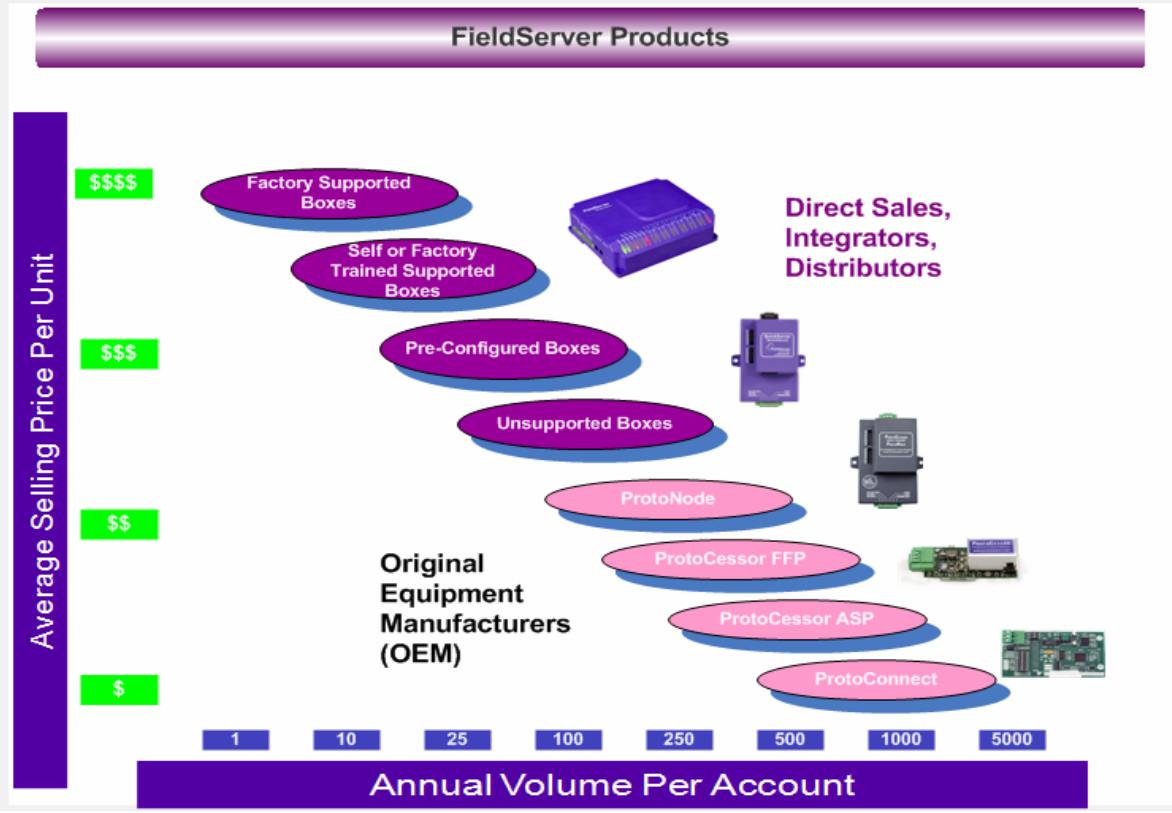
Sierra Monitor's FieldServer division has developed a translator to allow energy management connections between Cisco's EnergyWise protocol and external devices including power meters, lighting controls and other building automation devices. The translator, which is currently under test, opens opportunities for Cisco to increase the benefit of their EnergyWise offering and thereby expanding the market for FieldServer products.

***Source for Cisco EnergyWise System is from company brochure**

Beyond the Obvious

As the push toward energy efficiency continues to gain momentum, building automation remains a focus for the real estate community, building owners and campuses. Large automation suppliers depend upon gaining monitor and control access to more and more devices in the building. These devices range from standby generators to window shares, from lighting to power management at the work cubicle level. When the devices lack the appropriate communication protocol FieldServer products fill the need by translating the device protocol to the building's data back-bone protocol.

FieldServer supplies packaged protocol translation solutions (gateways) directly to building automation integrators and also through other manufacturer's sales channels where the addition of the protocol solution adds value to the overall offering. As price pressure eases unit costs for gateways downward, the trend is for integrators to find more uses for the gateway increasing the number deployed in each project.



FieldServer also supplies the same protocol translation capabilities in formats that can be purchased by OEM's and integrated into their offerings. The OEM products are sold under the ProtoCessor product name. As the manufacturer's note more and more interface requirements through their sales channels they identify revenue opportunities to either increase their selling prices or position their products in a more unique manner. FieldServer's ProtoCessor product is the fastest growing product line in the company as more OEM's recognize the opportunity and learn that the ProtoCessor products allow a fast, reliable, route to market. FieldServer's extensive knowledge of M2M communication protocols allows the OEM to enter a product arena that would otherwise represent high technological barriers and risks.

INVESTMENT THESIS

Sierra Monitor Corporation designs and develops hazardous gas monitoring devices for the protection of personnel and facilities in industrial work places, environment monitoring and control systems for remote telecom site management and protocol translation gateways that allow disparate machines to communicate with each other. While gas detection and telco site management products provide a stable business base the newer protocol gateway business is expected to accelerate overall growth of SRMC.

Primary product groups:

- Gas Detection
- Telecom Site Management
- Protocol Translation Gateways

The firm should capitalize on the expanding worldwide demand for cleantech knowledge-based products and services that improve operational performance, productivity, efficiency and safety in building

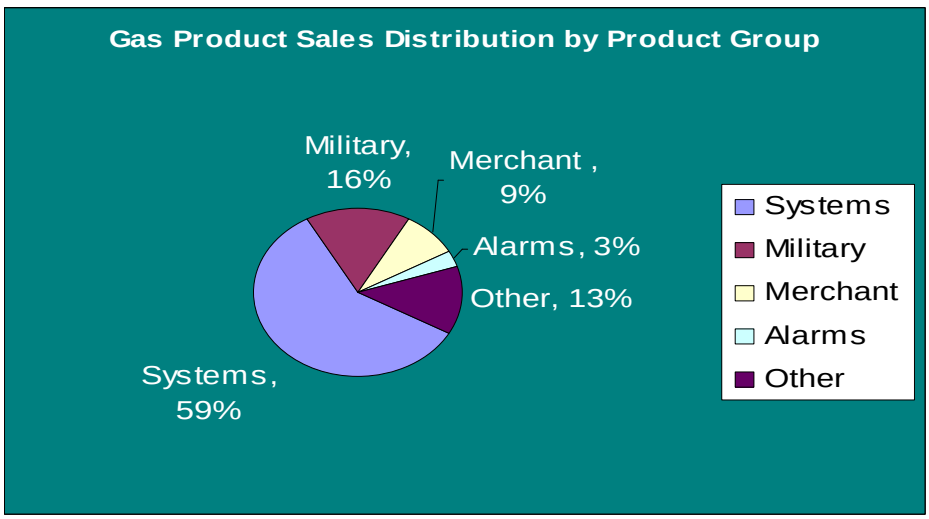
automation, industrial and military applications, while reducing demands on resources and energy consumption.

Gas Detection

Sierra Monitor's hazardous gas and fire detection systems, including combustible gas monitors, toxic gas monitors and flame detectors are used in industrial markets worldwide. The gas detectors range from basic gas monitors with alarms to complete plant-wide intelligent hazardous gas and flame detection systems utilizing digital communications between the sensors and the controller and further to the plant Distributed Control System. Taking the Sentry Gas Detection System as an example, it provides a comprehensive plant-wide controller/sensor system for monitoring combustible gas, oxygen deficiency and toxic gases to maintain safety in a plant. The flexibility of Sentry enables the customer to design a safety system that meets the firm's specific needs.

Product	Industry	Use	Price
Integrated Systems	Process & Muni Plants	Integrated Controller and Sensors with multiple communication choices	Highest
Unitary	Factories & Storage Areas	Alarm and Control in Field Device	High
Commodity Gas	Re-sellers/	Digital and Analog Solution	Moderate
Alarm Systems	Virtually Any Market	End users provide control infrastructure	Low

These systems utilize features such as recorded event information, graphical displays on central computers and web server displays to allow users to identify hazards and problems before they evolve into incidents which, could cause production delays and may prompt evacuation of personnel and potentially even cause property damage and physical injury.



Custom Systems

Sierra Monitor designs and fabricates gas detection systems customized for clients applications. The company maintains a UL (Underwriters Labs) certified design process that allows complete systems to leave the factory with UL marking. These systems may incorporate special enclosures, alarm devices, web interfaces and other options. Applications of customized system include the following.

- Duct monitoring of Silane in semiconductor tools

- Combustible gas monitoring in alternate fuel school buses
- Monitoring bus barns for alternative fuel (CNG) vehicles
- Ammonia monitoring in ice cream plant
- Combustible gas monitoring in telecommunications vaults

Telecom Site Management

SRMC also supplies microprocessor-based environment control products to the telecommunications industry. The control products are used to monitor temperature, gas, smoke and other environmental and security conditions in remote structures such as DSL distribution nodes, fiber optic booster stations and cell-tower site buildings. Environment controllers integrate various functions which would otherwise require discrete controls and alarm handling.

All segments of the telecommunications industry, land line, wireless, cable and satellite, employ vast networks of highly sophisticated communications equipment to deliver their services rapidly and reliably to their customers. Much of this equipment is deployed in remote, largely unmanned sites. Therefore it is natural that the firm offers a comprehensive array of Telecom Site Management Products. Each is microprocessor based and is designed in form, fit and function for the intended application and for the type of structure into which it will be deployed.

The equipment in these sites will vary, depending upon the signal and data transmission medium: copper, fiber, coax, RF. The structures housing this equipment will also vary, depending upon location and local building, zoning and environmental regulations. Common, however, to all equipment and structure types is the requirement for support elements that are critical to uninterrupted site availability and uncompromised site safety and security. Critical support elements include commercial power, HVAC, generators, DC plant and batteries and environmental sensors.

Over the next 15 to 20 years, copper access networks worldwide will be largely replaced by a fiber access network, creating massive opportunities for vendors, network builders, and service providers. The most important catalyst for this change is a growing perception that copper access networks will soon no longer be able to meet the ever-growing consumer demand for bandwidth, driven mainly by the Internet, IP, and the many services running over it. At the same time, competition to move customers onto complex service packages that include video is leading some to conclude that they must be first to deploy fiber, pre-empting or frustrating future competition.

Fieldserver Technologies

FieldServer Technologies consist of the Fieldserver and ProtoCessor business units. This technology targets commercial buildings infrastructure and essentially makes products that provide interoperability from device to enterprise networks. The result is the firm has a grasp on everything from energy efficiency and automation to roof-top air conditioning and lighting controls.

Research and spending over the next several years will focus on “zero net energy” building designs. The WBCSD (World Business Council for Sustainable Development) identified buildings as one of the five main users of energy where “mega trends” are needed to transform energy efficiency. They account for 40% of primary energy in most countries covered by this project and consumption is rising. The International Energy Agency (IEA) estimates that current trends in energy demand for buildings will stimulate about half of energy supply investments to 2030. If building site energy consumption in China and India grows to current US levels, China’s and India's consumption will be respectively about four and seven times greater than they are today. Energy consumption will grow dramatically without action to improve energy efficiency substantially. The construction boom, especially in China, is increasing energy demand significantly, but economic development and other factors are adding to the challenge because they also increase buildings’ energy needs.

SRMC sells several Fieldserver products to both original equipment manufacturers (OEMs) and through direct sales to integrators and distributors. From its low average selling price ProtoConnect which is targeted at companies that have a standard proprietary communications interface to its high margin X30 Linux based platforms, the firm provides Fieldserver products that cater to virtually any firm or building in the several industries.

Further legacy devices are now being linked to central sources. This enables the firm to provide a platform for remote monitoring and management. Therefore growth in this area is two-fold. It will not only come from new sales, but also from firms wishing to tie legacy products into a single system. FieldServer has become a growing piece of the solution in recent years. In 2009, combined revenue from sales of FieldServer and ProtoCessor products was approximately 45% of sales compared to approximately 40% in 2008 and 37% in 2007.

KAUST

King Abdullah University of Science and Technology (KAUST) is located on the coast of the Red Sea approximately eighty kilometers north of Jeddah in Saudi Arabia. Construction of the university involved a multi-billion dollar effort by a consortium of engineering and construction contractors. The entire campus, including nineteen massive academic buildings, hundreds of town center buildings and over a thousand student and faculty buildings is monitored and controlled via a system known as ICAS (Inter Campus Automation System). ICAS tracks every electrical and security device in the infrastructure including lights, window shades, motion sensors, fire alarm panels, computer screens, temperatures, water flow, and many other devices and parameters.

During construction the ICAS integrator used Sierra Monitor FieldServers for two primary tasks. The first was to interface to all academic building lighting panels. The second task was to interface to hundreds of fire panels distributed throughout the academic buildings, town center and residences. FieldServer supplied the interface products through a series of orders beginning in the second half of 2009 and continuing to the present including a large order shipped in Q4 of 2010. In addition to the supply of products FieldServer provided fee based remote technical support and also supplied three application engineers for a total of ten weeks of on-site support in Saudi Arabia. Due to the fact that all equipment used at KAUST must have a communication protocol known as BACnet it is very likely that there are many more FieldServer devices deployed in equipment at the university but sold through OEM channels to equipment manufacturers.

The KAUST project represents an excellent example of how FieldServer products and services can offer very high value technical solutions in multifaceted monitoring and control applications.

VALUATION

SRMC remains well positioned to achieve solid revenue growth and operating leverage given the trend toward to energy efficient buildings with machines that communicate with one another. We feel the company's competitive advantage is two fold. It connects not only new products in machine to machine (M2M) communication but also legacy products. The faster growing FieldServer Technologies subsidiary is an excellent complement to the high margin gas detection business used in industrial markets world wide. Further KAUST remains a model for future business and the balance sheet is a source of strength.

The company is trading at a reasonable 8.8x 2012 estimated EPS. We value the company based on the average of our P/E multiple (14.7x 2012 estimated EPS) and our two stage intrinsic model.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. (0 in Sierra's case) Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- A 10-year period with an earnings growth rate of 12.0% (average forecast) and a discount rate of 11.5%.
- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 10.4%.

With these inputs we arrive at a target price of $2.50.

RISKS

- While the overall world economy and markets have rebounded, the possibility of a double dip or a slow growth environment remains.
- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Mil)	Sep-11 Q3 11	Dec-11 Q4 11	Mar-12 Q1 12	Jun-12 Q2 12	Sep-12 Q3 12	Dec-12 Q4 12 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 E
REVENUE												
Net Revenue	**3.8**	**3.6**	**6.2**	**4.7**	**4.0**	**4.5**	**12.97**	**13.75**	**12.73**	**14.39**	**15.53**	**19.50**
Sequential Growth		*-6%*	*74%*	*-25%*	*-13%*	*11%*						
OPERATING EXPENSES												
Cost of Revenues	1.56	1.49	3.04	1.96	1.70	1.75	5.24	5.60	5.11	5.97	6.3	8.5
% of Revenue	*41.1%*	*41.7%*	*49.1%*	*42.0%*	*42.1%*	*38.9%*						
Gross Profit -	**2.2**	**2.1**	**3.2**	**2.7**	**2.3**	**2.8**	**7.73**	**8.15**	**7.62**	**8.4**	**9.2**	**11.1**
Proforma Gross Margin	*58.9%*	*58.3%*	*50.9%*	*58.0%*	*57.9%*	*61.1%*	*59.6%*	*59.3%*	*59.9%*	*58.5%*	*59.2%*	*56.7%*
R&D + Engg	0.55	0.56	0.57	0.54	0.52	0.55	2.1	1.9	2.0	2.0	2.2	2.2
% of Revenue	*14.5%*	*15.6%*	*9.2%*	*11.7%*	*13.0%*	*12.2%*	*16.1%*	*13.9%*	*15.4%*	*13.7%*	*14.2%*	*11.2%*
SG&A	1.38	1.30	1.63	1.60	1.56	1.62	4.62	5.37	5.24	5.30	5.55	6.60
% of Revenue	*36.4%*	*36.3%*	*26.3%*	*34.3%*	*38.7%*	*36.0%*	*35.6%*	*39.0%*	*41.2%*	*36.8%*	*35.7%*	*33.8%*
GW Amort, Restructuring, other	-	-	-	-	-	-	-	-	-	-	-	-
% of Revenue												
Total Operating Expenses	1.94	1.85	2.20	2.15	2.09	2.17	6.71	7.27	7.21	7.28	7.75	8.78
% of Revenue	*50.9%*	*51.9%*	*35.5%*	*46.0%*	*51.6%*	*48.2%*	*51.7%*	*52.9%*	*56.6%*	*51%*	*50%*	*45%*
Operating Income -	**0.3**	**0.2**	**1.0**	**0.6**	**0.3**	**0.6**	**1.02**	**0.88**	**0.41**	**1.1**	**1**	**2**
Operating Margin	*8.0%*	*6.4%*	*15.4%*	*12.0%*	*6.3%*	*12.9%*	*8%*	*6%*	*3%*	*8%*	*9%*	*12%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0	0	0	0	0	0	0.0	-	0.0	0	0	0
% of Revenue	*0.01%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.01%*	*0.07%*	*0.00%*	*0.07%*	*0.03%*	*0.01%*	*0.05%*
Tax Provision	0.1	0.1	0.4	0.2	0.1	0.2	0.43	0.39	0.2	0	1	1
Effective Tax Rate												
Net Income -	**0.18**	**0.14**	**0.57**	**0.33**	**0.15**	**0.36**	**0.60**	**0.49**	**0.22**	**0.68**	**0.9**	**1.7**
Net Income Margin	*4.8%*	*4.0%*	*9.2%*	*7.2%*	*3.8%*	*8.0%*	*4.6%*	*3.5%*	*1.7%*	*5%*	*6%*	*9%*
Adjustments			**0.01**	**0.01**								
EARNINGS PER SHARE												
EPS - Basic	$0.03	$0.01	$0.07	$0.05	$0.02	$0.04	$0.05	$0.04	$0.02	$0.09	$0.11	$0.17
EPS - Diluted	$0.03	$0.01	$0.07	$0.04	$0.02	$0.04	$0.05	$0.04	$0.02	$0.09	$0.11	$0.17

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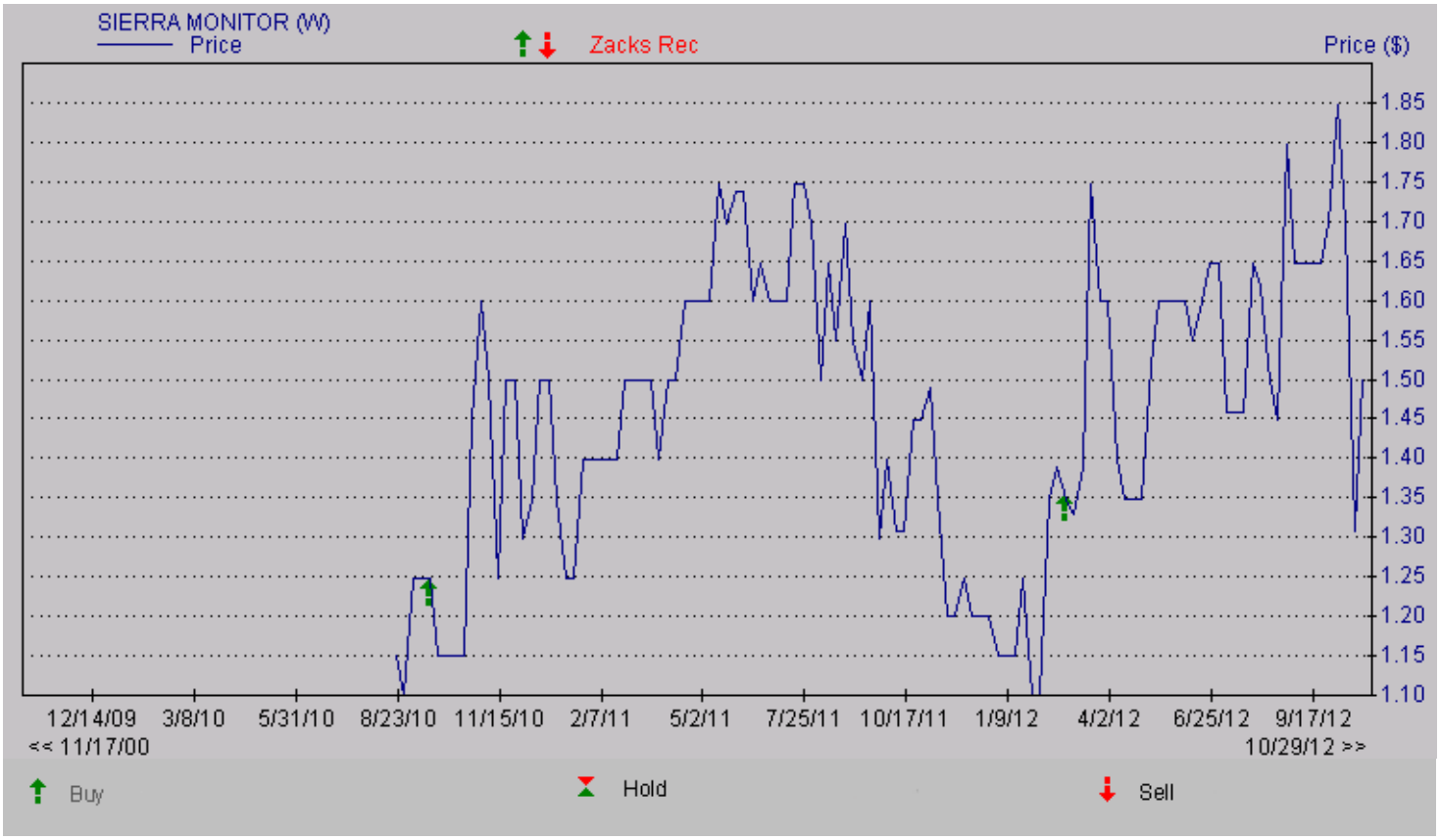
HISTORICAL ZACKS RECOMMENDATIONS



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