Zacks Small-Cap Research

August 16, 2011
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Arotech Corp (ARTX-NASDAQ)

ARTX: Delays Overshadow Progress- OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	03/03/2011
Current Price (08/15/11)	$1.45
Target Price	**$3.00**

OUTLOOK

Arotech Corporation is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military and nonmilitary air and ground vehicles. ARTX has a very strong diversified revenue stream which cuts across both foreign and domestic military, municipalities, and private firms. In several of the business divisions the Company faces fragmented or often times no competition. We see value in the shares and initiate with an outperform rating.

SUMMARY DATA

52-Week High	**$2.32**
52-Week Low	**$1.20**
One-Year Return (%)	**-7.05**
Beta	**1.60**
Average Daily Volume (sh)	**29,256**
Shares Outstanding (mil)	**15**
Market Capitalization ($mil)	**$21**
Short Interest Ratio (days)	**1.43**
Institutional Ownership (%)	**14**
Insider Ownership (%)	**15**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**12.2**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2011 Estimate	**N/A**
P/E using 2012 Estimate	**4.1**
Zacks Rank	**2**

Risk Level	**Moderate**
Type of Stock	**Small-Value**
Industry	**Electronic-Military**

ZACKS ESTIMATES

Revenue

(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	20.09 A	16.04 A	17.55 A	20.86 A	74.53 A
2010	21.15 A	18.90 A	16.36 A	17.33 A	73.74 A
2011	13.30 A	14.30 A	28.50 E	30.00 E	86.00 E
2012					100.00 E

Earnings per Share

(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	-$0.04 A	-$0.06 A	-$0.09 A	$0.06 A	-$0.25 A
2010	$0.01 A	$0.02 A	-$0.08 A	-$0.02 A	-$0.07 A
2011	-$0.18 A	-$0.15 A	$0.08 E	$0.09 E	-$0.16 E
2012					$0.36 E

ARTX gives annual estimates only, quarterly estimates are Zacks estimates

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WHATS NEW

On August 15, 2011, Arotech Corporation, reported financial results for its fiscal 2011 second quarter, ended June 30, 2011.

The second quarter performance resulted in a 24 percent year over year decrease in revenue, with revenue dropping $4.608 million to $14.296 million from $18.904 million for the three months ended June 30, 2010 Net income came in weak as well, falling $2.431 million year over year to a net loss of $2.071 million. This compares to net income of $360,000 million for the comparable quarter of 2010.

The decrease in revenues for the three months ended June 30, 2011 was due to delays in armor orders which Arotech had noted and forewarned about in previously released statements. Nevertheless, the Company anticipates the formerly delayed armor orders to be shipped in the 2011 second half.

As a result of this expected shipping time frame, as well as a $63.4 million contract for the US Army, the Company continues to forecast full year revenues to improve over its fiscal 2010 results and has raised its guidance for both fiscal 2011 and 2012.

While year over year gross margin fell 4.9 percent during the quarter, the decrease in net income was likewise the product of a $500,000 Net Allowance for Settlements that was received in 2010. Additionally, Arotech had $115,757 of Other Expenses during 2011 compared to $473,298 in Other Income received in fiscal 2010.Gross margin fell from 29.7 percent, in the second quarter of 2010, down to 24.8% for the three months ended June 30, 2011.

Still, Arotech's backlog was the best in the Company's history, reaching approximately $109.1 million as of June 30, 2011. This compares to a backlog of $40.4 million at June 30, 2010 and $43.1 million as of March 31, 2011.

More recently, as a result of strong revenues during the Q3 month of July as well as payments received in August, the Company was able to pay down its bank line to $0 and currently has substantial cash on hand. In addition, the last installment of a long term loan was paid off and 530,000 warrants that were not exercised were recovered from the lender.

For the full year 2011, Arotech forecasts revenues to be in the range of $85 million to $88 million, up from the previous guidance of $79 million to $82 million. The recently increased guidance would be a 17.3 percent year over year growth in revenues at the midpoint of the projected range compared to a 9.2 percent year over year increase at the midpoint of the previously anticipated range. The Company continues to forecast fiscal 2011 adjusted EBITDA to approach last year's $2.9 million.

For the full year 2012, Arotech anticipates revenues to be in the range of $95 million to $100 million, up from the previous guidance of $85 million to $95 million. The recently increased guidance would be a 12.7 percent year over year growth in revenues over anticipated revenues for fiscal 2011 at the midpoint of the projected ranges. This compares to a 4.1 percent year over year growth in revenues over anticipated revenues for fiscal 2011 at the midpoint of the previously projected range.

As a result of the increased revenue projection for 2012, the Company also raised its fiscal 2012 adjusted EBITDA projection to be in the range of $4.5 million to $5.5 million, up from the previously guided range of $3.75 million to $5.0 million.

Nonetheless, this forecasted adjusted EBITDA includes the possibility of reaching GAAP profitability.

Furthermore, Arotech's new battery program, SWIPES (Soldier Worn Integrated Power Equipment System), is proceeding nicely and the Company anticipates orders in second half of this year. Still, it should be noted that none of the SWIPES opportunities are included in the battery revenue guidance for 2011 or 2012.

$63.4 Million Order with Potential for $93.9 Million

On May 9, 2011 FAAC Incorporated, (Which operates as part of Arotech Corporation's Training and Simulation Division), announced it had received a $63.4 million contract award for the design, development, production, and delivery of 28 Virtual Clearance Training Suites (VCTS). VCTS simulates the wide array of large and small technical devices, purpose-built mine-protected detection and clearing vehicles, and ever-evolving tactics and techniques used by the U.S. Army to combat improvised explosive devices.

This award, from the U.S. Army Program Executive Office for Simulation, Training & Instrumentation (PEO STRI), is a base order for 28 systems is to be delivered incrementally over a 36-month period. Including all priced options this award is valued at up to $93.9 million.

INVESTMENT THESIS

- Through its three divisions, Arotech has a diversified base of customers that range from foreign governments to the FBI.
- The Company is often the only competitor in that industry or it competes in a highly fragmented area.
- Arotech is not dependent only on domestic military but also sells to foreign governments, municipalities, and private industry.
- Several new products look poised to contribute significant revenue.
- The balance sheet has been strengthened and the company now has $6.3 million in cash.
- As budget issues arise with municipalities and military spending, revenue is more likely to be pushed off rather than cancelled.

OVERVIEW

Arotech is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military and nonmilitary air and ground vehicles. The Company operates primarily through several subsidiaries, which are organized into three divisions. ARTX divisions and subsidiaries (all 100% owned) are as follows: Training and Simulation, Battery and Power Systems, and Armor.

Training and Simulation Division
The division is further broken down into three product areas. ARTX provides simulators, systems engineering and software products focused on training vehicle operators for cars and trucks. Customers include United States military, government, municipalities, and private industry through the FAAC name. The fully interactive driver-training systems feature state-of-the-art vehicle simulator technology enabling training in situation awareness, risk analysis and decision making, emergency reaction and avoidance procedures, and proper equipment operation techniques. The three product areas include:

- *Vehicle Simulation* group provides high fidelity vehicle simulators for use in operator training and is marketed under the FAAC and Realtime Technologies nameplates.
- *Military Operations* group provides weapon simulations used to train military pilots in the effective use of air launched weapons and also carries FAAC nameplate.
- *Use of Force* group provides training products focused on the proper employment of hand carried weapons and is marketed under the IES Interactive Training nameplate.

Training and Simulation	2010	2009
Revenue Growth	$35.6 Million (declined by 9.4%)	$39.2 Million
Margin Growth	12.4% op margin (declined)	12.9% op margin
Higher or Lower than Corporate Margin	Higher	Higher
Competition significant or sparse	Mixed- Military no competition, Vehicle Several firms	Significant in size yet most don't focus on niches
Barriers to Entry	Military high barriers to entry	Vehicle and Use of force, slightly lower
End Markets Served	Municipalities, Military, federal Govt, Homeland Security	Municipalities, Military, federal Govt, Homeland Security
End Markets Outlook	Municipalities are still stressed, Military more inelastic	GlobalRecession (Poor)

Competition in this segment is mixed and can range from large potential companies that stay out of Arotech's niche to smaller companies in the municipal space. For example in the military segment potential competitors are large, diversified defense and aerospace conglomerates who do not focus on the specific niches that ARTX does, while in the municipal market the Company competes against less

sophisticated software companies. In 2010, the Vehicle Simulations group accounted for approximately 54% of the Training and Simulation Division's revenues, Military Operations accounted for 24%, and Use of Force 22%.

The Vehicle Simulation group focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, subway trains, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles.

Trends

Looking at the training and simulation spending patterns, spending on simulators has been trending up for several years, because the technology increasingly has become critical to military training. Simulation training is a proven, cost-effective way of doing training. Despite the high cost of simulators, in the long term, it's more cost effective than live training.



The outlook for Municipalities

The budget crises that have nearly paralyzed states such as California and Illinois are likely to get worse, not better, in 2011 — despite the massive cuts that have already been made. Many of these states have been kept on life support for the past two years by $160 billion in emergency funding from the stimulus package, state governments now face the prospect of making ends meet without any help. New Jersey Governor Chris Christie called the situation a "day of reckoning" in a recent interview. Despite the weak performance it should be noted that in California, for instance, the simulation training budget comes from tickets rather from the state's funds directly. This insulates the Company from the weak performance of these states.



The Military Operations product area develops simulations and high fidelity analytical models for the Department of Defense (DOD). The simulations are used in systems ranging from instrumented air combat and maneuver training ranges (such as Top Gun), to full task training devices (Specifically the F-18 Weapon Tactics Trainer). The Company also supplies on-board software to support weapon launch decisions for the F-15, F16, F-18, F-22, and the Joint Strike Fighter aircraft.

Battery and Power Systems Division

The Arotech Corporation Battery and Power Systems Division consist of three wholly owned subsidiaries of Arotech Corp. Electric Fuel Battery Corporation, Electric Fuel Limited, and Epsilor Electronic

Industries. The Division manufactures and sells Lithium and Zinc-Air batteries (along with several other products) for defense and security products that have been used in both Afghanistan and in Iraq. The Division's main products include Lithium Ion Primary and Rechargeable batteries, Zinc-Air Batteries, Vest and Lifejacket safety lights, Chargers and State of Charge Indicators (SOCI) and batteries for sea, ground, air and space.

The two main types of batteries produced and sold by ARTX are Zinc-Air Batteries and Chargers and Lithium Ion batteries. Zinc-air is a non rechargeable (primary battery), with very high energy usage.

Zinc-Air batteries are safer than primary lithium battery packs in storage, transportation, use, and disposal, and are more cost-effective. They are lightweight, with up to twice the energy density of primary lithium battery packs. The competition's military Zinc-Air batteries utilize cylindrical cells, rather than the prismatic cells that ARTX developed. While cylindrical cells may provide higher specific power than our prismatic cells, the company believes they will generally have lower energy densities and be more difficult to manufacture.

The battery compartment of most military communications equipment, as well as other military equipment, is designed for the XX90 family of batteries, of which the BA-5590/U battery is the most commonly deployed. Another primary battery in this family is the BA-5390/U, which uses lithium-manganese dioxide ($LiMnO_2$) cells. Suppliers of $LiMnO_2$ batteries include Ultralife Batteries Inc., Saft and Eagle Picher.

Rechargeable batteries in the XX90 family include lithium-ion (BB-2590/U) and nickel-metal hydride (BB-390/U) batteries which may be used in training missions in order to save the higher costs associated with primary batteries. These rechargeable batteries have also become more prevalent in combat use as their energy densities improve, their availability expands and their State-of-Charge Indicator (SOCI) technologies become more reliable.

Zinc-Air battery military applications are widespread and range from communications range finders, to GPS, to Javelin Nightscopes. The batteries are known for their light weight, low cost, and inherent safety.

Battery & Power	2010	2009
Revenue Growth	$18.6 Million (increased 4.8%)	$17.8 Million
Margin Growth	0.15% op margin (growing)	Negative
Higher or Lower than Corporate Margin	Lower but several programs with potential	lower
Competition significant or sparse	Sparse	Sparse
Barriers to Entry	Zinc and Lithium Ion moderate	Zinc and Lithium Ion Moderate
End Markets Served	Military	Military
End Markets Outlook	Although budgets are constrained solid	Solid

SWIPES

SWIPES is Arotech's new patent pending technology that stands for Soldier Worn Integrated Power Equipment System. The system consists of a hub with 4 adapter leads and 1 power input lead. It is designed to be soldier worn in the protective vest outside the armor plate, but can also be used independently. The goal was to reduce the battery weight carried by soldiers by up to 30% on multi day missions. The Swipes system is a modular power distribution system that was designed for use with the Primary Zinc Air, BA 8180, ZA 8140 Short and the ZA 8140 Conformal batteries as the power source. The BA 5590, BB2590 or LI 145 may also be used.

- Hub contains circuit protection
- Hub and 5 connected 8" weigh approximately 6 oz.
- Chargers weigh approximately 6 oz each.
- Specialized applications can be developed upon request.



Special Forces
Despite having significant roles in the Vietnam War and in World War II,the special forces was re-defined in the early 1990s. On November 27, 1990, the U.S. Army 1st Special Operations Command was re-designated the U.S. Army Special Forces Command (Airborne). Its mission: to train, validate, and prepare Special Forces units to deploy and execute operational requirements for the war-fighting geographic combatant commanders.

Special Forces Soldiers have earned the title of "Quiet Professional." They have been involved in peacetime operations and armed conflicts around the world over the past five decades.
After the 9/11 terrorist attacks, Special Forces teams launched to remove the Taliban regime and destroy the Al Qaeda infrastructure within Afghanistan in support of Operation Enduring Freedom (OEF). Special Forces validated their capacity as the Army's premier Unconventional Warfare combat force during this time, organizing and fighting alongside a variety of Afghan resistance movements to defeat Taliban and Al-Qaeda militants in the harsh mountainous environment of Afghanistan.

Special Forces Soldiers continue to serve at home and abroad providing unconventional warfare expertise, humanitarian assistance and assisting with foreign internal defense in friendly foreign nations. Recent humanitarian assistance missions include Hurricane Katrina and Rita relief. Combat missions are ongoing in support of the Global War on Terrorism.

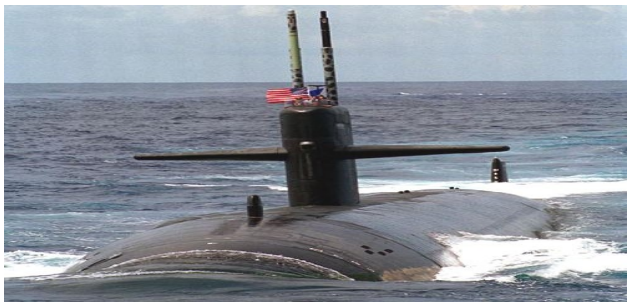
Looking closer at technology, Communications Sergeants are in charge of the sophisticated communications equipment the team carries. They are also the soldiers who relay any information gathered by the Intelligence Sergeants back to Special Operations Command (SOCOM). The Communications Sergeant may also be responsible for carrying out any Psychological Operations (PSYOP) related to broadcasting. Special Forces have become more prevalent on the battle field and the technology they carry has become more advanced and lightweight. They need powerful batteries and chargers that complement their battlefield lifestyle.

Lithium Batteries and Charging Systems

Epsilor Electronic Industries is located in Dimona, Israel and was acquired by the firm in 2004. The technology is focused on high-end primary and rechargeable military batteries and associated military chargers. The firm has developed military power packs from a wide range of electro chemistries such as Nickel Metal Hydride, Lithium-Ion and Lithium-Polymer.

Epsilor Electronic Industries
Epsilor Battery products have four potential markets that could drive growth in the next decade.

The underwater vehicle market could potentially use Epsilor Lithium-Ion packs for its underwater vehicles. The technology offers much better energy density than standard lead acid packs. Naval Trials are underway as of the first quarter of 2011. The market potential is $5 million annually.



Epsilor makes an advanced starter kits for starting heavy vehicles such as tanks. The ultra high power rechargeable lightweight portable power pack can deliver up to 3000 peak Amps current. Amy qualification could get underway in the second quarter of 2011.The market potential is $3 million annually.



Back up batteries and chargers for high-end UAV. This battery has a very high power and energy density. The battery's rugged construction will withstand the environmental conditions and operation in a temperature range from +60C to -60C. First battery is expected to be delivered by Q1 2012. The market potential is $1 million annually.



High-End rechargeable rockets for space rockets. These batteries operate in extreme environmental conditions and would replace old Silver-Zinc batteries. First battery is expected to be delivered by Q1 2012. The market potential is $1 million annually.



Main Battery for Space Satellite (GEO and LEO). This battery will be built with commercial Lithium Ion cells that will be selected and assembled in a unique process to verify the reliability of the battery. The program is expected to start in the first quarter of 2011 and have an operational battery by the first quarter of 2014. The market potential is $10 million annually.



Armor Division

The ARTX Armor division specializes in armoring vehicles and manufacturing armor kits for aircraft and vessels by using state-of-the-art lightweight ballistic materials, special ballistic glass and advanced engineering processes. The Company fully armors military vehicles and civilian SUVs, buses and vans. This division also provides ballistic armor kits for rotary and fixed wing aircraft under the name Armour of America.

The Fight Against IEDs

According to the CRS report for Congress, since October 2001, Improvised Explosive Devices (IEDs, or roadside bombs) have been responsible for many of the more than 2,000 combat deaths in Iraq, and 178 combat deaths in Afghanistan. IEDs are hidden behind signs and guardrails, under roadside debris, or inside animal carcasses, and encounters with these bombs are becoming more numerous and deadly in both Iraq and Afghanistan. The threat includes vehicle-borne IEDs, in which extremists drive cars laden with explosives directly into a target. DOD efforts to counter IEDs have proven only marginally effective, and U.S .forces continue to be exposed to the threat at military checkpoints, or whenever on patrol. IEDs are increasingly being used in Afghanistan, and DOD reportedly is concerned that they might eventually be more widely used by other insurgents and terrorists worldwide.

ARTX's armor products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide. ARTX vehicles have provided proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings.

Arotech is a leading supplier to the Israeli military, Israeli Special Forces and special services. The division provides products to the U.S. Army, and to military and defense and paramilitary customers worldwide. ARTX is also actively exploring marketing armor products in India, through Concord Safety Solutions Pvt. Ltd. ARTX owns 26% of this Indian company and an Indian vehicle company and an Indian armoring company each own 37%. According to The Hindu, Improvised Explosive Devices (IEDs) are responsible for 70% of troop deaths in India from January 2008 to March 2010. Dealing with these is a major part of the challenge faced by the government in Counter Insurgency (COIN) Operations. The surge in use of IEDs clearly indicate a paradigm shift in the Maoist's ploy to fight the government, which was based on direct combat by attacking small police or paramilitary groups in large numbers.

Armor	2010	2009
Revenue Growth	$19.5 Million (Increased 11.4%)	$17.5 Million
Margin Growth	Negative due to R&D ramp up	0.67% Op Margin
Higher or Lower than Corporate Margin	Lower but several programs with potential	lower
Competition significant or sparse	Fragmented	Fragmented
Barriers to Entry	High	High
End Markets Served	Military/ Paramilitary	Military/ Paramilitary
End Markets Outlook	Although budgets are constrained solid	Solid

Defense Budget Outlook

According to Bloomberg, Richard Durbin, the U.S. Senate's second-ranking Democrat, said the Defense Department spending bill for 2011 won't be passed separately from a larger package funding the government. Durbin, an Illinois Democrat who serves as assistant majority leader, said that including the defense spending bill is critical to passage of the overall spending package funding the government through Sept. 30, when fiscal year 2011 ends. The U.S. government, including the Pentagon, has been funded through a series of stopgap bills, called continuing resolutions, for five months while Congress debates long-term budget-deficit reduction. Despite the negative sentiment we feel the Company should be fine given the protective nature of the product as well as the diversification among customers.

A different world for Israel

Egypt was the first Arab country to sign a peace treaty in 1979 with Israel which has always relied on Mubarak as a partner in maintaining peace in the Middle East. Now that Mubarak is gone, Israel is terrified with the potential scenarios that could take place in post-Mubarak Egypt. "We have to keep two things in mind," the Israeli official said. "The first is that the only example we have of this kind of thing in the region is Iran in 1979. You can't take that out of your mind. The second is that if Egypt pulls back in any way from its peace with Israel, it will discourage anyone else in the region, including the Palestinians, from stepping forward. So the regional implications for us are significant."

The key factor in competing successfully in this field will be the Company's ability to penetrate new military and paramilitary markets outside of Israel, particularly those operating in Iraq and Afghanistan, India and the new Middle East.

Programs with Potential

During 2010, Arotech received over $7.3 million in orders from the Israel Defense Forces for the U.S.-built David, a patrol, combat command and reconnaissance armored vehicle that is specifically designed as an urban combat vehicle. The company also introduced the Tiger; a new cost-effective, highly-armored light protected all-terrain vehicle.

In 2010, ARTX entered into a teaming agreement with Textron Marine and Land Systems (TMLS), a division of Textron Systems. TMLS is a $2.3 billion supplier of military vessels and vehicles, part of the $15 billion Textron Corporation. The teaming agreement with Textron calls for joint production and marketing of MDT vehicles, which will be branded as Textron vehicles.

TIGER



DAVID



INDUSTRY OUTLOOK

INDUSTRY OUTLOOK - POSITIVE

The Defense Market
Growth in the defense spending, though decelerating after years of above-trend expansion, will help sustain an already elevated level demand. The evolution of the U.S. military and homeland defense, in response to new geopolitical threats of terrorism and insurgency, remains a work-in-progress. Although the growth curve may be past its inflection point, growth will continue and many large multi-year programs - which require time to build, implement and execute - have already been funded.

The majority of growth over the last several years came from the results of the 2005 Quadrennial Defense Review which was reflected in FY2007-2010 defense budgets. Every four years, the Pentagon conducts a strategic assessment of threats to national security and long-term military priorities. As the first QDR since 9/11, there was increased focus on intelligence of global terrorist networks, Special Operation Forces, un-manned aircraft, combat robots, network-centric warfare, and 'irregular warfare' - as with a regime change mission and the resulting insurgency in Iraq - and the "digital battlefield" which incorporates intelligence, surveillance and reconnaissance capabilities.

Operationally, by maintaining diversified program portfolios, most defense contractors are protected against shifts in policy or spending cuts of specific programs. Moreover, many such companies remain focused on expanding profit margins, in part, to offset declines in projected defense growth. Furthermore, several years of strong growth in defense spending yielded defense contractors with significantly stronger balance sheets, driven by substantial debt reduction, leaving billions of dollars in cash for acquisitions, increased dividends and/or share buybacks. Defense contractors will likely seek small earnings-accretive acquisitions as replacement for some of the growth in future defense budgets. Industry consolidation will likely continue with relatively small M&A deals which should provide investors with premium returns.

The main risks to defense stocks remain: (i) the potential for cuts in the growth of federal budget defense outlays, (ii) cuts in the absolute level of spending, and (iii) uncertainty over current and future geopolitical conflicts (e.g., the Middle East, China, North Korea).
In 2011 and beyond, we expect the best growth opportunities within the defense market will likely be with companies focused on the more covert and cryptic products and services for network-centric warfare and the digital battlefield: e.g., information technology (IT), secure communications, surveillance, protection, reconnaissance, and intelligence.

INDUSTRY POSITION

The Company competes in several industries where competition can range from having no competition to having several competitors.

VEHICLE SIMULATORS-Several potential competitors in this segment are large, diversified defense and aerospace conglomerates who do not focus on Arotech's specific niches. In municipal market applications, the Company competes against smaller, less sophisticated software companies.

MILITARY OPERATIONS- no significant competitors participate in the markets Arotech serves. Larger companies such as Boeing, Raytheon and Cubic outsource to ARTX.

USE OF FORCE- Several established companies that provide similar products and services, as well as companies whose products do not compete directly, but are closely related: Firearms Training Systems, Inc., Advanced Interactive Systems, Inc., and LaserShot are the main competitors.

Armor- The global armored car industry is highly fragmented. Major suppliers include both vehicle manufacturers and aftermarket specialists. Mercedes-Benz has the largest vehicle-armoring market share. Among aftermarket specialists, the largest share of the vehicle-armoring market is held by O'Gara-Hess & Eisenhardt, a subsidiary of Armor Holdings, Inc. Other aftermarket specialists include International Armoring Corp., Lasco, Texas Armoring and Chicago Armor (Moloney).

Lithium-ion battery- Bren-tronics Inc. (in U.S.) controls much of the U.S. rechargeable market, ABSL Power Solutions Limited (a wholly owned subsidiary of CIP Industries Incorporated LLP) in the United Kingdom, which has the majority of the English military market, and Ultralife Batteries, Inc. in the United States.

Zinc-Air battery- The BA-8180/U is the only Zinc-Air battery to hold a US Army battery designation and an NSN. It does, however, compete with other primary (disposable) batteries, and primarily lithium based batteries. In some cases it will also compete with rechargeable batteries.

Aviation and marine safety products- Main competition for TSO and SOLAS-approved lifejacket lights is ACR Electronics Inc. of Hollywood, Florida. Other significant competitors in the marine market include Daniamant Aps of Denmark and England, and SIC of Italy.

VALUATION

Due to budget constraints and weak economic outlooks for many countries, 2011 will be a challenging year for all defense firms. However, due to the protective nature of Arotech's products and their diversified revenue stream we feel the firm will outperform the overall defense industry. Beyond 2011 several products such as the Tiger and David armored vehicles, the underwater vehicle market, and the space satellite businesses have the ability to drive top and bottom-line growth for several years.

We used two models to value the firm.

…Two Stage Free Cash Flow to Equity Model

FCFE = Net Income - Net Capital Expenditure - Change in Net Working Capital + New Debt - Debt Repayment

Assumptions

- The firm is expected to grow at a higher growth rate in the first period.
- The growth rate will drop at the end of the first period to the stable growth rate.
- The free cash flow to equity is the correct measure of expected cash flows to stockholders. (rather than dividends)

Rationale for using the Model
As Arotech begins to ramp up revenues in several of the areas of potential we highlighted earlier, we expect the firm to grow at a higher overall rate than the industry. As These products mature and the firm faces more competition we expect the growth rate to level off.

Weakness of the Model
As you add more layers to the model it is more sensitive to the assumptions you make. The growth may look more "lumpy" than we have it in the model.

Output
We used the following inputs:

- A 10-year period with a FCFE growth rate of 12.5% and a discount rate of 12.00%.
- A continuing period assumed to go on forever, with FCFE growing at 5% and a discount rate of 11.14%.

With these inputs we arrive at a target price of $2.80.

According to the model, the firm appears undervalued.

…Price to Earnings Multiples/ Price to Sales Multiples

Due to its simplicity the Price/Earnings ratio is easily the most widely used metric in all of finance. The first strength of the model is that it is intuitive. It is simply the price paid for current earnings. It can also act as a proxy for other firm characteristics such as risk and growth. There is a downside to the P/E ratio in that it has the potential to reflect investor's mood rather than the fundamentals of the firm. It also eliminates assumptions about risk, growth, and retention ratio (something discounted cash flow models account for.)

While not as popular as Price/Earnings or Price/BV, Price/Sales is not influenced by accounting decisions in depreciation, inventory and extraordinary charges. P/S multiples are much less volatile than P/E multiples. However if the problem with the firm lies in cost control the P/S ratio will not reflect this flaw.

The trailing twelve month P/E ratio is not applicable due to the earnings number being negative for 2010. This is likely to be the case in 2011 as well due to delays in Armor. **The firm appears reasonably valued when compared to the 2012 estimated EPS and undervalued compared to the industry when looking at the P/S Ratio.**

Metric	ARTX	Industry Average
P/E TTM	N/A	15.90
P/E 2011 (E)	N/A	15-17
P/E 2012 (E)	4.03	13-15
P/S	0.33	0.88

Our price target of $3.00 per share is based on a blend of these models. We would add shares at these levels.

RISKS

- Several of the company's fields of business are highly competitive.
- ARTX faces risks related to general domestic and global economic conditions. The possibility of a double dip or a budget crisis could hurt business.
- A significant portion of Arotech's business is dependent on government contracts Therefore reduction or reallocation of defense or law enforcement spending could reduce revenues.

INSIDER TRADING AND OWNERSHIP

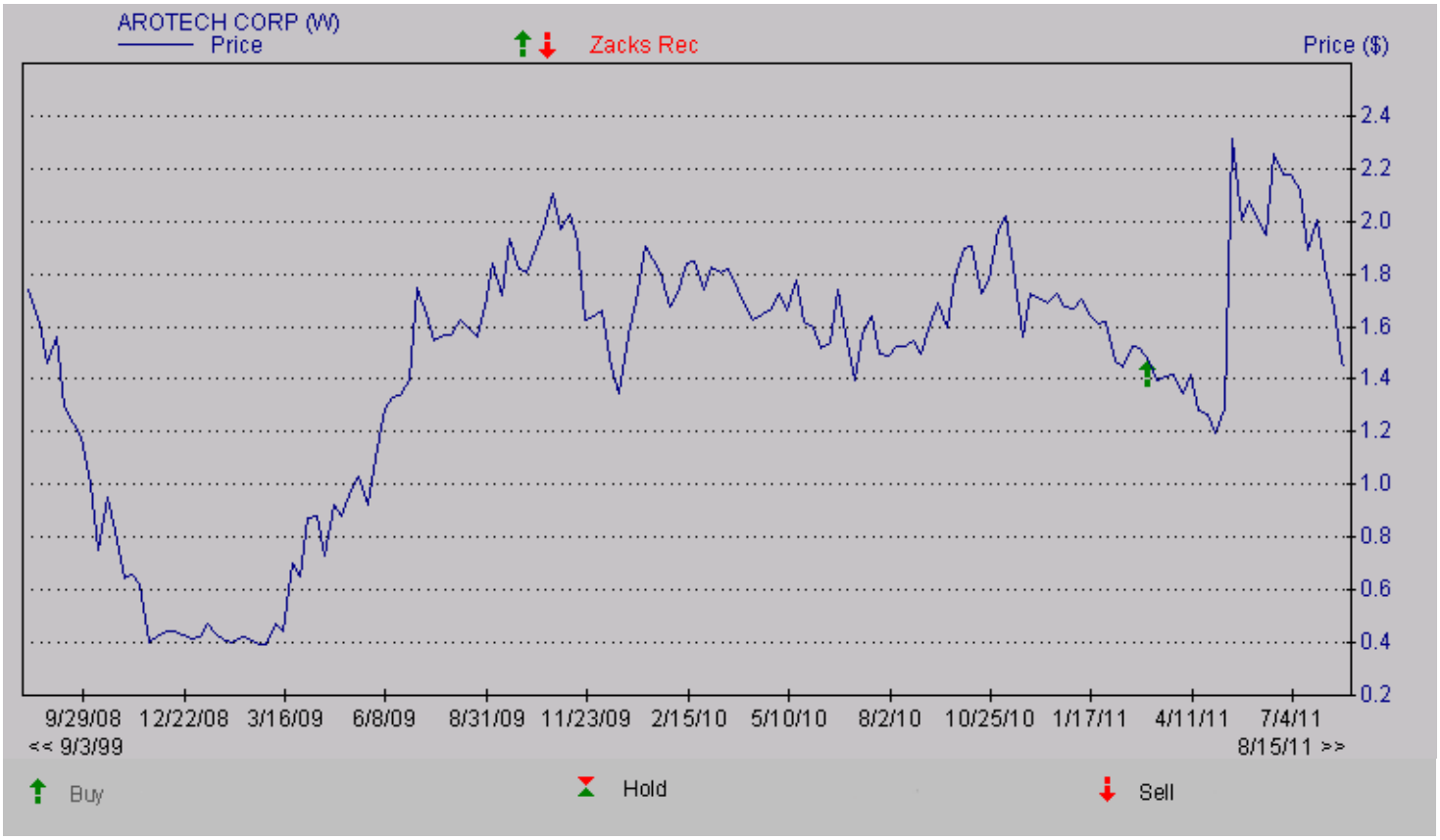
Institutional and mutual fund holders own 13.07% of the company's outstanding shares. The top five institutional holders are Credit Suisse Securities (with 5.95% of shares outstanding), Dimensional Fund Advisors (2.42%), Merrill Lynch, Pierce, Fenner & Smith Inc (1.29%), The Vanguard Group, Inc. (1.20%) and Renaissance Technologies (1.11%). Over the past quarter three of the top five holders were net sellers while two were buyers.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Millions)	Jun-10 Q2 10	Sep-10 Q3 10 E	Dec-10 Q4 10	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11 E	FY 2007	FY 2008	FY 2009	FY 2010 E	FY 2011 E
REVENUE											
Net Revenue	**18.90**	**16.4**	**17.3**	**13.3**	**14.3**	**28.5**	**57.72**	**68.95**	**74.53**	**73.74**	**86.00**
Sequential Growth		*-13%*	*6%*	*-23%*	*7%*	*99%*					
OPERATING EXPENSES											
Cost of Revenues	13.28	12.26	12.24	10.52	10.75	21.38	39.64	50.18	54.41	53.11	64.5
% of Revenue	*70.3%*	*74.9%*	*70.6%*	*79.1%*	*75.2%*	*75.0%*					
Gross Profit -	**5.62**	**4.1**	**5.1**	**2.8**	**3.5**	**7.1**	**18.08**	**18.77**	**20.12**	**20.6**	**21.5**
Proforma Gross Margin	*29.7%*	*25.1%*	*29.4%*	*20.9%*	*24.8%*	*25.0%*	*31.3%*	*27.2%*	*27.0%*	*28.0%*	*25.0%*
R&D + Engg	0.76	0.67	0.28	0.55	0.46	0.68	1.9	1.7	1.3	2.5	2.8
% of Revenue	*4.0%*	*4.1%*	*1.6%*	*4.1%*	*3.2%*	*2.4%*	*3.3%*	*2.4%*	*1.8%*	*3.4%*	*3.3%*
SG&A	4.35	4.05	4.64	4.36	4.42	5.00	17.32	18.79	17.17	17.16	19.75
% of Revenue	*23.0%*	*24.8%*	*26.8%*	*32.8%*	*30.9%*	*17.5%*	*30.0%*	*27.3%*	*23.0%*	*23.3%*	*23.0%*
GW Amort, Restructuring, other	*0.42*	*0.44*	*0.44*	*0.48*	*0.48*	*0.44*	1.4	*0.3*	1.5	*1.72*	*1.90*
% of Revenue											
Total Operating Expenses	5.54	5.16	5.36	5.39	5.36	6.12	20.58	20.74	19.95	21.41	24.45
% of Revenue	*29.3%*	*31.6%*	*30.9%*	*40.5%*	*37.5%*	*21.5%*	*35.7%*	*30.1%*	*26.8%*	*29%*	*28%*
Operating Income -	**0.08**	**-1.1**	**-0.3**	**-2.6**	**-1.8**	**1.0**	**(2.50)**	**(1.97)**	**0.17**	**-1**	**-3**
Operating Margin	*0.4%*	*-6.5%*	*-1.6%*	*-19.6%*	*-12.7%*	*3.5%*	*-4%*	*-3%*	*0%*	*-1%*	*-3%*
NON-OPERATING ITEMS											
Non operating Income/Expense	0.5	0	-1	0	0	0	-0.3	(0.39)	-2.4	0	1
% of Revenue	*2.50%*	*0.89%*	*-4.39%*	*0.85%*	*-0.81%*	*0.53%*	*-0.50%*	*-0.57%*	*-3.24%*	*-0.35%*	*1.16%*
Tax Provision	0.2	0.2	-0.8	0.1	0.1	0.0	0.27	1.48	0.8	0	0
Effective Tax Rate											
Net Income -	**0.36**	**-1.10**	**-0.26**	**-2.64**	**-2.07**	**1.16**	**(3.05)**	**(3.83)**	**(3.05)**	**-0.9**	**-2.2**
Net Income Margin	*1.9%*	*-6.7%*	*-1.5%*	*-19.9%*	*-14.5%*	*4.1%*	*-5.3%*	*-5.6%*	*-4.1%*	*-1%*	*-3%*
EARNINGS PER SHARE											
EPS - Basic	$0.03	-$0.08	-$0.03	-$0.19	-$0.15	$0.08	-$0.27	-$0.30	-$0.24	-$0.07	-$0.16
EPS - Diluted	$0.02	-$0.08	-$0.02	-$0.18	-$0.15	$0.08	-$0.27	-$0.30	-$0.24	-$0.07	-$0.15

Ken Nagy, CFA Zacks Investment Research 8/15/2011

HISTORICAL ZACKS RECOMMENDATIONS



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