Zacks Equity Research

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Sierra Monitor

SRMC-OB

SRMC: Zacks Company Report - OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/16/2010
Current Price (02/01/11)	$1.40
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 and initiate our outperform rating.

SUMMARY DATA

52-Week High	**$1.60**
52-Week Low	**$1.10**
One-Year Return (%)	**N/A**
Beta	**0.09**
Average Daily Volume (sh)	**2,538**
Shares Outstanding (mil)	**11**
Market Capitalization ($mil)	**$16**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**14**
Insider Ownership (%)	**N/A**
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	**20.0**
P/E using 2010 Estimate	**15.5**
P/E using 2011 Estimate	**11.6**
Zacks Rank	**3**

Risk Level	**N/A,**
Type of Stock	**N/A**
Industry	**Industrial Serv**
Zacks Rank in Industry	**N/A**

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	3.9 E	13.9 E
2011	3.5 E	3.8 E	4.1 E	4.4 E	15.8 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 E	$0.09 E
2011	$0.01 E	$0.02 E	$0.04 E	$0.05 E	$0.12 E

Zacks Projected EPS Growth Rate - Next 5 Years % **20**

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KEY POINTS

- The high margin gas detection business is used in industrial markets world wide.
- Against a back drop of macro trends in fuel efficiency, green initiatives, and cleantech the firm launched new technology that enables machine to machine (M2M) communication in energy and building automation applications.
- Legacy products as well as new products can be integrated into engineered systems.
- Sierra Monitor offers flexible, customizable products that range from high average selling prices to low ASP products that produce incremental revenue.
- Gross margins have historically been in the 58-60% range.
- The firm's balance sheet is a source of strength with zero bank debt and a strong cash position.

OVERVIEW

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.

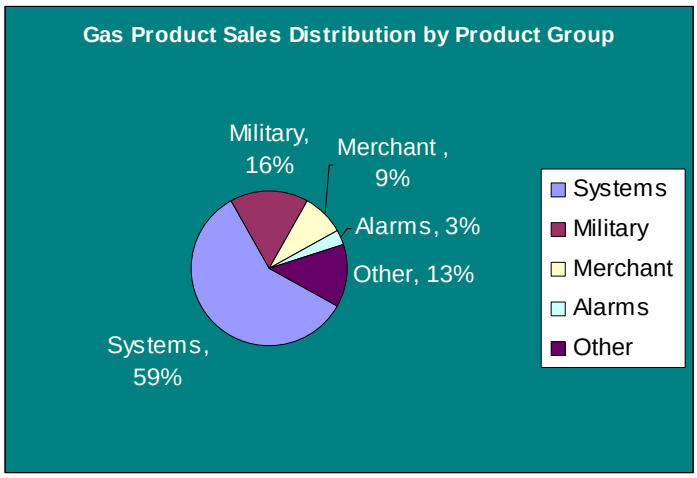
The commercial order backlog as of December 31, 2009 stood at approximately $1,760,000. The firm ships the majority of its products within the same quarter that the purchase order is received.

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. Revenue from all products sold to the telecommunications industry was approximately 6% of sales in 2009.

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 an order to be 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.

Balance Sheet and Fundamentals

SRMC ended the third quarter of 2010 with approximately $2.2 million of cash on hand and no bank debt. Over the third quarter the firm maintained a strong backlog, grew sales by 13%, achieved a gross margin of 59%, grew the FieldServer product line by 46%, controlled fixed costs and achieved income from operations of approximately $390,117. Gross profit as a percent of sales was approximately 60% in 2009 and 59% in 2008. SRMC's gross margins, which vary by product mix and channel of distribution, have historically remained at this level.

INDUSTRY OUTLOOK

INDUSTRY OUTLOOK -Positive

Our outlook for the Industrial Products-Services industry is Positive. In terms of consumption, the EIA predicts that increasing industrial demand for fuel, a shift from lighter to heavier crudes in manufacturing and the growth of biofuel production will mean "the share of industrial energy use by the energy-intensive industries grows slightly, from 67 percent in 2008 to 70 percent in 2035, despite declines in energy consumption for several other industries."

A December 2009 report from ExxonMobil estimates that due to economic and population growth, global energy demand will rise by 1.2 percent per year through 2030, resulting in 35 percent more energy consumption two decades from now than the 2005 average.

Increasing efficiency will be vital for meeting future added demand. According to a July 2009 McKinsey & Company report, a $520 billion investment in optimizing U.S. energy efficiency through 2020 would yield $1.2 trillion in gross energy savings and reduce end-use energy consumption by 9.1 quadrillion Btu, or roughly 23 percent of projected demand over the next decade.

McKinsey outlines specific measures that can be used to improve energy usage nationwide: recognizing energy efficiency as a way to meet future energy needs; implementing proven, piloted and emerging efficiency strategies on national and regional levels; identifying sources for funding upfront energy investments; forging greater alignment between utilities, manufacturers, regulators, government agencies and consumers; and fostering innovation in new energy technologies.

INDUSTRY POSITION

The markets in which SRMC participates are highly competitive and generally price sensitive. Many competitors have far greater financial, marketing and manufacturing resources than SRMC by virtue of their relationships with larger companies as divisions or subsidiaries of such companies. The principal competitive factors in the industry are reliability, ease of use, product support and price.

Gas detection products compete with systems offered by Detector Electronics Corporation, Draeger Safety Inc., General Monitors Inc., Mine Safety Appliance Company, Honeywell Life Safety and others.

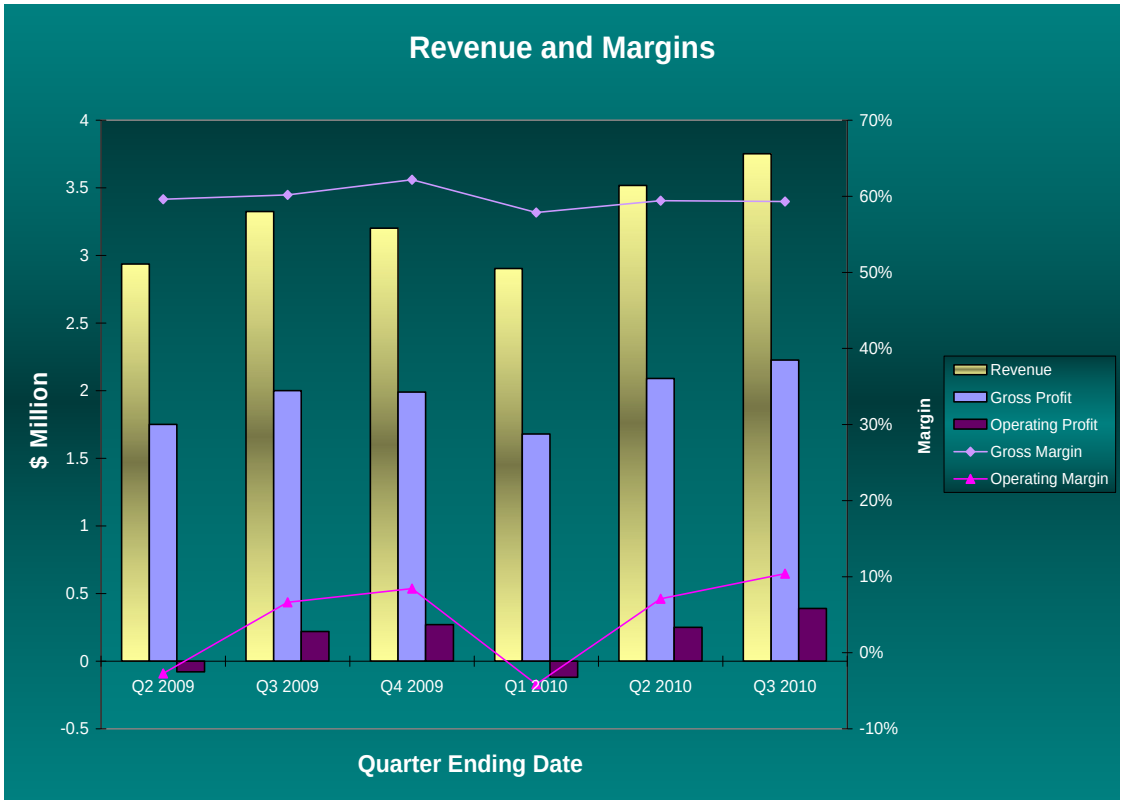
FieldServer and ProtoCessor products compete with products or alternate methods and technologies offered by, among others, HMS, Control Solutions Inc., Loytec Electronics, Prosoft Technology, Automated Logic, Cimetrics, Kalki Communications Technologies, Honeywell Tritium and TAC Schneider Electric. Most of the firm's competitors offer broad product lines including items that do not compete with its products.

RECENT NEWS

On October 27th 2010 SRMC announced results for the third quarter of fiscal year 2010 ending September 2010. Revenue for the period was $3.8 million rising 8.6% sequentially from $3.5 million and up 12.9% year over year.

Third quarter net income increased 79% to $234,746 or $0.02 per share (basic and diluted), compared to net income of $131,477 or $0.01 per share (basic and diluted) in the same prior year period.

Sierra Monitor had $2,168,533 in cash at September 30, 2010 with no bank borrowings. Net trade receivables at September 30, 2010 were $2,209,120. At September 30, 2010, the Company's Days Sales Outstanding was 53 days.



Significant Business highlights include

- Joined Cisco Systems Developer Network to allow customers to purchase FieldServer products through the Cisco reseller channel.

- Received new order for FieldServer Gateways to link toxic gas monitoring safety systems in semiconductor clean room operations.

- Entered window and shade controls market with contracts to develop FieldServer interfaces to electronic shade controls for commercial buildings.

- Shipped FieldServer Gateways for use in the smoke and flame detection system on advanced-technology U.S. Navy ships.

- Signed agreement with a major water heater and boiler systems manufacturer to develop protocol drivers allowing FieldServer data connections between their products and building automation systems.

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 11.6x 2011 estimated EPS. We value the company based on the average of our P/E multiple (20.8x 2011 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. 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 10%.
- A continuing period assumed to go on forever, with earnings growing at 6% and a discount rate of 12%.

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

RISKS

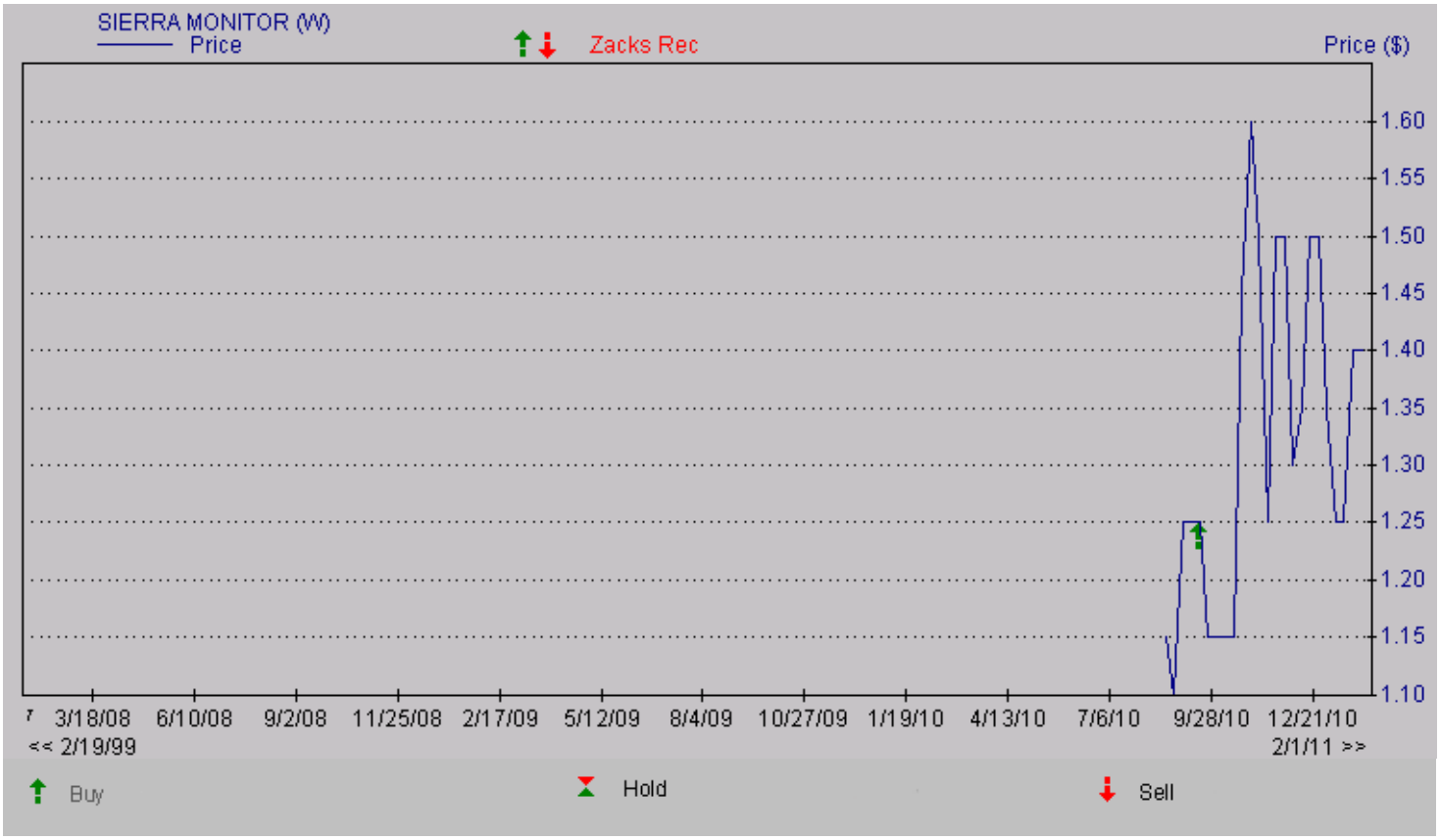
- While the overall world economy and markets have rebounded, the possibility of a double dip or a slow growth environment remains.
- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Thousands	Sep-09 Q3 09	Dec-09 Q4 09	Mar-09 Q1 10	Jun-10 Q2 10	Sep-10 Q3 10	Sep-10 Q3 10 E	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 E	FY 2011 E
REVENUE												
Net Revenue	**3.32**	**3.20**	**2.90**	**3.52**	**3.8**	**3.9**	**10.85**	**12.97**	**13.75**	**12.73**	**13.92**	**15.80**
Sequential Growth		*-4%*	*-9%*	*21%*	*7%*	*4%*						
OPERATING EXPENSES												
Cost of Revenues	1.29	1.21	1.22	1.43	1.53	1.58	4.38	5.24	5.60	5.11	5.50	6.4
% of Revenue	*38.8%*	*37.9%*	*42.2%*	*40.7%*	*40.7%*	*40.5%*						
Gross Profit -	**2.0**	**1.99**	**1.68**	**2.09**	**2.2**	**2.3**	**6.48**	**7.73**	**8.15**	**7.62**	**8.4**	**9.4**
Proforma Gross Margin	*61.2%*	*62.1%*	*57.8%*	*59.3%*	*59.3%*	*59.5%*	*59.7%*	*59.6%*	*59.3%*	*59.9%*	*60.5%*	*59.5%*
R&D + Engg	0.52	0.47	0.48	0.50	0.50	0.52	1.8	2.1	1.9	2.0	2.2	2.4
% of Revenue	*15.5%*	*14.6%*	*16.6%*	*14.3%*	*13.2%*	*13.3%*	*16.7%*	*16.1%*	*13.9%*	*15.4%*	*15.8%*	*15.2%*
SG&A	1.30	1.26	1.32	1.33	1.34	1.35	3.88	4.62	5.37	5.24	5.25	5.35
% of Revenue	*39.1%*	*39.2%*	*45.4%*	*37.8%*	*35.7%*	*34.6%*	*35.8%*	*35.6%*	*39.0%*	*41.2%*	*37.7%*	*33.9%*
GW Amort, Restructuring, other	-	-	-	-	-	-	-	-	-	-	-	-
% of Revenue												
Total Operating Expenses	1.81	1.72	1.80	1.83	1.84	1.87	5.69	6.71	7.27	7.21	7.45	7.75
% of Revenue	*54.6%*	*53.8%*	*62.0%*	*52.1%*	*48.9%*	*47.9%*	*52.5%*	*51.7%*	*52.9%*	*56.6%*	*54%*	*49%*
Operating Income -	**0.22**	**0.27**	**-0.12**	**0.25**	**0.39**	**0.5**	**0.78**	**1.02**	**0.88**	**0.41**	**1**	**2**
Operating Margin	*6.6%*	*8.3%*	*-4.2%*	*7.1%*	*10.4%*	*11.5%*	*7%*	*8%*	*6%*	*3%*	*7%*	*10%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.0	0.0	0.0	0.0	0	0	0.0	0.0	-	0.0	0	0
% of Revenue	*0.00%*	*0.03%*	*0.00%*	*0.03%*	*0.00%*	*0.02%*	*0.13%*	*0.07%*	*0.00%*	*0.07%*	*0.07%*	*0.06%*
Tax Provision	0.1	0.1	0.0	0.1	0.2	0.2	0.30	0.43	0.39	0.2	0	0
Effective Tax Rate												
Net Income -	**0.13**	**0.13**	**-0.07**	**0.15**	**0.24**	**0.30**	**0.50**	**0.60**	**0.49**	**0.22**	**0.74**	**1.4**
Net Income Margin	*4.0%*	*3.9%*	*-2.5%*	*4.3%*	*6.3%*	*7.7%*	*4.6%*	*4.6%*	*3.5%*	*1.7%*	*5%*	*9%*
EARNINGS PER SHARE												
EPS - Basic	$0.01	$0.01	$0.00	$0.01	$0.03	$0.03	$0.04	$0.05	$0.04	$0.02	$0.09	$0.12
EPS - Diluted	$0.01	$0.01	$0.00	$0.01	$0.03	$0.03	$0.04	$0.05	$0.04	$0.02	$0.09	$0.12

Ken Nagy, CFA Zacks Investment Research 2/2/2011

HISTORICAL ZACKS RECOMMENDATIONS



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