



Stock Focus

Security Stocks: Bank On The Bankers

Andrew T. Gillies, 09.29.06, 6:00 AM ET

WASHINGTON -

The presence of bullish investment bankers in a particular business sector is no guarantee of its good health. It sometimes indicates just the opposite. In 2000, for example, bankers at San Francisco's Robertson Stephens were prospering on dot-com and technology business. The bank folded two years later, victim of a tech market gone abruptly south.

These days, you'll find plenty of bullishness at a boutique banking outfit with a unit catering to the homeland security industry. John Shaw, president of New York's **Legend Merchant Group**, says he expects homeland security to experience "explosive" growth in the coming years. "Our pipeline is rather robust," adds colleague Scott Greiper, a Legend Merchant principal and head of its homeland security practice, the Convergent Security Group (CSG).

In the investment context, we've been troubled on occasion by the possibility of [terror bubbles](#). Here, however, we don't interpret the happy talk from the i-bankers as a sign of impending bust. In fact, those interested in homeland security stocks and takeover plays should heed arguments from Greiper and his CSG colleagues.

Why's that? For starters, recent activity on Capitol Hill shows Congress' continued eagerness to shell out big on security. This month, the Senate loaded up a port security bill with \$3.5 billion in extra funds to make mass transit safer. That legislation passed the Senate 98-0.

And CSG's execs don't want for security bona fides. The unit launched last March and in April signed on Greiper, who had been an equity analyst covering the homeland security market at C.E. Unterberg, Towbin. Thomas Gallagher, who officially joins CSG this week, had until June 2006 headed up **Wachovia's** defense and aerospace investment banking business. He also recently worked as an independent adviser to Boeing on its bid, ultimately successful, for the Department of Homeland Security's [SBInet program](#). (Note: CSG's Thomas Gallagher is not the same as the noted Washington analyst employed by broker dealer ISI Group.)

Gallagher sees three reasons why CSG's mergers and acquisitions practice is likely to remain busy in the years ahead. First, it's often easier for big companies to acquire technology than to develop it themselves. The same holds true for cultivating customers, particularly in an area like national security, where personal relationships between contractors and agencies play an important role.

Reason number three further sets homeland security business apart. "When you buy a small company in the homeland security arena," Gallagher says, "it understands the procurement process and ways of doing business with the government." Given the vagaries of procurement, Gallagher explains, that knowledge becomes all the more valuable if the acquirer can use it to sell other products to the customers in question.

One snag: rich valuations. Take RAE Systems, which sells chemical and radiation detection systems. Its enterprise value, or market value plus net debt, now stands at 64 times its earnings before interest, taxes and depreciation. In March of 2004, General Electric picked up InVision Technologies, a explosives detection company, at an enterprise multiple of only 8.

Gallagher counters that multiples may often be overstated because of peculiarities of government contracting. “In a business where earnings can be stepped up very quickly by actions of policy makers in Washington,” he says, “instantaneous readings of valuation may be a little misleading.”

Greiper agrees. “Multiples are a function of growth,” he says, adding that acquirers in homeland security often pay healthy premiums to acquire good technology or customer rosters.

Fair enough. So what about stock picks? CSG, despite Scott Greiper’s analyst past, does not make stock recommendations. But the group does produce market reports that identify key players in various homeland security areas. For the accompanying table below, we started with 27 U.S.-listed companies appearing in CSG’s recent report on ground transportation security, authored by Greiper and colleague Mark Sauter.

From that group, we present a handful of companies with enterprise multiples below 15. These companies have not been tagged by CSG as targets, but they are worth considering. Example: American Science & Engineering. Shares of the Billerica, Mass. company, which makes inspection systems, carry an enterprise multiple of 8 and an P/E ratio of 20, using the consensus estimate on earnings for the coming 12 months. The latter multiple looks decent relative to the 20% average forecast for annualized growth in profits at American Science over the next three to five years.

Homeland Security: Consolidation Plays?

Company	Price	Change From 52-Week High	Enterprise Multiple	Enterprise Value (\$mil)
American Science & Engineering	\$49.53	-47%	8.3	\$389
Cubic	19.84	-19	13.5	565
Flir Systems	27.17	-13	13.2	1,895
Intergraph	42.83	-17	8.1	1,014
L-3 Communications Holdings	78.34	-11	10.9	14,331
Thermo Electron	39.44	-6	13.8	6,677

Prices as of Sep. 28. Sources: FT Interactive, and Reuters Fundamentals via FactSet Research Systems