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# Cogent Systems (COGT)

## 3Q-05 Earnings Review: Strong EPS On Light Revenue

Reason for Report: **Earnings Update**

**BUY**

**Recent Price: \$23.46**

### Market Data

Market Capitalization (bln)	\$2.25
Enterprise Value (bln)	\$2.25
Fully Diluted Shrs Outstnd (mln)	96.1
Float (mln)	24.9
Ave. Volume (3 month)	712,000
Institutional Ownership	20.5%
Insider Ownership	51%
Exchange	NASDAQ

### Balance Sheet Data

Shareholders' Equity (mn)	432
Price / Book Value	5.2
Net Cash (Debt) (000s)	230
Working Capital (000s)	340
Long-term Debt (000s)	0
Total Debt to Capital	0

Margin Analysis	2004A	2005E	2006E
Gross Margin (%)	<b>65.8%</b>	<b>63.5%</b>	<b>64.0%</b>
Operating Margin (%)	<b>38.0%</b>	<b>50.2%</b>	<b>50.6%</b>
Net Margin (%)	<b>48.5%</b>	<b>41.7%</b>	<b>37.3%</b>
EBIT Margin (%)	<b>38.0%</b>	<b>50.2%</b>	<b>50.6%</b>

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### Summary and Investment Thesis

- **COGT Reports Operating EPS of \$0.22, Exceeding Consensus Expectations By \$0.05**

Cogent reported EPS from continuing operations of \$0.22, an increase of 120% from the same period a year earlier. On a GAAP basis the Company reported EPS of \$0.21 per diluted share. Both measures exceeded the consensus expectation and our estimate. While EPS and gross margin came in well above expectation and the prior quarter levels, a variety of factors contributed to revenue coming in below expectations. "Lumpiness" in revenue is not new for COGT and we believe underlying momentum continued in the quarter. We maintain our Buy rating and a \$32 price target based on our belief that shares could trade at 35X our FY 2006 operating EPS estimate of \$0.91.

- **Revenues Increased 64%**

3Q-05 revenues were \$38.4 million, up 64% annually from revenues of \$23.4 million in the year ago period. GAAP Net Income for 3Q-05 was \$20.1 million, or \$0.21 per diluted share. This compares to GAAP net income of \$20.4 million, or \$0.29 per diluted share, in the year ago period which included a net tax benefit of \$11.6 million.

- **New Contract Wins + Higher Deferred Revenue = Greater Visibility**

The combination of recent new contract wins and outstanding growth in deferred revenue during the quarter give us additional confidence that the Company continues to gain traction and is solidly established as a leader in the AFIS space. Not only does the company have a solid balance sheet with nearly \$370 million in cash, it also has a strong order backlog estimated to exceed \$130 million.

### Review & Estimates, In mlns except per share data (fiscal year ends Dec.)

	FY2003A	FY2004A	FY2005E	FY2006E
<b>Revenues</b>	\$32.2	\$87.7	\$162.6	\$236.3
<b>EBIT</b>	10.4	33.3	81.6	119.6
<b>Net Income</b>	9.2	42.5	67.8	88.1
<b>EPS Full Year-Diluted</b>	0.14	0.38	0.72E	0.91E
<b>Operating Cash Flow</b>	19.8	58.4	81.6	119.6
<b>P/E</b>	167.6x	61.7x	32.6x	25.8x
<b>EV/EBIT</b>	240.4x	75.0x	30.6x	20.9x
<b>Q1 EPS</b>	0.00	0.08	0.12A	0.20E
<b>Q2 EPS</b>	0.01	0.10	0.17A	0.21E
<b>Q3 EPS</b>	(0.02)	0.29	0.22A	0.24E
<b>Q4 EPS</b>	0.14	0.09	0.20E	0.26E

Cogent is a provider of automated fingerprint identification systems (AFIS) and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide.

### Highlights of the Quarter

- Cogent reported EPS above expectation and very strong growth in deferred revenue which somewhat compensate for a slight revenue shortfall compared with consensus expectations. The street had been expecting revenue of approximately \$42 million and operating EPS of \$0.17. 3Q-05 net revenues were \$38.4 million, a 64% increase over net revenues of \$23.4 million in the same period a year ago. Operating EPS came in \$0.05 above consensus at \$0.22, up 127% annually. GAAP net income for 3Q-05 was \$20.1 million, or \$0.21 per diluted share. This compares to GAAP net income of \$20.4 million, or \$0.29 per diluted share, in the year ago period which included a net tax benefit of \$11.6 million, resulting primarily from the termination of the Company's S corporation tax election. 3Q results include non-cash items totaling \$1.3 million related to the amortization of stock-based compensation.
- The Company continues to be included in virtually all competitive opportunities for large Automated Fingerprint Identification Systems (AFIS) implementations worldwide. On the call management discussed recent contract awards that add visibility to COGT's competitive strength. COGT was awarded an initial order to install a national AFIS for the Royal Canadian Mounted Police's (RCMP) Real Time Identification (RTID) project. COGT prevailed after rigorous independent testing that showed COGT's high performance and ability to provide a seamless, accurate and timely system which can support large databases.
- Management also discussed two other recently awarded multi-million dollar contracts. The first is a contract to install an AFIS for Puerto Rican law enforcement with advanced features including faster response time, more accurate identification and the ability to search additional fingerprint records. The second is an award from Holland for the delivery of a national fingerprint identification system for visitor monitoring. This AFIS will tie in with the EuroDac system and is planned to be linked into the future EU-VIS program.
- Significant customers mentioned on the call as contributing to revenue during the quarter included the Department of Homeland Security, Venezuela, Los Angeles County, Italy, Fresno, CA, San Joaquin County, and Pay By Touch.
- We view the balance sheet as generally strong with most key metrics well within appropriate ranges. Days Sales outstanding (DSO) are a little elevated for our taste but not to a level that raises significant concerns given the large increase in deferred revenue in the quarter. DSO increased 13 days to 83 from 70 in the prior quarter. Cash and investments are now nearly \$370 million, with cash increasing \$53 million in 3Q. Deferred revenue jumped \$20 million, an increase of 64% from the second quarter, which is largely attributable to contract revenue from the National Electoral Council of Venezuela being pushed out.

### Risks

Cogent has derived a significant portion of revenues from a limited number of customers; timing of revenues is unpredictable and can vary significantly from original expectations. In addition product mix and timing can cause fluctuations in margins and profitability in any given reporting period. Prominently represented among major customers are international, federal, state and local governments and government agencies. Substantial revenue also comes from subcontracts under federal government prime contracts, and the success and growth of Cogent's business depends on successful procurement of government contracts either directly or through prime contractors. Accordingly, changes in government contracting policies or government budgetary constraints could adversely affect financial performance. Government entities and prime contractors that use COGT as a subcontractor have latitude to reduce their purchases under existing contracts, may have rights to terminate contracts at-will or to abstain from exercising options to renew contracts. Many government customers are subject to significant budgetary constraints. The award of additional contracts from government agencies could be adversely affected by spending reductions or budget cutbacks at these agencies.

### Summary and Conclusions

We continue to view Cogent as a leader in the high growth biometric authentication market and would view price weakness as an opportunity to initiate, or add to, positions for long-term risk tolerant investors. We believe that AFIS and other biometric authentication solutions continue to gain acceptance and visibility which should drive above average revenue growth rates for the next several years. We view Cogent as one of the premier players in this industry with strong revenue growth, attractive margins and a strong competitive position that should combine to allow its shares to command a premium multiple. Although our revenue estimates have been adjusted down modestly to \$162.6 mm for FY2005 and \$236.3 mm for FY2006 we remain positive on the story. The Company continues to produce very high growth and we believe there is potential upside to our estimates. We are maintaining our BUY rating and a \$32 price target based on our expectation that the shares can trade at what we view as a conservative multiple of 35X our FY2006 earnings estimate of \$0.91 per share.

Cogent Systems Income Statement - for fiscal year ending December 31 (\$ millions except EPS)																	
	FY03			FY04			FY05			FY06			FY07				
	Mar	Jun	Dec	Mar	Jun	Dec	Mar	Jun	Dec	Mar	Jun	Dec	Mar	Jun	Dec		
	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05E	1Q06E	2Q06E	3Q06E	4Q06E	1Q06E	2Q06E	3Q06E	4Q06E	FY06E
<b>FYE: December</b>																	
Product Revenue	23.52	12.69	13.62	19.93	28.45	74.70	31.78	35.56	32.97	43.75	144.05	46.50	48.50	54.50	58.50	208.00	
Services & Maintenance Revenue	8.67	2.70	3.44	3.52	3.33	12.99	4.06	3.80	5.48	5.20	18.54	5.75	6.80	7.85	7.90	28.30	
<b>Total Revenues</b>	<b>32.18</b>	<b>15.40</b>	<b>17.06</b>	<b>23.45</b>	<b>31.78</b>	<b>87.69</b>	<b>35.84</b>	<b>39.35</b>	<b>38.45</b>	<b>48.95</b>	<b>162.59</b>	<b>52.25</b>	<b>55.30</b>	<b>62.35</b>	<b>66.40</b>	<b>236.30</b>	
Cost of Product Revenue	7.88	2.37	3.15	7.58	12.46	25.55	13.84	14.59	8.03	17.62	54.08	17.50	18.25	20.58	21.58	77.91	
Cost of Services Revenue	2.05	0.62	0.91	1.01	1.07	3.61	1.09	1.25	1.06	1.20	4.60	1.38	1.63	1.91	1.92	6.84	
Deferred Comp. Amortization	0.31	0.11	0.24	0.24	0.17	0.77	0.20	0.19	0.16	0.20	0.74	0.10	0.10	0.10	0.10	0.40	
Total Cost of Revenues	10.24	3.10	4.30	8.83	13.70	29.93	15.12	16.04	9.24	19.02	59.42	18.98	19.98	22.58	23.60	85.15	
<b>Gross profit</b>	<b>21.95</b>	<b>12.30</b>	<b>12.76</b>	<b>14.62</b>	<b>18.09</b>	<b>57.76</b>	<b>20.72</b>	<b>23.32</b>	<b>29.21</b>	<b>29.93</b>	<b>103.17</b>	<b>33.27</b>	<b>35.32</b>	<b>39.77</b>	<b>42.80</b>	<b>151.15</b>	
Sales and marketing	2.85	0.81	0.80	0.84	1.38	3.83	1.53	1.58	1.42	2.06	1.48	2.09	2.21	2.49	2.66	9.45	
Research and development	6.50	1.66	1.50	2.00	1.73	6.89	1.91	1.78	1.69	2.45	7.84	2.61	2.77	3.12	3.32	11.82	
General and admin.	2.05	0.82	0.93	0.99	1.25	3.98	1.73	1.74	1.96	2.45	7.87	2.48	2.63	2.96	3.15	11.22	
Amortization & Non-cash Items	0.17	(0.11)	(0.69)	(0.24)	(0.17)	(1.22)	(0.20)	(0.19)	(0.16)	(0.20)	(0.74)	(0.23)	(0.21)	(0.22)	(0.23)	(0.89)	
Total Operating Expenses	11.57	3.17	2.53	3.58	4.19	13.48	4.97	4.92	4.91	6.75	16.45	6.95	7.39	8.35	8.90	31.60	
<b>Operating income (excl charges)</b>	<b>10.38</b>	<b>9.13</b>	<b>10.23</b>	<b>11.04</b>	<b>13.89</b>	<b>44.28</b>	<b>15.75</b>	<b>18.40</b>	<b>24.29</b>	<b>23.18</b>	<b>81.62</b>	<b>26.31</b>	<b>27.93</b>	<b>31.41</b>	<b>33.90</b>	<b>119.55</b>	
Interest & other income/exp.	0.62	(0.04)	(0.05)	(0.11)	(0.95)	(1.14)	(1.39)	(1.57)	(2.57)	(1.62)	(7.15)	(1.23)	(1.32)	(1.43)	(1.47)	(5.45)	
Interest expense	0.15	0.00	0.36	0.00	1.24	1.60	0.28	0.11	0.34	0.25	0.99	0.22	0.25	0.21	0.21	0.89	
Income before taxes	9.91	9.17	10.64	11.14	16.08	47.03	17.42	20.08	27.21	25.05	89.76	27.76	29.50	33.05	35.58	125.89	
Income taxes (benefit)	0.58	3.48	4.04	4.23	6.11	17.87	6.10	4.42	5.99	5.51	22.01	8.33	8.85	9.92	10.67	37.77	
<b>Net income</b>	<b>9.19</b>	<b>5.68</b>	<b>6.60</b>	<b>6.91</b>	<b>9.97</b>	<b>29.16</b>	<b>11.32</b>	<b>15.66</b>	<b>21.22</b>	<b>19.54</b>	<b>67.75</b>	<b>19.43</b>	<b>20.65</b>	<b>23.14</b>	<b>24.91</b>	<b>88.12</b>	
<b>EPS - From Continuing Operations</b>	<b>\$0.14</b>	<b>\$0.08</b>	<b>\$0.10</b>	<b>\$0.10</b>	<b>\$0.11</b>	<b>\$0.38</b>	<b>\$0.12</b>	<b>\$0.17</b>	<b>\$0.22</b>	<b>\$0.20</b>	<b>\$0.72</b>	<b>\$0.20</b>	<b>\$0.21</b>	<b>\$0.24</b>	<b>\$0.26</b>	<b>\$0.91</b>	
<b>EPS - GAAP</b>	<b>\$0.14</b>	<b>\$0.07</b>	<b>\$0.11</b>	<b>\$0.29</b>	<b>\$0.11</b>	<b>\$0.56</b>	<b>\$0.11</b>	<b>\$0.16</b>	<b>\$0.21</b>	-	-	-	-	-	-	-	
Shares out (Fully Dil)	67.85	68.6	69.3	71.0	91.7	75.82	91.80	92.30	96.08	96.30	94.12	96.50	96.70	96.90	97.10	96.80	
Yr-to-Yr Rev % Chg	NA	295.1%	224.6%	686.8%	58.5%	172.5%	132.8%	130.7%	64.0%	54.0%	85.4%	45.8%	40.5%	62.2%	35.6%	45.3%	
Yr-to-Yr EPS % Chg	NM	NM	NM	NM	-23.1%	183.9%	48.9%	78.3%	127.0%	86.7%	87.2%	63.3%	25.8%	8.1%	26.4%	26.5%	

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<b>SPECULATIVE BUY</b>	We believe the enrolled company could appreciate more than 10% relative to the general market for U.S. equities during the next 12 to 24 months, if certain assumptions about the future prove to be correct.
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#### **Michael R. Anderegg, CFA, Senior Research Analyst Information Security and Data Storage**

In addition to his position as a Senior Research Analyst at Harbinger Research, Mr. Anderegg is currently President of MRA Research, an independent research and trading systems consulting firm. He holds the CFA Charter and is a member of the San Francisco and Twin Cities analyst societies. His most recent research position was Research Analyst covering the Network Security Software and Storage Industries for a sell-side technology research boutique in San Francisco. His previous employers include leading companies such as IDS-American Express, GE Capital and First American Asset management. His 20 years of financial analysis, management and investment experience includes fixed income trading, treasury management, private placements, equity analysis, and portfolio management.

He earned an MBA in Finance from the University of Minnesota and a BA in Economics from Hamline University. Mr. Anderegg is also a member of the Technical Securities Analysts Association of San Francisco.

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