

Business

Defense Contractor Has The Right Technology At The Right Time

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Applied Signal does classified work on various surveillance aircraft, such as the Predator drone.

The Obama team has a list of defense programs it wants to cancel or tamp down.

But spending on intelligence gathering, surveillance and reconnaissance — or ISR — and cybersecurity are not among them.

Applied Signal Technology ([APSG](#)), a supplier of technology in both areas, reported after Tuesday's market close that its second-quarter profit more than doubled from the prior year to 31 cents a share. Revenue jumped 18% to \$53.5 million.

The stock soared 14% on Wednesday to 25.

Chief executive William Van Vleet cited strong sales from its core ISR products and rising demand for broadband communication gear, including its next-generation surveillance system, the Model 680 Raider.

"They have a very strong background in this area called communications intelligence," said Michael Lewis, analyst with BB&T Capital Markets. "That is their competitive advantage."

The firm provides software-based electronic equipment to monitor for potential national security threats — borders, harbors and all manner of communications overseas, such as via cell phones, land lines and e-mails.

"Their products are used in listening posts all around the world," including large government facilities with satellite dishes, Lewis said. "I call them snooping technologies."

They're put on towers, poles, unmanned aircraft, ships and harbor boats.

When its advanced algorithms sniff out signs of trouble, government intelligence is notified.

Analysts say the firm has long provided technology to the National Security Agency and Central Intelligence Agency. One analyst suspects that the NSA is the firm's top customer right now.

But Applied Technology won't confirm any of that. "Much of our work is classified," Van Vleet said. Most employees have government security clearances.

This secretiveness, or lack of "visibility," as analysts put it, has hampered efforts by Wall Street to forecast quarterly earnings.

"Eighty percent of the stuff they do is classified, so having a strong opinion about what the quarter is going to look like is dangerous," said analyst James McIlree of Collins Stewart. "You just don't get a good quarter-to-quarter indication of the business."

Analysts polled by Thomson Reuters underestimated second-quarter profit by 11 cents a share. They estimate that profit for the full fiscal year, which ends in October, will rise 44% over last year to 91 cents a share.

As secretive as the firm is, the level of disclosure has improved since Van Vleet took over as CEO last year from founder Gary Yancey.

"The new CEO has provided the investment community with a better snapshot of what the firm is doing and the related opportunities that lie ahead," Lewis said.

The company still won't disclose the actual names or sources of government contracts. But now, it gives major programs "aliases," or code names, so that their big contracts can at least be tracked over time.

Aliases for the five largest contracts are ASA, High Beam, Tiffany, Stone Face II and Spector.

"You won't find them in any government record, but it allows some sort of accountability and continuity," Van Vleet said. "Believe it or not, this is an improvement."

In fiscal 2008, for example, ASA made up 15% of sales, up from 9% in 2007. Stone Face II accounted for 12% of sales in both 2007 and 2008. Stone Face I ended in 2007, as did the alias Simple Edge.

"ASA is ending this year," Van Vleet said. "The follow-on is called Next-Generation ASA."

It will be, that is, if Applied Signal wins the bid for it, as it expects. Van Vleet says the award will likely be announced in the third quarter.

"We're the incumbent and the government has been pleased with our performance," Van Vleet said.

In any event, the new ASA contract (whatever it is) will be a lot bigger than its predecessor, \$200 million vs. \$75 million over five years.

Analysts expect cybersecurity, now a small part of Applied Signal's business, to become its fastest growing segment.

Applied Signal specializes in a small niche of cybersecurity solutions, high-speed communication network monitoring.

It sells directly to the government, including the Department of Defense as well as prime contractors.

Van Vleet says \$7 billion a year is projected to be spent on government cybersecurity.

Of course, the pie will be divvied among many suppliers, including prime government contractors such as Northrop Grumman ([NOC](#)), SAIC ([SAI](#)), Boeing ([BA](#)) and Lockheed Martin ([LMT](#)).

Cybersecurity awards to Applied Signal have started to trickle in this year to the tune of about \$5 million, Van Vleet says.

That's small potatoes even to a small firm like Applied Signal, which posted \$186 million in sales last year. But it's not complaining.

"It's just the beginning," said Van Vleet.

More work is expected to come from ISR contracts, where Applied Signal has "few pure competitors" in its field of communication intelligence, Van Vleet says.

Advanced Signal's software engineers custom-develop products to meet clients' needs, though basic hardware boxes are often bought off-the-shelf to save on costs.

Van Vleet has been cutting operational costs in other ways. For example, his team reduced employee benefits and stock-based compensation. He also consolidated five divisions into three and reduced excess office capacity.

Meanwhile, Van Vleet aims to double what had been modest growth on the topline, from 5% to 7% a year to 10% to 12%, mainly by winning new business. In that vein, the firm has added a suite of new services to offer product support.

Acquisitions might provide additional growth.

"We're actively screening candidates," Van Vleet said.