

# EQUITY RESEARCH REPORT



**AdZone Research, Inc.**  
**OTCBB : ADZR**

Randy Lewis, CFA – Analyst  
October 7, 2003

Close as of: October 7, 2003  
DJIA: 9,654.61  
S&P 500: 1,039.25  
NASDAQ Composite: 1,907.85  
Russell 2000: 520.77

**SPECULATIVE Buy RECOMMENDATION**

<b>Stock Price:</b>	<b>\$0.18</b>	<b>Market Cap.:</b>	<b>\$11.16 M</b>	<b>TTM P/E</b>	<b>N/A</b>
<b>52 Week Price Range:</b>	<b>\$0.01 –0.24</b>	<b>Shares Outstanding:</b>	<b>62.0 M</b>	<b>Current Ratio</b>	<b>0.21</b>
<b>Industry/Sector:</b>	<b>Info. Systems</b>	<b>Float (est):</b>	<b>24.0 M</b>	<b>Fiscal Year</b>	<b>Mar.</b>
<b>3–mo. Avg. Vol. (est.)</b>	<b>757,000</b>				

## BASIS FOR RECOMMENDATION

- We are initiating a **Speculative Buy** recommendation for AdZone Research, Inc. (OTCBB:ADZR). AdZone provides tracking and monitoring of targeted information on the Internet, with an expanded focus on global Internet analysis of security-related data transmissions. Current and past experts in Counter-Intelligence /Counter-Terrorism have labeled AdZone's NetGet™ product the first commercially developed tool



able to operate at the BIT level that identifies the presence of clandestine communication and intrusion occurring over the Internet. The company's goal is to integrate its NetGet™ system with a major defense contractor's product and service line, and through that relationship, monitor the Internet on behalf of intelligence and defense agencies.

- Recent defense budgets are significantly higher than in prior years, especially in areas related to intelligence, surveillance, and reconnaissance and homeland security because of increased counter-terrorism activities following 9/11. Including supplemental funding, the federal budget allocated \$17 billion to homeland security in fiscal 2001. This amount increased to \$29 billion in 2002, and President Bush has budgeted \$38 billion for FY 2003. All told, the U.S. spends roughly \$100 billion on homeland security.
- The company is at a critical turning point as it is attempting to transition from a development stage to a revenue producing company. While such transitions generally entail a high degree of risk, they also have the potential to generate high levels of returns for investors. Assuming that AdZone is able to meet certain financial and operational targets, the stock may prove highly undervalued.

## BUSINESS OVERVIEW

Launched in 2000, AdZone Research, Inc. (OTCBB: ADZR), a Delaware corporation, is a development stage company providing proprietary software that monitors the Internet for virtually all types of activity. AdZone provides tracking and monitoring of targeted information on the Internet, with an expanded focus on global Internet analysis of security-related data transmissions. The company has developed three key focus areas: Online Advertising Data, Online Biotech Tracking and Online Terrorism Tracking. Its technology is scalable, and capable of supporting additional products and services of value to its numerous marketplaces.

Current and past experts in Counter-Intelligence/Counter-Terrorism have labeled AdZone's NetGet™ product the first commercially developed tool able to operate at the BIT level that identifies the presence of clandestine communication and intrusion occurring over the Internet. The company's goal is to integrate NetGet with a major defense contractor's product and service line, and through that relationship, monitor the Internet on behalf of intelligence and defense agencies. While NetGet has other uses than national security and counter-terrorism activities, we feel that this portion of the company's business model holds the most near-term promise for investors and will thus be the focus of this report.

## THE MARKET

### Homeland/National Security

No one can deny that the events of September 11, 2001 changed our lives forever. Recent defense budgets are significantly higher than in prior years, especially in areas related to intelligence, surveillance, and reconnaissance and homeland security because of increased counter-terrorism activities following 9/11. Including supplemental funding, the federal budget allocated \$17 billion to homeland security in fiscal 2001. This amount increased to \$29 billion in 2002, and President Bush has budgeted \$38 billion for FY 2003. All told, the U.S. spends roughly \$100 billion on homeland security. This figure includes services from federal, state and local law enforcement and emergency services, but excludes most spending for the armed forces.

The U.S. government is also among the largest buyers of information technology systems and services in the world. According to market research firm, INPUT, Inc., the U.S. government's information technology budget for fiscal year 2003, an important element of AdZone's addressable market, is projected to be approximately \$50 billion, an increase of 11% from 2002. Current forecasts, according to INPUT, for federal information technology spending are for a compound annual growth rate of approximately 10% over the next three to five years.

The U.S. government's focus on modernization through increased spending on information technology reflects the critical role that this capability plays both in national security and in improving government efficiency. The transition from the single threat, cold war era to today's multiple and more widely dispersed threats, most notably the war on terrorism, coupled with the rapid rate of technological change, has increased the U.S. military's need for more efficient and advanced information, communications, and military platform capabilities. It logically follows that the Internet will be a large part of this transformation, and with increased online use, comes increased need for online security.

## Corporate Security

Corporations also need to protect themselves against the threat of terrorism and unwanted intrusion. One-third of companies are still not adequately equipped to deal with an attack on their computer networks by cyberterrorists, according to a study by the Internet Security Alliance conducted last Fall. The study found that 88% of firms now recognize that protecting valuable information is essential to their company's survival; up from 82% since the September 11 terrorist attacks. The study also found that 48% of respondents said that the September 11 attacks has made them more concerned about terrorism and its possible impact on their organizations. Almost half of the respondents said their companies have increased spending on information security since last year, and 38% said this trend would continue in 2003.

## Potential Customers - Demand

AdZone's main role is to apply its monitoring expertise as a cyber security tool for industry and government as part of the larger Homeland Security and other defense-related endeavors. Therefore, the demand for NetGet is quite large and can potentially come from:

1. Defense and Intelligence Contractors
2. Federal Intelligence and Defense Agencies
3. State Intelligence and Defense Agencies
4. Local Law Enforcement Agencies
5. International Intelligence and Defense Agencies
6. Domestic Corporations
7. International Corporations

## PRODUCTS AND SERVICES

### NetGet™

AdZone's proprietary NetGet™ system can monitor virtually anything on the Web. The original system, which incorporates logic from the field of astrophysics, was designed for maximum flexibility, allowing virtually any type of Web content to be monitored, stored and analyzed. The NetGet technology is based on an extremely open platform that is composed of four integrated elements:

- Crawler
- Artificial Intelligence ("AI") agent
- Database
- Report Generator

The Crawler specifically was designed to be language independent and format neutral. After its initial *pass*, a baseline (a series of keywords) is established against which all future deviations are both identified and stored. Furthermore, it immediately engages the AI agent to follow all the links it finds on targeted Web pages. The findings are then aggregated and analyzed to determine if historical data needs to be re-examined (to re-open prior trails) and to "learn" new strategies on a going-forward basis. Finally, these two elements (Crawler and AI agent) are both able to cycle on a non-standard, yet effectively continuous, basis so that the target sites do not see unusual levels of activity.

All the subsequent data is stored in a specially designed database structure composed of 50 interwoven sub-bases. This facilitates the operation of the AI agent while providing a broad range of reports that can be generated. Currently, the system tracks more than 500,000 URLs. However, this is fully scalable up to more than 30 million for anti-terrorism applications.

## Competitive Factors

AdZone is one of many companies involved in Internet tracking and providing information systems solutions and support services for agencies of the U.S. and civil governments. Most activities in which the company engages are very competitive and require highly skilled and experienced technical personnel to compete. Competitors include large defense contractors (i.e. General Dynamics Corporation, Lockheed Martin Corporation, Northrop Grumman Corporation and Science Applications International Corporation) as well as smaller and medium sized companies (CACI International Inc., Dynamics Research Corporation, Veridian Corporation and ViaSat, Inc.). Despite the relatively large number of firms involved in the company's target market, AdZone is able to separate itself from the competition due to the following:

1. First, a key component of AdZone's business model is to partner for R&D and marketing with an established contractor. Thus, many of the firms that would be viewed as competitors are actually potential strategic partners. In addition, AdZone is believed to be an attractive partner for larger government contractors since it is headquartered in a HUBZone (Historically Underutilized Business Zone), and under the Small Business Administration, qualifies the large contractor to allocate up to 25% of the total contract to smaller subcontractors, thereby enhancing its likelihood of winning the bid.
2. Next, from a technological standpoint, NetGet's competitive strengths are the facts that:
  - It is the only commercially developed Web tracking product that is able to monitor data and information at the BIT level. No other product that we know of has the ability to break down data that small.
  - It is the only scanning technology that integrates logic from astrophysics. Based on the background of AdZone CEO, Charles Cardona, these sophisticated applications are built into the system. (Due to space constraints, we urge investors to view the company's filings and other materials for complete backgrounds on the management team and advisors).
  - Report analysis is more sophisticated. Because monitoring can be broken down like no other product, it follows that the analysis gleaned from the information will be superior.

## FINANCIAL INFORMATION

**Revenue and Earnings.** AdZone is a development stage company, with its financial results reflecting that status. During the quarter ended June 30, 2003 (Q1 '04), the company realized just \$39,125 in revenues. In the same period, AdZone incurred a net loss of approximately \$77,000, or \$(0.00) per share, as compared to a net loss of approximately \$172,000, or \$(0.02) per share, for the three months ended June 30, 2002.

Since the company has not fully commenced operations, management is of the opinion that current financial results are not a meaningful indicator of future operations. And it indeed appears this is the case. During the first fiscal quarter, the company obtained a \$50,000 contract from a major United States defense contractor, its second revenue-generating contract from a major industry player. While the revenues associated with these contracts are small, it does show that during its third year of operation, the company has finally turned the corner from simply owning eye-catching technology to revenue generation. This is an important step for a company that has had to deal with the dot-com meltdown, the economic effects of 9/11, and general waning economic conditions as obstacles the past couple of years. In addition, AdZone has transitioned itself from solely a Web advertising monitoring service (which it can still pursue), to a firm with a bona-fide counter-terrorism initiative as its primary focus - and the contracts are in this area.

**Liquidity and Capital Requirements.** At the end of its last fiscal quarter ending June 30, 2003, the company had an accumulated deficit of \$3.1 million, and a working capital deficit of \$452,000. Management estimates the company will need an additional \$500,000 to continue to fund operations for the remainder of the calendar year, not including the \$51,000 it currently has on the books. AdZone is operating lean, however, with a cash burn rate of about \$40,000 a month. To date, the principal source of liquidity has been sale of equity securities, and we expect this to continue to be the case. Because of the need for financing, the success of the company is to a large extent dependent on its ability to raise capital, and obviously it will have to done fairly quickly. Toward that end, the company is currently pursuing a \$500,000 private placement to meet short-term needs. It should be noted the company's financial statements still carry a going-concern opinion.

## OUTLOOK/VALUATION

Up until this past summer, the company could have been characterized by one thing – unlucky timing. With good technology and a solid method of tracking Internet use, management brought the product to market just in time for the dot-com bust, when Web advertising experienced a colossal drop-off and skepticism was rampant. AdZone was certainly not alone in this regard, however, and on the plus side, it didn't take millions of dollars in capital to realize the timing was off. Obviously things changed when national security became of paramount importance, and it was discovered that the NetGet system was a superior product of its kind in helping the anti-terrorism effort.

Thus, AdZone has been positioning itself over the last several months to take advantage of a very large market where existing products are only marginally meeting the growing demands for anti-terrorism efforts at the technological level. The company is at a critical turning point as it is attempting to transition from a development stage to a revenue producing company. While such transitions generally entail a high degree of risk, they also have the potential to generate high levels of returns for investors. Assuming that AdZone is able to meet certain financial and operational targets, the stock may prove highly undervalued.

First and foremost, the company is now in the mix with the major government contractors. As it relates to this fact, we believe that the most likely scenario (and the pay-off to investors) is that AdZone will eventually become an acquisition target. There seems to be a consolidation wave in the defense industry right now. Lockheed Martin Corp.'s purchase of defense information- technology company Titan Corp. has given other small information-technology companies a boost as investors consider which might be the next takeover target. In August, General Dynamics Corp. completed the acquisition of Veridian Corp., a network security and intelligence company. Chris Mecray, analyst with Deutsche Bank in New York, said the Lockheed deal with Titan confirms that the sector continues to consolidate.

Big defense contractors seem eager to get their hands on the technology companies as the U.S. has changed its approach to defense to more intelligence gathering, which requires sophisticated computer networks and tracking, rather than big guns and equipment. AdZone certainly seems to fit into this mix, particularly having already signed a contract with a major defense firm. Of course, when the acquisition takes place and at what price cannot be known now.

In the interim, we would expect relationships to continue to grow in the area of homeland security. It would be likely that as these relationships grow, a formal partnership arrangement could be formed, whereby a larger firm (most likely a large defense contractor) would fund the company's R&D and marketing efforts. In addition to the potential grants and revenue that a partnership can bring, there are other reasons why partnering with larger, established companies is a good idea:

- The government has difficulty dealing with small companies;
- Potential partners would already have relationships with federal agencies & departments;
- Defense contractors have already been cleared for the highest levels of security;
- Potential partners would have visual enhancement & decryption technology to further exploit AdZone's findings.

Of course, valuing a start-up with solid potential is a daunting task at best. We have not put together our traditional earnings model because the timing and amount of revenue cannot be estimated with any reasonable certainty at this time. Therefore, we are not placing a specific price target for the stock, but have outlined a strong argument for undervaluation relative to its current \$0.18 price in this report. As we see in the biotech world, companies that are just transitioning from start-up to potentially high revenue-generation are often afforded high valuations. In short, the current market cap of \$11.2 million is very small relative to what can be realized in terms of earnings and revenues over the next several years.

---

EquityNet Research is an independent research firm and has been compensated \$6,000 by Investor Relations Network, the issuer's investor relations firm, for this research report. The information contained herein has been obtained from sources which are believed to be reliable, but the accuracy or completeness of the contents cannot be guaranteed. Any opinions and/or projections expressed herein are solely of the writer and are subject to change without notice. This report under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report contains forward-looking statements include expressions of belief, expectation, contemplation, estimation and other expressions not relating to historical facts and circumstances. These forward-looking statements are subject to numerous risks and uncertainties that may cause such statements not to prove accurate. Any recommendations contained in this report may not be suitable for all investors. Any investment recommendations in this report contain a high degree of risk and a prospective investor is encouraged to review in detail the company's prospectus and/or other additional information. Any projections or estimates herein made assume certain economic and industry conditions and parameters subject to change.

EquityNet Research ♦ 14011 Ventura Boulevard, Suite 301 ♦ Sherman Oaks ♦ CA ♦ 91423  
Phone: 818-783-5006 Email: [info@equitynet.net](mailto:info@equitynet.net)