

EQUITY RESEARCH REPORT



Sionix Corporation
OTCBB : SINX

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October 22, 2002

Close as of: October 21, 2002
DJIA: 8,538.24
S&P 500: 899.72
NASDAQ Composite: 1,309.67
Russell 2000: 368.63

Buy RECOMMENDATION

Date of Report:	<i>Oct. 22, 2002</i>	Market Cap.:	<i>\$24.8 M</i>	Revenues (\$)	P/S
Stock Price:	<i>\$0.33</i>	Shares Outstanding:	<i>75.0 M</i>		
52 Week Price Range:	<i>\$0.11 – 0.65</i>	Float:	<i>22.4 M</i>	2001A	<i>N/A</i>
Industry Sector:	<i>Water Treatment</i>	12-18 mo. Target Price:	<i>\$1.00</i>	2002E	<i>N/A</i>
30-day Avg. Vol. (est.)	<i>43,000</i>			2003E	<i>\$14.3M 1.73</i>

BASIS FOR RECOMMENDATION

- We are initiating a **Buy** recommendation for Sionix Corp. (OTCBB: SINX). Sionix is involved in the development of new water purification systems that offer several advantages over existing products. The Company's Dissolved Air Flotation (DAF) technology utilizes and refines existing DAF technology for a more efficient pre-treatment process using ordinary air or oxygen instead of chemical filter aids. In addition, it helps ordinary filters meet new EPA water regulations and eliminates potentially cancer-causing precursors while reducing the risk of bacterial or parasitic contamination, such as Cryptosporidium, E-coli and Giardia, or disinfection by-products from Chlorine or Trihalomethanes (THM's). The system requires less energy than a conventional filtration system, and only a fraction of the floor space.



- There is great demand for effective water treatment systems. Water supply is viewed by many as the next global crisis; while the quantity of water is fixed, the world population is increasing. A World Bank report expects worldwide expenditures to exceed \$600 billion over the next decade to augment water reserves as demand outstrips available supplies due to agricultural development. In addition, the EPA reports 5,000 to 10,000 of 55,000 communities in the U.S. are in violation of the Safe Drinking Water Act at any given time. Those numbers are expected to increase, as more stringent EPA rules are implemented for small public water systems. In addition, urbanization in the Third World and the spread of agricultural activities have increased the demand for public water systems.
- Management projects that revenues could approach \$14.3 million in FY 2003. At \$0.33 per share, the stock is trading at 1.73 times expected revenue for FY '03. Given this low current valuation and future growth that can be expected, we believe there is significant upside potential for the stock.

BUSINESS OVERVIEW

Since 1998, Sionix Corp. (OTCBB: SINX), a Utah corporation located in Irvine, CA, has been focused on the development of new-technology water purification systems utilizing Dissolved Air Flotation (DAF). The Company has completed initial phases of testing, and is currently previewing its products with experienced treatment plant managers and certified operators to gauge their level of acceptance. Sionix has commenced production and marketing of its DAF Water Filtration systems, Automatic Back-Flush Filtration System and other related products. Initially, Sionix plans to target the group of 185,000 small to medium water providers, as well as industrial users in the U.S. who have a need for a clean, consistent water supply. The Company plans to offer financing and continual product upgrades to its customers.

THE MARKET

The Importance of Clean Water Treatment

The importance of clean water should not be under-estimated. On a local level, reports from the Environmental Protection Agency (EPA) list 5,000 to 10,000 of 55,000 communities in the U.S. that are currently in violation of the Safe Drinking Water Act at any given time. Those numbers are expected to increase, as more stringent EPA rules are implemented for small public water systems. The Association of Metropolitan Water Agencies estimates that \$2 trillion is needed over the next 20 years for repair, rehabilitation, operation, and maintenance of the U.S. water and wastewater treatment infrastructure. The importance of effective water treatment is also critical from an economic standpoint as health concerns and impure water can ruin a product and discharge violations can lead to major fines. The beverage industry, for instance, would be hard pressed to receive customer complaints that are traced back to the water treatment of total water management systems.

On an international level, water supply is viewed by many as the next global crisis; while the quantity of water is relatively fixed, the world population is increasing. The U.S. Department of Commerce and the commercial service section at the U.S. Embassy in London have documented that the European Community members plan to spend \$152 billion on new public drinking water and sewage treatment plants by the year 2010. A World Bank report prepared for a symposium expects worldwide expenditures will exceed \$600 billion over the next decade to augment water reserves as demand outstrips available supplies due to agricultural development.

In general, there are two methods of water treatment: point of use, and outsourced. Many consumers, both industrial and individual, choose to treat their water themselves at the point-of-use (POU). POU technologies improve water quality in a variety of ways. Harmful contaminants, unusual taste, color and odor of water may be corrected with POU devices. For those firms, which do not wish to treat water themselves, outsourcing of water treatment is available. Typically, suppliers in this industry own and operate their systems to provide customers with specified quantities of water at an acceptable level of quality.

Market Size - Supply

The size of the water quality systems market in the U.S. has been estimated at over \$86 billion. Of this total, municipalities control 63% of the market followed by private sectors firms with 37%. The \$86 billion estimate does not include the \$3 billion water and wastewater engineering market and the \$10 billion in costs incurred internally by manufacturing plants to operate and maintain their own wastewater treatment systems. Included in this total is \$5 billion market for equipment such as water treatment

systems. These treatment systems are needed by a variety of water providers, including the 185,000 small to medium water providers in the U.S. alone.

Potential Customers - Demand

The demand for clean water comes from many sources. Sionix plans to provide a portable product with low cost, and pure output that is capable of servicing the needs of a broad range of potential customers. The Company plans to initially target the 185,000 small-to-medium water providers in the U.S. alone, followed by an expansion into international markets. Several potential customers are listed below:

Consumer Waste Management: People receive their water from two sources: a private well, or a community water system. Roughly 15% of the U.S. population relies on individually owned and operated sources of drinking water, such as wells, cisterns, and springs. Those who receive their water from these sources are solely responsible for the safety of the water. The remaining 85% receives its water from community water systems. These water systems are required to meet the standards set by the (EPA).

Military/National Guard: Demand for portable water due to disruptions in the normal supply during a natural disaster or military operation is often high. The ability of the Guard to treat water using a portable system would be of inestimable value during these emergency situations.

Industrial Users: Water contaminated during the production process must be purified before it can be reused or disposed of. Several types of companies have a need to treat post-use wastewater including chip manufacturers, producers of paper products, and the dairy industry.

Food and Beverage Industry: Beverage, beer, and food producers require water of a specific quality that must be controlled and monitored during the production process. In addition, waste water disposal for the dairy, meat and poultry processing industries.

Healthcare Industry: Both hospitals and pharmaceutical companies require clean water and produce contaminated water that must be treated before release into the common sewer system or reused.

Desalination: This is an important measure to enhance the supply of water and will be of increasing importance as the demand for clean water increases in the future.

Competitive Factors

The water quality systems market is very fragmented with over 50,000 companies. Most of these firms are privately held and others are divisions of publicly traded firms that do not report financial data for their water business units. While water and wastewater treatment is often a small cost relative to the total cost of production for many companies, these firms cannot afford the costs that result from the use of water at unacceptable levels of quality. Therefore, industry participants with proven products and services can create significant barriers to entry in this market.

PRODUCTS AND SERVICES

The Company's patented water treatment systems have several attractive features that are listed below.

1. Because it is modular, the system is designed for quick installation.
2. Cost effective for even the smallest water utilities or commercial applications.

3. Easily expandable and upgradeable; adding Ultra-Violet and micro-filtration equipment to a DAF unit is similar to adding a new hard drive to a personal computer. The modular system may be sold as a complete treatment system, or as individual components, and can be used for wastewater management in nearly every industry.
4. Sionix has also arranged for lease financing to guarantee that customers will always have access to preventative maintenance programs, and any refinements made to product line.

The following is an overview of the Company's product line:

Sionix Modular Solids Separator Filtration System: The Company's DAF Particle Separator technology utilizes and refines the current DAF technology for a highly efficient pre-treatment process using ordinary air or oxygen along with chemical filter aids. In addition, it helps ordinary filters meet new EPA Safe Drinking Water Act regulations and eliminates potential cancer-causing disinfection by-product precursors such as Trihalomethanes (THM's), while reducing the risk of bacterial or parasitic contamination, particularly Themes, Cryptosporidium, E-Coli and Giardia.

This product is a more efficient method of saturating re-circulated post-filter water with excess dissolved air and applying this excess air in the form of microscopic bubbles when injected into water. More specifically, the Sionix DAF separator provides a denser concentration of white water bubbles within a more restricted space, traveling a shorter distance from the high-pressure zone to the low-pressure zone. This process requires less energy than a conventional treatment system, and only a fraction of the floor space.

Sionix Water Treatment Office Automation Software Program: This software program contains an extensive library of state and federal water and water treatment regulations, an operator training and testing program, automatic health department report compiler, and a systematic safety, health and environmental affairs implementation program and resource manual. In addition, the software contains the operating code for (SCADA) Supervisory Control and Data Acquisition hardware system. The SCADA software incorporates an initial automatic systems integration set-up program, and can be operational within hours.

Sionix SCADA Hardware: This specialized hardware provides a treatment facility with online, real-time monitoring of its treatment, storage and distribution systems. The hardware, combined with the Sionix SCADA software, automatically monitors wet-chemistry, and includes continuous in-line chemical sensors, an optimum ozone level controller, automatic self-cleaning filtration system controls, and automatic filter-to-waste control programs.

Production. The Company has all the components in place necessary to build and ship product. Under current capacity, management estimates that it can produce four units a month; however, capacity is immediately expandable under arrangements with several contract manufacturers. While all manufacturing and assembly is currently performed here in the U.S., the Company is ready to expand some assembly functions overseas. On average, the lead-time to receive the materials necessary for production is eight weeks, with a three-week window for assembly and shipping. As production increases, we would certainly expect at least the lead-time for raw materials to contract. It should be noted as well that, as with any start-up manufacturing of this caliber, production costs (certainly on a per-unit basis) are higher in the short-run. For instance, Sionix estimates that certain costs associated with information technology and specific components of assembly, will be incurred and spread out over the first six months of production as the Company finalizes its set-up procedures.

FINANCIAL INFORMATION

Revenues and Earnings. For the three months ended June 30, 2002, Sionix had no revenues and an operating loss of \$280,469, principally due to research and development costs, as well as general and administrative expenses. Management expects initial revenues from product sales to begin in the first quarter of FY 2003 (ending December 31, 2002), resulting in net revenues of \$14 million for the fiscal year. These estimates are based on the expectation that the Company will sell 28 product units in FY 2003, at an average sales price of \$500,000 per unit.

Liquidity and Capital Requirements. At the end of its last fiscal year, the Company had an accumulated deficit of \$9.5 million, and management estimates the Company will need an additional \$500-600k to continue to fund operations for the remaining of the calendar year, not including the \$800,000 it currently has on the books. As a normal course of business, once purchase orders are signed, Sionix receives a 50% deposit on each unit – or \$250k – thereby funding most of the cost of per-unit production. To date, the principal source of liquidity has been sales of securities. Because of the need for financing, the success of the Company is to a large extent dependent on its ability to raise capital. Sionix recently secured an equity line-of-credit for \$7.5 million, however, so we do not see capital deficiency as a near-term problem, though investors can expect significant dilution during the next fiscal year. If the business model is executed according to plan, outside capital should not be necessary past FY 2004.

OUTLOOK/VALUATION

Sionix has been positioning itself over the last several years to take advantage of a very large market where existing products are not meeting the growing demands for clean water. Now, with past litigation behind it and product positioning in place, Sionix 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 Sionix is able to meet its financial and operational targets, the stock may prove highly undervalued. It is our opinion that Sionix has the potential to generate millions of dollars in future revenues because of several factors: the Company has a patented product, the potential market is huge (\$86 billion dollars); and it offers a water treatment solution that meets the growing demand for clean water more effectively at a lower cost. In fact, the Company already has pending purchase orders for 5-8 units.

Of course, valuing a start-up with huge potential is a daunting task at best. Comparable public companies are few and their multiples vary widely. For instance, AquaCell Technologies (AMEX:AQA), a company that specializes in consumer, point-of-use water filtration for five-gallon dispensers, is trading at 5.74 times TTM sales, while its sales are only \$1 million with a negative EBITDA of -\$3.4 million. Aqua Care Systems (OTCBB:AQCR), on the other hand, a company involved in municipal water filtration (among other things) has sales of \$8.5 million and is only trading at 0.09 times sales. Therefore, a valuation comparison based on multiples seems a bit fruitless.

While our valuation is largely subjective at this stage, we feel justified in setting a 12-18 month price target of \$1.00 per share. Our justification is for several reasons. First, the Company's product is a high-ticket item; therefore, an underestimation in the number of units sold can lead to dramatically more revenue. Next, 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 \$24.8 million is very small relative to what can be realized in terms of earnings and revenues over the next several years.

Sionix Corporation

Projected Statement of Operations & Earnings

(In \$ Thousands, except per share data)

Actual - A Estimates - E	Fiscal 2001-A 30-Sep-01	Q1 2002-A 31-Dec-01	Q2 2002-A 31-Mar-02	Q3 2002-A 30-Jun-02	Q4 2002-E 30-Sep-02	Fiscal 2002-E 30-Sep-02	Fiscal 2003-E 30-Sep-03	
Revenue								
Unit Sales	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 14,000	97.9%
Service Revenue	-	-	-	-	-	-	300	2.1%
Total Revenue	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 14,300	100.0%
Cost of Goods Sold	-	-	-	-	-	-	8,956	62.6%
Gross Profit	-	-	-	-	-	-	5,344	37.4%
Operating Expenses								
General & Administrative	1,242	393	209	257	233	1,092	4,234	29.6%
Research & Development	177	22	-	18	15	55	419	2.9%
Total Operating Expenses	1,419	415	209	275	248	1,147	4,653	32.5%
Operating Income (Loss)	(1,419)	(415)	(209)	(275)	(248)	(1,147)	691	4.8%
Other (Income) Expense								
Depreciation & Amortization	28	5	5	5	5	20	240	1.7%
Interest Expense (Income), net	(2)	(1)	1	(1)	1	-	-	0.0%
Other Expense (Income)	17	-	-	-	-	-	-	0.0%
Legal Settlement (Income)	(110)	-	(132)	(200)	-	(332)	20	0.1%
Total Other (Income) Expense	(67)	4	(126)	(196)	6	(312)	260	1.8%
Income (Loss) Before Taxes	(1,352)	(419)	(83)	(79)	(254)	(835)	431	3.0%
Income Taxes	1	1	-	-	-	1	-	0.0%
Estimated Tax Rate	-	-	-	-	-	-	-	0.0%
Net Income (Loss) Before Extraordinary Item	\$ (1,353)	\$ (420)	\$ (83)	\$ (79)	\$ (254)	\$ (836)	\$ 431	3.0%
Extraordinary Item - Gain (Loss) on Debt Settlement	-	-	\$ 18	\$ (19)	\$ -	\$ (1)	\$ -	0.0%
Net Income (Loss)	\$ (1,353)	\$ (420)	\$ (65)	\$ (98)	\$ (254)	\$ (835)	\$ 431	3.0%
Earnings Per Share:								
EXCLUDES ALL NON-CASH CHARGES	\$ (0.02)	\$ (0.01)	\$ (0.00)	\$ (0.00)	\$ (0.00)	\$ (0.01)	\$ 0.01	
Reported	\$ (0.02)	\$ (0.01)	\$ (0.00)	\$ (0.00)	\$ (0.00)	\$ (0.01)	\$ 0.01	
Weighted Average Shares:								
Basic & Fully Diluted Shares Out.	55,603,611	63,289,568	62,493,660	65,778,236	73,298,786	66,215,063	85,000,000	

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