



DECEMBER 18, 2008

UPDATE REPORT

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IMPLANT SCIENCES CORPORATION (AMEX: IMX)

INDUSTRY: SECURITY

DISCLOSURES: 1, 5, 10

RATING: BUY

RISK: HIGH

CLOSING PRICE 12/17/08	TRAILING P/E (TTM)	SHARES OUT (MILS.)	MARKET CAP (MILS.)	3-5 YEAR REV. GROWTH	PRICE TARGET
\$0.28	NM	13.5	\$3.8	N/A	\$1.00

ANNUAL DATA – JUNE YEAR END			
	2008A	2009E	2010E
EPS	\$ (0.65)	\$ (0.28)	\$(0.10)
P/E	N/M	N/M	N/M
REVENUE (MIL.)	\$5.1	\$15.3	\$20.2
P/S	0.75	0.25	0.19

EARNINGS					
	Q1	Q2	Q3	Q4	ANNUAL
2010E	\$ (0.05)	\$ (0.03)	\$(0.02)	\$ 0.00	\$ (0.10)
2009E	\$ (0.05)	\$ (0.08)	\$(0.08)	\$ (0.07)	\$ (0.28)
2008A	\$ (0.18)	\$ (0.39)	\$(0.17)	\$ 0.09	\$ (0.65)
2007A	\$ (0.17)	\$ (0.15)	\$(0.16)	\$ (0.52)	\$ (0.97)

IMX Clears Financing Hurdle

IMX's transformation into a single-focus security company is well underway. Importantly, IMX has put numerous operational challenges behind it and secured new financing. IMX appears on the road to profitability by the end of next fiscal year, and may even make an attractive acquisition target. We rate IMX a BUY at current levels.

In welcome news, IMX executed on December 10, 2008 a Note and Warrant Purchase Agreement with DMRJ Group, LLC, an affiliate of Platinum Partners Value Arbitrage Fund L.P. that will not only allow it to both repay its existing debt to Bridge Bank, N.A. and redeem the approximately \$1.2 million of Series D Preferred Stock held by Laurus Master Fund, Ltd. and its affiliates, but also have funds left over for working capital. Particularly in this financing environment, we are encouraged to see this progress.

IMX issued a \$5.6 million Senior Secured Convertible Promissory Note, bearing interest of 11%, to DMRJ. \$616,000 of interest will be prepaid upon the issuance of the Note; \$1 million of principal is due on December 24, 2008; and the remaining principal and interest are due on December 10, 2009.

If converted, the entire \$5.6 million note would dilute current shareholders by about 25.1 million shares. However, IMX currently holds some \$2 million in unrestricted cash and equivalents on its balance sheet and its continuing (security business) operations are cash-generative, so we believe the company will likely prefer to pay the first \$1 million in cash if possible.

In addition, IMX issued a five-year warrant to purchase 1 million shares of its common stock at \$0.26 per share.

In lieu of fees, IMX transferred to DMRJ 1.5 million shares of common stock of CorNova, Inc., a privately-held, development stage medical device company in which IMX held an approximate 15% ownership interest. Since IMX is exiting the medical business and will no longer service stents after the end of the year, this makes strategic sense for IMX to monetize this asset in some fashion. These shares are held on the balance sheet at zero.

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If total fees were 10% of \$5.6 million dollars, or \$560,000, this implicitly values all of CorNova at about \$36 million. While at one point we had hoped IMX might see much more for this asset, not only has the market slumped since Johnson & Johnson (NYSE: JNJ: \$58.78 – Not Rated) paid \$1.4 billion for stent company Conor Medsystems in February 2007, but also stent technology has considerably fallen from favor.

Valuation and Recommendation

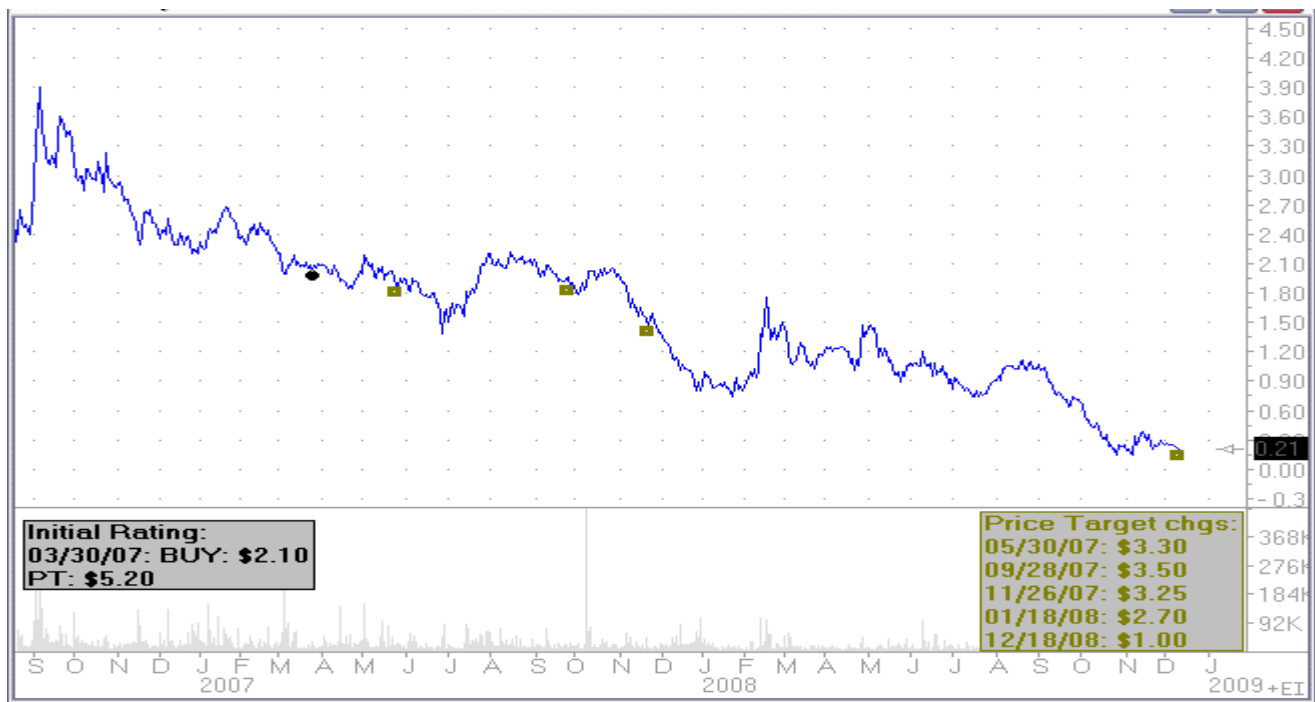
Having shipped a \$2.7 million spike of orders in support of the Beijing Olympics, and previously announced additional backlog of more than \$4.2 million worth of QS-H150 portable explosives detectors to ship to Asia and Europe in F4Q08 and F1Q09, we now project a lighter F2Q09 for IMX.

We assume 20% sequential volume growth in the third and fourth quarters of FY09, dropping to 15% in F1Q10 and 10% subsequently. We assume R&D relatively flat and some leverage of SG&A. We assume a small but growing component of service revenues.

We have recognized the interest payments on the new Note as they are incurred, although in cash terms, as noted above, \$616,000 will be prepaid and presumably amortized. We also incorporate the new fully diluted share count, including the five-year warrants and \$4.6 million of the convertible note (assuming the first \$1 million is paid in cash), when the company breaks even, which we now project for F4Q10. (It should be noted that in our model, even if the full \$5.6 million is converted, the company still breaks even in F4Q10.)

These assumptions lead us to revenues targets of \$15.3 million for FY09 and \$20.2 million for FY10.

To reflect lower valuations across the market, we bring our valuation multiple for IMX down from 3x sales per fully diluted share to 2x sales per fully diluted share. Since the diluted share count has also risen, this brings our price target from \$2.70 to \$1.00 on IMX. Since this target still represents a substantial gain from recent prices near \$0.25, and since the stock still strikes us as potentially an attractive acquisition for a strategic buyer in the defense space, we maintain our **BUY** rating.



(In thousands except for per-share numbers. Historicals restated to exclude some elements of discontinued businesses)

Implant Sciences Corporation

Quarter:

Quarter Ending:

	FY09	FY09E	FY09E	FY09E	FY10E	FY10E	FY10E	FY10E
	1st	2nd	3rd	4th	1st	2nd	3rd	4th
	9/30/2008	12/31/2008	3/31/2009	6/30/2009	9/30/2009	12/31/2009	3/31/2010	6/30/2010
Total Revenue	\$5,948	\$2,582	\$3,098	\$3,717	\$4,293	\$4,767	\$5,296	\$5,889
Cost of Revenue	\$3,172	\$1,459	\$1,750	\$2,069	\$2,390	\$2,654	\$2,904	\$3,180
Gross Profit	\$2,776	\$1,123	\$1,348	\$1,648	\$1,903	\$2,113	\$2,392	\$2,709
Gross Profit Margin	47%	44%	44%	44%	44%	44%	45%	46%
Research and Development	\$1,020	\$1,020	\$1,020	\$1,020	\$1,020	\$1,020	\$1,020	\$1,020
Sales, General and Admin.	\$2,366	\$1,027	\$1,232	\$1,479	\$1,493	\$1,419	\$1,430	\$1,472
Non-Recurring Items								
Operating Income	(\$610)	(\$924)	(\$905)	(\$851)	(\$610)	(\$326)	(\$58)	\$217
Change in value of embedded derivatives related to preferred stock features (non-cash)	0							
Earnings Before Interest and Tax	(\$610)	(\$924)	(\$905)	(\$851)	(\$610)	(\$326)	(\$58)	\$217
Interest Income (Expense), net	(\$24)	(\$154)	(\$154)	(\$154)	(\$154)	(\$154)	(\$154)	(\$154)
Earnings Before Tax	(\$634)	(\$1,078)	(\$1,059)	(\$1,005)	(\$764)	(\$480)	(\$212)	\$63
Equity Earnings Unconsolidated Subsidiary	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net Income-Continuing Operations	(\$634)	(\$1,078)	(\$1,059)	(\$1,005)	(\$764)	(\$480)	(\$212)	\$63
Distribution to preferred	(\$189)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net Income Applicable to Common	(\$823)	(\$1,078)	(\$1,059)	(\$1,005)	(\$764)	(\$480)	(\$212)	\$63
Net Income Applicable to Common Per Share	(\$0.06)	(\$0.08)	(\$0.08)	(\$0.07)	(\$0.05)	(\$0.03)	(\$0.02)	\$0.00
Net Income Per Share	(\$0.05)	(\$0.08)	(\$0.08)	(\$0.07)	(\$0.05)	(\$0.03)	(\$0.02)	\$0.00
Shares outstanding	13,468	13,487	13,505	14,080	14,080	14,080	14,080	36,619

FY07	FY08	FY09E	FY10E
\$5,087	\$5,152	\$15,345	\$20,246
\$4,504	\$3,577	\$8,450	\$11,128
\$583	\$1,575	\$6,895	\$9,118
11%	31%	45%	45%
\$1,811	\$3,097	\$4,080	\$4,080
\$6,212	\$6,414	\$6,104	\$5,815
3,748			
(\$11,188)	(\$7,936)	(\$3,289)	(\$777)
\$961	82	0	0
(\$10,227)	(\$7,854)	(\$3,289)	(\$777)
(\$616)	\$116	(\$486)	(\$616)
(\$10,843)	(\$7,738)	(\$3,775)	(\$1,393)
(\$158)	\$0	\$0	\$0
	24		
(\$11,001)	(\$7,714)	(\$3,775)	(\$1,393)
(\$951)	(\$1,058)	(\$189)	\$0
(\$11,064)	(\$8,772)	(\$3,964)	(\$1,393)
(\$0.98)	(\$0.73)	(\$0.29)	(\$0.10)
(\$0.97)	(\$0.65)	(\$0.28)	(\$0.10)
11,325	11,935	13,635	14,080

DISCLOSURES:

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Buy	Immediate purchase is recommended. The security expected to outperform the market over the next 12 to 18 months.
Accumulate	Purchase of the stock is recommended for above average appreciation over the next 12 to 18 months, but the buyer may have an opportunity to acquire the stock within a 10% trading range.
Hold	Holding the stock is recommended because the share price has moved above the specific "Buy" range and, therefore, appreciation potential is less than or equal to the market.
Sell	The stock has reached the target price objective and/or conditions have changed sufficiently to alter the outlook for the stock.

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Moderate	The security has about the same volatility as the market and/or the company carries a level of leverage in line with its peer group.
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