



July 2, 2008

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DIGITAL ALLY, INC. (DGLY)

BUY - \$8.56

SPECIAL SITUATIONS

PLEASE REFER TO DISCLOSURES ON PAGES 9 AND 10 FOR IMPORTANT INFORMATION

Initiating Coverage With Buy Rating And \$15 Price Target.

Changes: Initiation of Coverage

FINANCIAL SUMMARY					
EPS	<u>2006</u>	<u>2007</u>	<u>2008E</u>	<u>2009E</u>	Price
Mar	(\$0.08)	\$0.01	\$0.10		\$8.56
Jun	(\$0.08)	\$0.03	\$0.07E		52-Week Range
Sep	(\$0.10)	\$0.18	\$0.11E		\$1.95-\$11.41
Dec	<u>(\$0.01)</u>	<u>\$0.05</u>	<u>\$0.13E</u>		12-Month Target
FY	(\$0.26)	\$0.28	\$0.40E	\$0.60E	Shares O/S (mil)
P/E	n/a	30.6x	21.4x	14.3x	15.3
					Market Cap (\$mil)
					\$130.9
					Avg. Daily Vol
					58,314
					Inst. Ownership
					2%
					Est. 3 Yr EPS Growth
					30%
Revenues	<u>2006</u>	<u>2007</u>	<u>2008E</u>	<u>2009E</u>	
Mar	\$0.01	\$3.4	\$8.6		
Jun	\$0.8	\$3.8	\$8.8E		
Sep	\$1.4	\$5.1	\$9.8E		
Dec	<u>\$1.8</u>	<u>\$7.0</u>	<u>\$10.8E</u>		
FY	\$4.1	\$19.4	\$38.0E	\$49.4E	
					Est. Reporting Date
					7/2007

Key Points

1. We are initiating coverage of DGLY with a BUY rating and \$15 price target. Our earnings per share estimates for 2008 and 2009 are \$0.40 and \$0.60, respectively. With our outlook for 30% compounded earnings growth over the next several years, we believe the 25x valuation multiple on 2009E EPS implied in our price target to be reasonable.
2. We believe the features of DGLY's core DVM-500 product positions the company favorably relative to the offerings of its competitors. Furthermore, we believe the domestic and international markets in which DGLY competes are sizeable (~70,000 domestic law enforcement fleet vehicles are replaced annually) and large follow-on orders from existing customers have provided evidence of positive customer experience with DGLY products.
3. DGLY has built its business from \$4 million in revenues in 2006 to a \$34 million annualized run-rate in the March 2008 quarter on the basis of one key product – the DVM-500. Additional product introductions are planned for 2H 2008 to supplement the company's law enforcement offerings, while expanding the company's presence into new markets including transportation services and military applications. Strong revenue growth has driven significant leverage in margins from losses in 2006 to a 29% operating income margin in the March 2008 quarter.
4. We believe DGLY's recent introduction of wireless data download capabilities for the DVM-500 removes a competitive disadvantage for the company in the marketplace and we believe the add-on sale of this feature will be accretive to gross margin rates. Furthermore, we expect upcoming radio frequency certification of the DVM-500 for use in the European Union will position DGLY to capitalize on emerging international opportunities that were not previously accessible to the company.



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5. DGLY enjoys a strong balance sheet with \$4.9 million in cash and no debt at the end of the March 2008 quarter. Our outlook for strong EBITDA margins in the upper 20%-low 30% range in 2008-2009 amidst modest capital expenditure requirements lead us to believe that DGLY will be a healthy free cash flow generator over the next several years. As evidence of the company's confidence in its fundamental outlook and its ability to generate positive cash flow while investing for growth in its business, DGLY recently announced a \$10 million share repurchase authorization.

BUSINESS DESCRIPTION

DGLY is based in Overland Park, Kansas and specializes in the production and marketing of digital video imaging and storage products for use in law enforcement and security applications. DGLY's key product, the DVM-500, is an in-car rear view mirror with integrated digital audio/video recording capabilities. Customer shipments of the in-car rear view mirror commenced in March 2006. DGLY also sells a digital flashlight with audio/video recording capabilities (DVF) for law enforcement applications. Both the rear view mirror and flashlight record video and audio data onto an integrated flash-memory card for subsequent downloading to a centralized data repository. DGLY has recently begun selling the DVM-500 with wireless download capabilities via radio transmission.

PRODUCT OVERVIEW: DVM-500 IS FOUNDATION, WHILE FUTURE PRODUCTS TARGET NEW MARKETS

DGLY's existing products include the DVM-500, which is an in-car rear view mirror with integrated digital audio/video recording capabilities, and a digital recorder flashlight (DVF). Below, we take a closer look at the attributes of each product:

- **DVM-500**

An increasing number of arrests each year and the related need for corroborating arrest evidence is driving wide-scale adoption of in-car audio/video systems for patrol and police cars. The DVM-500 is a self-contained video recorder, microphone, and digital storage device that is integrated into a rear-view mirror in the police vehicle. The DVM-500 includes a monitor, GPS, and a 900 MHz audio transceiver. Beyond providing corroborating evidence for arrests, the DVM-500 increases accountability for officers and suspects in civilian/officer interactions by capturing audio and video data within and around police vehicles.

The DVM-500 was first shipped in March 2006 and sells at ~\$4,000 to law enforcement agencies. The sales cycle for the law enforcement market typically involves sizable lead times due to field testing and municipal funding requirements. The DVM-500 has been shipped to over 1,700 customers since March 2006 and has a presence in every state. Key product features of the DVM-500 are as follows:

- a wide-angle zoom lens,
- video and audio compression and recording,
- data archiving in multiple media formats,
- a 900 MHz audio transceiver with automatic activation,
- GPS,
- data playback using windows media player,
- an industry-leading standard 2-year warranty.



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We note DGLY recently introduced a wireless download feature for the DVM-500, which enables data to be transferred to a central repository via radio frequency transmission. The introduction of this feature eliminates what was previously a competitive disadvantage for DGLY in the marketplace. The wireless download option adds approximately \$1,000 to per-unit revenues with modest incremental cost basis. Therefore, we believe the introduction of the wireless download option will be accretive to gross margin rates at DGLY.

- **DVF**

DGLY launched the DVF in early 2008 and the product sells for \$1,600. DVF sales to date have represented a nominal portion of total sales at the company. The DVF is a flashlight with a built-in digital video and audio recording system. The DVF features one-button start/stop recording, on-board flash memory, large field of view for digital and audio recording, date and time stamping, LED bulb, and data access safeguards. The stored data is available for subsequent download to a centralized repository and can be transferred to a DVD or CD. We believe the most likely law enforcement application for the DVF over time will be the recording of roadside DWI sobriety examinations.

We look for DGLY to launch several new product lines over the next year to tap new end markets. Below, we discuss key recent and upcoming product developments:

- **DVM-250**

DGLY has targeted the DVM-250 product for application in the transportation industry. The audio/video recorder is integrated into a rearview mirror and can be installed in any vehicle by removing the existing mirror. DGLY envisions the DVM-250 for use in transportation end-markets including taxicabs, buses, limousines, and motor coach operators as well as service vehicles in the utility, telecommunications, and package delivery industries. DGLY will begin selling the DVM-250 in August for \$1,000 per unit.

- **Other Product Development**

We expect DGLY to launch the DVM-750 in 2H 2008. The DVM-750, which is a more robust version of the DVM-500, has 4 recording devices, 2 of which are active simultaneously. As a comparison, the DVM-500 has 2 recording devices of which 1 device is active at a time. We believe the DVM-750 will be priced somewhat below \$5,000. In addition, DGLY is planning the launch of an audio/video recording system for buses. The product will be a more robust version of the DVM-750 with multiple recording device configuration options. Depending on the configuration chosen, we expect DGLY's bus product will price in the \$2,000-\$8,000 range. Finally, DGLY is developing a digital audio/video recording device to be incorporated into helmets used by motor cycle police, military personnel, and front line responders in riot gear. We expect the DVM-250, DVM-750, bus recorder, and helmet recorder products to be introduced in 2H 2008-early 2009 with initial field trials commencing shortly after product launch. We expect field trials on new products to lead to revenue traction for DGLY in 2H 2009.



TARGET MARKET OVERVIEW

The law enforcement market is the key market served by DGLY's DVM-500 product and we expect law enforcement to continue to generate the bulk of DGLY revenues into the foreseeable future. DGLY's future growth in the law enforcement market will be driven by: (1) capturing market share within the existing law enforcement vehicles fleet, (2) improving attachment rates in new vehicles added to the fleet, (3) expanding presence in international law enforcement markets, and (4) improving attachment rates for the DVF.

As a starting point for assessing the potential of the domestic law enforcement market, it is estimated that 50% of the ~450,000 vehicles used by the U.S. law enforcement community are equipped with a video recording system – roughly half of these installations employ digital recording technology. With a useful life of 6-7 years, it is estimated that approximately 70,000 law enforcement vehicles are replaced each year. Fleet turnover is a positive for DGLY as either the existing vehicle recording system must be reinstalled in the new vehicle or a replacement recording system must be purchased. Using the data above, full digital recording deployment into the U.S. fleet with a \$4,000 ASP per vehicle represents a total domestic market potential of \$1.8 billion and the vehicle replacement market represents an annual market potential of \$280 million. We believe DGLY's recording system creates advantages for it in the existing and replacement fleet markets due to the ease of installation associated with a rear view mirror - we note competitor products often require in-car wiring and in-dash or in-console equipment mounting.

Although DGLY enjoys the large domestic market potential described above, the company's largest transactions in recent quarters have been generated from an undisclosed international customer. Orders from this customer include a \$5.1 million order shipped in the December 2007 quarter and a 1,000-unit follow-on order, which we believe shipped in the June 2008 quarter. The 1,000-unit order represents the fourth order from the international customer and, upon shipment, DGLY will have delivered 2,800 units to the customer. We believe DGLY has received interest in its products from multiple international markets including countries of the European Union and former eastern block. To date, DGLY has been prevented from selling into Europe as the 900 MHz radio transmission frequency used in the DVM-500 is not allowed in Europe as 900 MHz is the frequency used in European cell phone transmissions. DGLY anticipates having an adjustable frequency transceiver available for European law enforcement by August 2008, which we believe could release pent-up demand in that market.

To date, DGLY's DVF product has generated nominal revenues, however, the product presents the opportunity to tap end-markets outside of police car installations including private security, home inspection services, the insurance industry (claims adjusters), homeland security, the US Coast Guard, municipal fire departments, U.S. military, and infrastructure inspection services.

COMPETITIVE LANDSCAPE

The audio/video recording device market for law enforcement applications is highly competitive and DGLY competes with a number of players that offer similar solutions. We believe WatchGuard, L-3 Mobile-Vision, and Integrian are the company's most significant competitors. However, when we examined the product features and attributes of DGLY's DVM-500 compared to the products of its key competitors, we noted several differences which we believe are perceived as value-added by potential customers. We believe the product differences we noted are key drivers to DGLY's strong product adoption growth, especially given its relatively recent introduction to the market in 2006. In the table below, we summarize how the offerings of DGLY and its competitors are differentiated by product feature.



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Digital Ally, Inc. - Competitive Landscape								
Competitor	Unit Price	Windshield Mounted	Dash/Console/Headliner Mounted	Solid-State Memory	GPS	Wireless File Transfer	Warranty	Back Office Software Included
Digital Ally	~\$4,000	Yes	No	Yes	Yes	Optional	2-Year	Yes
WatchGuard	~\$5,000	Yes	No	No	No	No	1-Year	No
L-3 Mobile-Vision	~\$5,000	No	Yes	Yes	Yes	Optional	1-Year	No
Integrian	~\$5,000	No	Yes	Yes	Yes	Optional	1-Year	No
ICOP	~\$5,000	No	Yes	No	Yes	Optional	1-Year	No
Coban	~\$5,000	No	Yes	No	Yes	Optional		No
International Police Technology	~\$5,500	Yes	No	Yes	Yes	Optional	1-Year	No
Martel	~\$3,000	No	Yes	Yes	Yes	No	1-Year	No

Source: Company Reports and Dougherty & Company Research

We note the above data demonstrates that DGLY is highly price competitive in the market and it is one of only several solutions that are available with windshield mounting, while the majority of products consume more space in a patrol car with dash/console/headliner mounting. We believe DGLY's solid state recording capabilities enhance the operating reliability of its system and the recently introduced availability of wireless file transfer for DGLY eliminates what was a competitive disadvantage for the company's products. Finally, we note DGLY's DVM-500 is the only product we are aware of that comes standard with a 2-year warranty and includes back-office data repository software with a device purchase. Back office software must be purchased separately for competing products. We believe the combination of these product features positively differentiates DGLY's DVM-500 on multiple levels and favorably positions the company versus its competitors.

As evidence of the market acceptance and competitive strength of DGLY's DVM-500, we have summarized the company's major product announcement wins below. We note DGLY has forged statewide purchase agreements with West Virginia, Arkansas, Wisconsin, New Mexico, Mississippi, and Utah, which should encourage broad product deployment in those markets. In addition, we note West Virginia and DGLY's international customer have placed multiple follow-on orders, which validates favorable customer experience with the product. Amidst the absence of significant international orders in the March quarter, DGLY estimates that approximately 60% of order activity was from existing customers.

Digital Ally, Inc. DVM-500 - Significant Order Announcements				
Customer	Announce Date	Order Quantity	Value	Notes
West Virginia State Police	02/01/07	124	Not Disclosed	1-year contract with renewal options enabling state, county, and municipal agencies to buy at contracted terms.
Arkansas State Police	07/30/07	70	Not Disclosed	1-year contract with renewal options enabling state, county, and municipal agencies to buy at contracted terms.
Wisconsin Department of Transportation	07/30/07	50	Not Disclosed	1-year contract with renewal options enabling state, county, and municipal agencies to buy at contracted terms.
New Mexico General Services Department	07/30/07	Not Disclosed		Price agreement enabling all New Mexico agencies to purchase DVM-500 at contracted terms.
Mississippi Department of Public Safety	08/02/07	300+	\$1.25MM+	Agreement enables Mississippi state, county, and municipal agencies to purchase DVM-500 at contracted terms.
State of Queretaro, Central Mexico	08/06/07		Not Disclosed	Details not announced. This is not the same customer that placed subsequent large international orders.
International	11/29/07		\$5.1MM	All \$5.1 million of this order was shipped and recognized in Q4 2007.
International re-order	04/10/08	265	Not Disclosed	
Utah General Services Department	04/17/08		Not Disclosed	Agreement enables Utah state, county, and municipal agencies to purchase DVM-500 at contracted terms.
West Virginia State Police	04/17/08	50	Not Disclosed	
West Virginia State Police	04/17/08	100	Not Disclosed	West Virginia indicated intention to order 200 additional systems later in 2008.
International re-order	05/30/08	1,000	Not Disclosed	4th order from customer. 2,800 units will have been shipped to this customer upon fulfillment in Q2 2008.

Source: Company Reports



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FINANCIAL CONDITION AND ESTIMATES OF FUTURE OPERATING RESULTS

We are initiating coverage of DGLY with estimates for revenues and earnings per share of \$38.0 million and \$0.40, respectively, in 2008 and \$49.4 million and \$0.60, respectively, in 2009. Our 2008 revenue estimates are within range of the company's guidance for revenues of "approximately \$40 million," however, we have positioned our estimate somewhat conservatively in relation to guidance due to our belief that large international orders have been and will remain a key source of revenues for DGLY and we acknowledge that the timing and scale of such orders can be difficult to predict over short periods of time. The company estimates that its model will generate operating margins of 29% at a \$40 million revenue threshold. As our revenue estimate is somewhat below the \$40 million level, our earnings per share estimate is based off of operating margins of 27.8%, which implies our expectations for slightly lower fixed cost leverage at our revenue estimate. Our FY2008 estimates reflect YOY revenue growth of 96%, pre-tax earnings growth of 270%, and earnings per share growth of 43%.

Our FY2009 estimates include revenue growth of 30% to \$49.4 million on continued strong adoption of the company's DVM-500 product as well as emerging contributions as the year progresses from the DVF, DVM-250, DVM-750, the bus transport recording device, and the helmet recording devices described above. We are expecting further operating margin expansion in 2009 to 32% due to leverage of fixed costs. We note DGLY estimates it can increase unit production by 50% from levels implied in 2008 revenue guidance without requiring additional headcount. As such, we see substantial labor cost leverage in DGLY's operating model with continued revenue growth.

We believe DGLY will remain a company with modest capital investment requirements in 2008-2009. We are projecting capital expenditures of ~\$800,000 in 2008 and \$600,000 in 2009. We expect lower capital expenditures in 2009 due to a non-recurring 2008 investment to construct a radio test chamber. With projected EBITDA margins of 28.5% in 2008 and 33.0% in 2009, we expect that modest investment requirements will enable DGLY to produce free cash flows of almost \$3 million in 2008 and ~\$8 million in 2009, which should bolster the company's already healthy balance sheet. DGLY's March balance sheet includes \$4.9 million in cash and no debt. We note DGLY recently demonstrated confidence in its ability to maintain a healthy balance sheet with free cash flow generation as it invests to grow its business by approving a \$10 million share repurchase authorization effective through June 2010.

Regarding June quarter estimates, we are projecting revenues of \$8.8 million and earnings of \$0.07 per share. We note DGLY disclosed on June 30 that it expected its revenue for the June quarter to mark the ninth consecutive quarter of sequential revenue growth, although it did not specifically quantify expected June quarter sales. Our June quarter estimate is modestly above March quarter revenues of \$8.6 million. We are modeling for June quarter gross margins in the mid-fifty percent range, down from 61.9% in the March quarter due to sales mix shift into international markets. We note DGLY announced a 1,000-unit order from an international customer on May 30 and we believe the order was delivered in the June quarter. As international orders are fulfilled through distributors as opposed to DGLY's sales force, gross margins earned on such transactions are lower than domestic orders. We expect the large international order volume in the June quarter to dilute gross margins sequentially. In addition, we also expect several sources of higher operating costs to emerge in the June quarter versus March including compensation expense under the 2008 stock option plan, which had not yet been ratified at the beginning of the year, higher R&D costs tied to the aforementioned development of products slated for 2H 2008 launch, and costs such as printing and production related the annual shareholder meeting, which was held in the June quarter.



MANAGEMENT TEAM & SELECTED DIRECTOR BIOS

Stan Ross (CEO) - Mr. Ross has served as Chairman and Chief Executive Officer of DGLY since September 1, 2005 and is the Chairman and Chief Executive Officer of Infinity Energy Resources, Inc., which he joined in 1992. From 1991 until March 1992, he founded and served as President of Midwest Financial, a financial services corporation involved in mergers, acquisitions and financing for corporations in the Midwest. From 1990 to 1991, Mr. Ross was employed by Duggan Securities, Inc., an investment banking firm in Overland Park, Kansas, where he primarily worked in corporate finance. From 1989 to 1990, he was employed by Stifel, Nicolaus & Co., a member of the New York Stock Exchange, where he was an investment executive. From 1987 to 1989, Mr. Ross was self-employed as a business consultant. From 1985 to 1987, Mr. Ross was President and founder of Kansas Microwave, Inc., which developed a radar detector product. From 1981 to 1985, he was employed by Birdview Satellite Communications, Inc. which manufactured and marketed home satellite television systems, initially as a salesman and later as National Sales Manager.

Robert Haler (VP-Engineering and Product Development) - Since November 2003, Mr. Haler has served as VP of Product Development for DGLY. Prior to accepting his role at DGLY, Mr. Haler was Product Development manager for Tri Square Communications, where he led engineering efforts on radio communications technologies. Prior to joining Tri Square, Mr. Haler was President and Owner of Lymax's Earth Sky and Astronomy, which marketed astronomical telescopes to consumers and universities.

Ken McCoy (VP-Sales and Marketing) - Mr. McCoy has worked in the law enforcement services industry for approximately 35 years and joined DGLY in 2004 initially in a consulting role. In 1969, Mr. McCoy joined Kustom Signals, Inc. as National Sales Manager and President of the company for the Radar Division and established Kustom as the first company with a nationwide direct sales force to market speed radar devices. After leaving Kustom, Mr. McCoy joined CMI, Inc. as National Sales Manager and Vice President. While at CMI he also established a nationwide sales organization and introduced the first Hand Held Radar Gun (the Speedgun), the first one-piece moving car radar with dual readouts (the Speedgun II), and the first infrared alcohol breath testing instrument (the Intoxilyzer). In 1976, Mr. McCoy co-founded MPH Industries, Inc., a traffic speed enforcement products company, and served as President of MPH Industries from 1976 to 1988 overseeing all business operations. In 1992, Mr. McCoy formed his own marketing organization to sell law enforcement products throughout the U.S.

Thomas Heckman (CFO and Treasurer) - Prior to joining DGLY in 2007 initially in a consulting role, Mr. Heckman provided consulting and business investment services to client companies from 2001-2007. From 1983 until 2001, Mr. Heckman was employed by Deloitte and Touche, LLP, including 6 years as an audit partner.

Leroy C. Richie (Director) - Mr. Richie has been the Lead Outside Director of DGLY since September 2005 and he has also been a member of the board of directors of J.W. Seligman & Co. since 2000. Mr. Richie's experience also includes former service as Vice President of Chrysler Corporation and General Counsel for automotive legal affairs, where he directed all legal affairs for that company's automotive operations from 1986 to 1997.

Edward Juchniewicz (Director) - Mr. Juchniewicz has been a Director of DGLY since September 2005. Mr. Juchniewicz joined the Central Intelligence Agency in 1953 and retired in 1986 as Associate Deputy Director for Operations.



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RISK CONSIDERATIONS

Short-Term Operating Margin Risk: While DGLY has produced 9 consecutive quarters of sequential revenue growth, the company's emerging operating scale subjects its financial results to significant swings in operating profitability due to changes in sales mix, sales channels, infrastructure investment, and research and development initiatives, etc. As a result, DGLY's operating margins have ranged from 5% to 29% over the last 5 quarters. Volatility in these and other factors impacting DGLY's operating profitability could have a material adverse impact on short-term operating results.

Municipal Funding Risk: DGLY products are sold to local, state, and federal governmental entities throughout the United States and demand from governmental customers is impacted by the availability of funding. Budget and funding challenges for DGLY's governmental customers could have a material adverse impact on the company's operating results and financial condition.

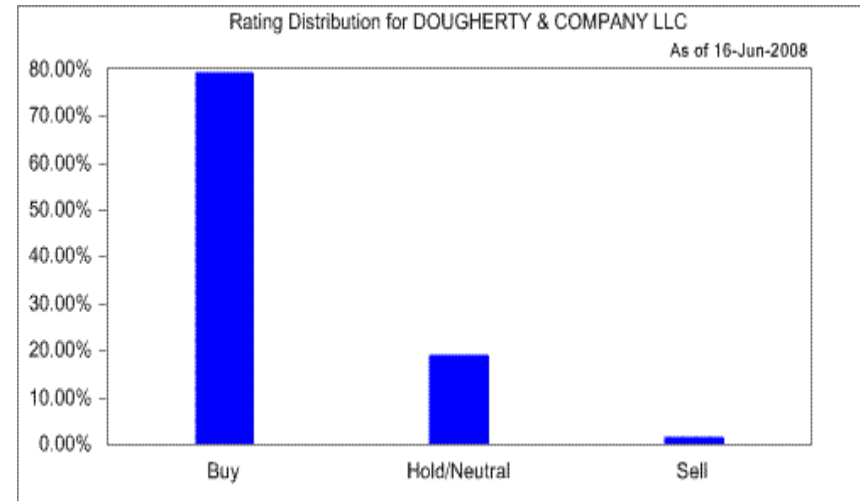
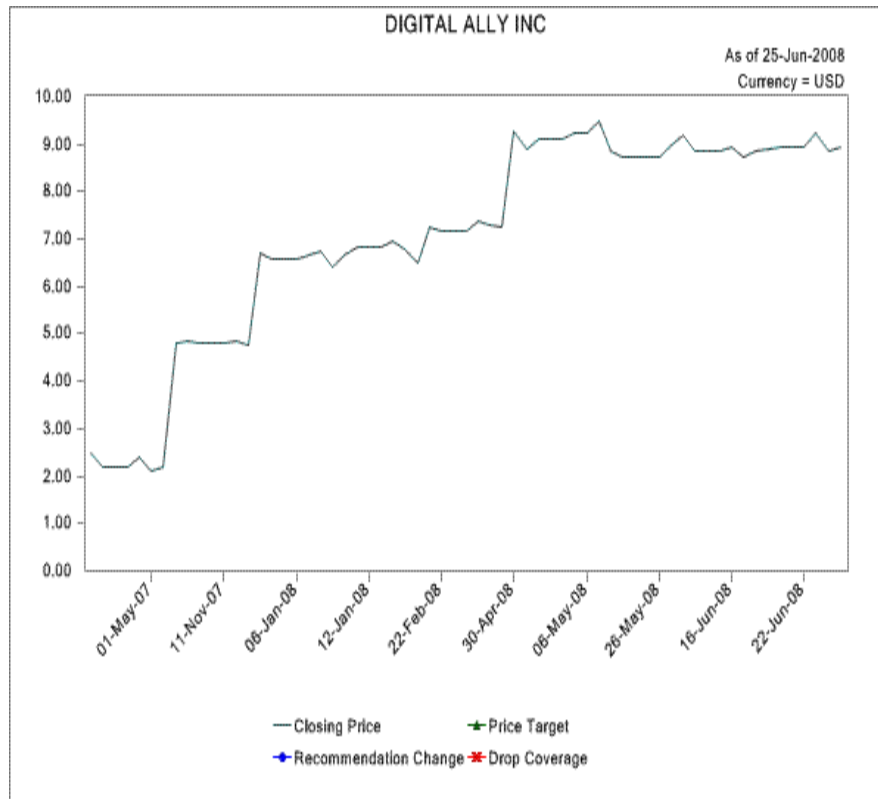
Customer Concentration Risk: DGLY's emerging operating scale subjects the company's operating results to heightened reliance on sales to a limited number of key customers. In particular, DGLY has benefited from the sale of approximately 2,800 DVM-500 units to a single international customer in recent quarters and we estimate that this customer represented over 2/3 of total company revenues in the December 2007 quarter. If DGLY's existing large international customer ceases purchasing product from the company and additional large customers are not identified, DGLY could experience a material adverse impact to its operating results and financial condition.

Competition Risk: DGLY competes directly with a number of suppliers of audio/video surveillance products used in law enforcement applications. Failure to produce and market differentiated products at competitive prices to a broad customer audience could result in a loss of market share to competitors, which could have a material negative impact on the company's operating results and financial condition.

Intellectual Property Right Risk: DGLY has filed for patent protection in the United States and certain other countries to cover proprietary technology in its products. The patents are under review by the U.S. Patent Office and no patents have been issued. In addition, DGLY licenses certain critical technology in its products from a licensor. While patents may limit the ability of others to introduce competitive products, there is no assurance that these protections will effectively prevent the development or sale of competing products. Furthermore, the cost to pursue reinforcement of intellectual property rights may be significant. The failure of DGLY to protect its intellectual property rights in a cost-effective manner could have a material and adverse impact on the company's financial condition and results of operations.

Sole Supplier Reliance Risk: DGLY devices rely on sole source suppliers for semi conductor chips and radios. While the company believes substitute products are available, certain redesign and other work would need to be completed if a transition from a sole source supplier is required. Such a transition could have a material adverse impact on the company's operating results and financial condition.

For additional risks associated with DGLY, refer to the company's latest financial statements and other documents on file with the SEC.



Percentage of researched companies within each of the three rating categories (Buy, Hold/Neutral, Sell) for which Dougherty & Company has provided investment banking services within the last 12 months: Buy 2%, Sell 0%, Hold/Neutral 0%.

DIGITAL ALLY INC

Currency = USD

Date	Closing Price	Recommendation Change	Date	Closing Price	Price Target

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