Intrinsyc Software International Inc. (ICS–TSX), $0.75

Look Beyond Near Term Results

Ranjit Narayanan, CFA 416-864-2605 rnarayanan@mgisecurities.com
Michael Zylberlicht, Associate 416-864-2694 mzylberlicht@mgisecurities.com

March 24, 2008

Stock Rating: Buy

Target Price: $1.75 (prev. $2.00)

US$000, Yr-end Dec 31	F06 *	F07 *	F08E **	F09E **
Revenue	18,657	19,706	23,016	45,775
EBITDA	(12,495)	(14,164)	(14,960)	(1,140)
EPS f.d	(0.24)	(0.18)	(0.11)	(0.01)
Price/Sales	6.0x	5.6x	4.8x	2.4x
EV/Sales	3.7x	3.5x	3.0x	1.5x

Projected return	133%
Shares outstanding (basic) ***	148,100
Market capitalization	111,075
52-week High/Low	$1.30/$0.39

Balance sheet as of Mar 08 (est.):

Cash ***	42,000
Debt	0

* In C$; yr end was Aug 31.

** In US$; company switching to US$ reporting and FY aligned with CY

*** Incl. impact of recent financing

Source: Company reports; MGI Securities Inc.

Company Profile: Intrinsyc Software International Inc. is a wireless software solutions provider. Its business is based on licensing software products developed in-house and providing systems integration services. Intrinsyc targets the growing wireless handheld market which includes consumer mobile handsets, personal navigation devices, smartphones, and other consumer converged devices.

Event

Reports transition period results. Inflection point expected in 2H/F08.

Investment Opinion

Details. ICS reported results for its transition period on Thursday after the close. Revenues came in at $5.2mm and loss per share was $0.06. We were expecting revenues of $5.0mm and loss per share of $0.03. Foreign exchange negatively impacted revenues by $425K. Higher operating expenses and one time expenses (closing of UK office) largely explain the variance in loss per share.

Soleus Based products to launch in Q2. Management confirmed on the call that handheld devices based on the initial design wins are expected to launch in Q2. At the recent World Mobile Congress in Barcelona we had the opportunity to see handheld devices from the first two reference design wins the company had secured. Launch customers for these devices appear to have been finalized. **These data points indicate the company is executing on its strategy and is on track to begin receiving high margin royalty revenues beginning 2H/08, which will signal ICS' gradual transition to becoming a software company.**

Outlook Positive. We believe the pipeline of design win opportunities remain intact and company reaffirmed guidance for one reference design win per quarter.

Valuation and Recommendation

We maintain our BUY recommendation but reducing target to $1.75 (previously $2.00). Our $1.75 target equates 4.8x EV/F09 Sales (no change to prior multiple; target change accounts for recent share dilution from financing). On an EV/Sales basis, ICS trades at 1.5x consensus F2009 estimates, well below its peer group at 2.3x and the recent pullback offers an attractive buying opportunity ahead of pending catalysts materializing.

Reports Transition Quarter – Inflection Point Expected 2H/F08

ICS reported results for its transition period on Thursday after close. Revenues came in at $5.2mm and loss per share was $0.06. We were expecting revenues of $5.0mm and loss per share of $0.03. Foreign exchange negatively impacted revenues by $425K. Higher operating expenses and one time expenses (closing of UK office) largely explain the variance in loss per share. We note ICS is changing its fiscal year end from August to December and the results cover the four month period from September to December. As a result comparison to prior year or previous period (Q4/F07) quarters are not relevant.

Services Dominate Revenue Profile Ahead of Transition. Services revenues accounted for 78% of total revenues with hardware accounting for 12% and software the remainder. Soleus based software revenues in the quarter were $140K vs. $80K in the quarter ended Aug/07 and reflect upfront license fees from Soleus design wins secured in the transition period (2 design wins were announced in this period). ICS is expected to begin receiving royalty revenues when Soleus design partners (so far company has announced six design wins) launch handheld products based on Soleus. We expect product shipments from the initial design wins (announced in 1H/CY07) to begin in Q2/F08 with royalty revenues from these shipments commencing in 2H/F08. **Royalty revenues are high margin in nature and will mark the company's gradual transition to a mobile software company from a pure play wireless engineering services company.**

Gross Margins Impacted by FX and Contract Timing. Gross margins in the quarter were 36%, below our expectation of 47% due to negative foreign exchange impact ($425K) of 5% and delays in recognizing services engagements that were underway with an OEM client but could not be recognized due to delays in formal contract signing. Also Intrinsyc was providing Soleus related support work to three Soleus design win customers at lower billing rates, which impacted margins. The company believes these engagements were necessary to help customers accelerate product development based on the Soleus platform. Management expects services margins to improve in the upcoming Q1 quarter given visibility into ongoing service engagements.

Operating Expenses Up. Operating expenses in quarter were $7.8mm vs. our expectation of $6mm. The key difference was on account of a $1.0mm accrual to G&A expenses related to compensation resulting in G&A expense of $2.2mm in the transition period vs. $1.2mm for the quarter ended Q4/F07. We expect G&A expenses to return to normal levels in Q1. Sales and marketing and Research & Development expenses were slightly above our expectations as the company invests (staff recruitment in new Taiwan office, senior management hires etc) to execute on its Soleus go to market strategy.

Industry Trends Remain Favourable

The market opportunity that ICS is targeting for Soleus is the mid-market handheld device segment that includes few or several multi-media features (camera, MP3 player, location based features, gaming, mobile TV etc) and that are priced competitively (i.e., below the price point of high-end devices like Blackberry). Handset devices in this mid-market segment (i.e., feature phones) typically lack the processing power, memory and battery power required to run a high capacity operating system (OS) such as Windows Mobile or Symbian that can support advanced multi-media applications. Intrinsyc's Soleus platform offers handset/device Original Device Manufacturers (ODM), Original Equipment Manufacturers (OEM's) as well as silicon vendors a flexible platform that enables them to bring new handset designs with multi-media capabilities to market faster and in a cost efficient manner. Key trends in the industry that in our opinion support Intrinsyc's strategy:

(i) Mobile Operators facing Cost and Pricing Pressures – Mobile wireless operators are facing the twin challenges of declining ARPU (Average Revenues per User) as traditional voice services become commoditized and the pressure to reduce operating costs. As a result, carriers are emphasizing higher margin data services (games, video, SMS, etc) and standardizing the number of operating systems, platforms and applications they support on their networks. Handset vendors who can supply carriers with **competitively priced phones** that can support multi-media applications (that drive data revenue for the carriers) based on a single platform are better positioned to chosen by carriers. **Intrinsyc's Soleus platform is modular, cost effective and can be used to develop several versions of the same handset design with limited custom coding. This addresses a key pain point of the wireless operator (standardise on fewer platforms and applications) as well as handset vendor requirements (develop innovative multimedia handsets that can drive data revenues for carriers in a cost effective and timely manner).**

(ii) Asia is at Wireless Forefront – Asia based carriers especially in the advanced markets of Japan and Korea have traditionally been at the forefront of cutting edge wireless multi-media services. Now, China appears to be poised to replicate these trends. With over 500mm wireless users and cellular coverage available for over 1 billion subscribers, the Chinese market is expected to remain a solid growth story. **In China and other developing markets like India, mobile devices are likely to be the interface through which users likely access the Internet for the first time.** However, handset price points will have to be competitive. Our checks indicate that not all well established handset brands will be able to penetrate this segment by offering handsets with multi-media features at a lower price point than in developed markets they serve as they risk brand dilution. We believe Asia based handset ODM's/OEM's are better positioned in this regard as they are less impacted by brand dilution concerns given their flexibility to white label products. Soleus directly addresses this need for a competitive price point as it is a cost effective platform and **Intrinsyc has/is establishing deep relationships with such vendors (has already secured several design wins with Asian OEM's/ODM's), which opens up a vast market opportunity for the company.**

(iii) User Interface a Key Differentiator – The User Interface (UI) refers to the "look and feel" and features available on the wireless phone screen. With Apple's launch of its iPhone, based on touch screen technology, the UI has become a focal point of differentiation for wireless carriers and a key tool driving the handset purchase decision and usage of multi-media services. One of Soleus' differentiating features is its UI engine, which gives wireless operators and manufacturers unique control over the customization and branding of the mobile handset experience. The Soleus UI Framework can support unlimited customer experiences from one platform and in addition to customizing familiar elements of the UI (such as status indicators, colors, fonts, wallpaper, etc.), the Soleus UI Framework allows customization of the full user experience including the available applications. One of the key Soleus R&D priorities in F08 is refinements to the Soleus UI Framework and User Experience and we believe this will be a differentiator for Soleus especially as it approaches handset vendors looking to move away from in-house RTOS platforms.

(iv) RTOS Model not Sustainable - RTOS or Real Time Operating Systems are in-house developed proprietary code based operating systems that several handset manufacturers have traditionally relied on. In a stable development environment with limited handset models and limited features, RTOS based platforms are effective. However, in a dynamic environment with new features and designs being introduced constantly, the inflexibility of RTOS platforms requires extensive custom coding for each handset, which increases cost of development and time required for development of new designs. RTOS based platforms still accounts for the bulk of the feature phone segment – in 2007 it is estimated feature phones accounted for 60% of the 1.2 billion handsets shipped (or 700mm feature phone units) of which only 15% were non-RTOS based (or ~ 100mm - 120mm units). We believe the remainder of the feature phone segment which is currently RTOS based (~ 550mm – 600mm units) will eventually be forced to move away from the rigid inflexible RTOS based architecture to more open platforms. **Intrinsyc's Soleus OS platform has a modular, open architecture and is well positioned to address the legacy platform challenges that handset vendors face, which is a large market opportunity.**

Google and Android – Competitive Implications?

A key competitive development in recent months has been Google's announcement of Android, a software stack that will include an operating system, middleware and application suite. The Android platform was announced in November 2007 by Google in conjunction with several partners including hardware vendors (Samsung, Motorola, LG, HTC etc), operators (NTT DoCoMo, KDDI, China Mobile, Telecom Italia etc), silicon vendors (Marvell, TI etc) collective known as the Open Handset Alliance. Google is positioning Android as a low cost (or even free) open and comprehensive platform for mobile devices. Google's primary goal it appears in floating this initiative is to replicate its phenomenal success in the world of PC based Internet advertising revenues in the mobile advertising market as well through an OS platform likely optimized to run its web browser.

With Android likely to be offered free, it is a potential threat to Soleus and this is a development that needs monitoring but there are several issues that Google needs to address before Android could be proclaimed a success. They include:

(a) Google is working with a diverse set of partners including mobile operators, handset manufacturers, chip set vendor etc, each of whom have their own agendas and priorities and forging a common set of objectives among disparate partners may not always be easy;

(b) The success of the platform will depend on the enthusiasm of application developers to build new mobile applications and until there is a sufficient installed base of Android driven handsets in the marketplace, application developers may delay introducing such applications (the chicken and egg syndrome);

(c) Google has traditionally not been a mobile software company and any technical or performance problems including lack of sufficient drivers and technical support for application developers could impact the success of the platform;

(d) Mobile operators have traditionally exerted control and influence over the mobile handset user interface (UI) as well as the number and types of devices and third party applications that run on its networks.

Large operators like AT&T and Verizon maybe reluctant to cede control over these aspects (especially if it impacts their pricing structure for services), which could delay the adoption rate of this platform.

ICS' management indicated that the pipeline of design win opportunity remains intact and has not been impacted by external developments like Android. We would agree with this view at this point as Soleus is based on Windows CE and there are thousands of application developers and software engineers familiar with Windows technology. Android is brand new and still evolving and at present lacks a critical mass of application developers who have developed applications based on this platform. As ICS secures more new design wins and as existing OEM partners introduce additional designs based on Soleus, the stickiness of the platform is enhanced. We therefore do not consider Android an immediate pressing threat but nevertheless, Android warrants monitoring going forward. Our take is the market size (especially feature phone segment) is large enough in the medium term to accommodate several players and we do not view Android as an immediate threat to Intrinsyc.

Outlook and Catalysts

Soleus based products to launch in Q2. Management confirmed on the call that handheld devices based on the initial design wins are expected to launch in Q2. At the recent World Mobile Congress in Barcelona, we had the opportunity to see handheld devices from two reference design wins the company had secured. In March 2007, ICS had announced its first Soleus mobile OS license win with a global manufacturer of personal navigation and handheld devices. We believe this license win was with the subsidiary of a leading Taiwan based manufacturer of personal navigation devices (PND's), personal digital assistants (PDA's) and smartphones. We had a chance to view the product (PND device with voice and IM capability) and the launch customer for this product we believe is a Taiwan based wireless services provider. We also reviewed Micro-Star International's (MSI) 5608 handset, which is based on Soleus and was ICS' second design win (June 5th, 2007). This product (a hybrid PND and mobile TV device) was unveiled at the Consumer Electronics Show (CES) in January with shipments expected to begin mid-year. The launch customer we believe is a China based OEM. Although anticipated volume shipments were not disclosed we conservatively forecast both these devices to ship at least 100K – 300K units initially. **These data points indicate the company is executing on its strategy and is on track to begin receiving high margin royalty revenues beginning 2H/08, which will signal ICS' gradual transition to becoming a software company (please see our initiating coverage report dated February 8th for details). The company indicated it is seeing no delays in the product launch schedules of its design wins customers.**

Pipeline Intact. Management indicated the company's pipeline of approximately 30 prospects including OEM's/ODM's and silicon vendors remains intact and reaffirmed guidance for one reference design win per quarter. In December, Intrinsyc had announced a strategic development alliance with Japan-based Original Equipment Manufacturer (OEM) of consumer electronics products. It is likely this alliance could escalate into a design win.

Reiterate Samsung Potential. In Barcelona (World Mobile Congress) we had the opportunity to speak to representatives from Samsung and they confirmed that the application processor they will be embedding Soleus into (design win # 6 with Samsung LSI Semiconductor division – Jan 30th, 2008) will be targeted at mobile devices including PND's, PMP's (personal media players), feature phones targeted at the China market as well as consumer electronic devices. This reaffirms our earlier checks prior to initiating coverage where feedback we received indicated Samsung could likely target several customers in the consumer electronics segment including Sanyo, Tom Tom and likely Epson in addition to Samsung Mobile. **We are conservatively forecasting $9.0mm in royalty revenues from this deal in F09, although our analysis indicates potential royalty revenues from this deal could exceed our forecast by $15mm - $25mm, which could add $0.01 - $0.02 to F09 EPS over and above our forecast.**

Outlook Positive. In our opinion, F08 is a transition year for the company as products based on Soleus are launched, royalty revenues kick-in and the company executes on its go to market strategy (securing additional design wins, co-marketing with silicon design partners, enhancing and extending the Soleus platform). With 98% topline growth expected in F09, we have a positive outlook for ICS. Eliminating one outlier estimate, we are above consensus for F09 (current consensus in C$ - company switching to US$ reporting) with revenues of $45.7mm (vs. cons for $41.8mm) and EPS of $(0.01) (vs. cons for $(0.02)). Our above consensus forecast reflects our confidence in the potential of recent deals (especially Samsung) to significantly impact financials heading into F09. We expect the company to reach EBITDA break-even in 2H/F09.

Pending catalysts for the stock include:

- New design wins from ODM's/OEM's or silicon vendors;
- Commencement of royalty revenue ramp from previously secured design wins;
- Commencement and ramp up of royalties from Samsung deal (expected in late 2H/F08);
- Additional design wins from existing ODM/OEM partners;

- Potential for accretive acquisitions

The stock can be news driven with design win announcements acting as temporary catalysts for the stock and the stock could likely be volatile in the short-term but we recommend investors take a medium to longer term view of this story as we expect sustainable multiple expansion once royalty revenues commence and the company transitions to a higher mix of high margin software revenues and positive earnings. Two new recent senior hires (GM's for Asia Pacific and Americas/Europe) including a former Intel executive with extensive contacts in Asia we view as positive as the company executes on its business plan.

Valuation and Recommendation

We maintain our BUY recommendation but reducing target to $1.75 (previously $2.00). On the back of positive feedback from customers and partners, favourable industry trends and tangible signs of execution on strategy we are maintaining our Buy rating. Our revised $1.75 target equates 4.8x EV/F09 Sales (no change to prior multiple; target change accounts for recent share dilution from financing). **On an EV/Sales basis, ICS trades at 1.5x consensus F2009 estimates, well below its peer group at 2.3x and the recent pullback offers an attractive buying opportunity ahead of pending catalysts materializing.**

Our $1.75 target equates to 4.8x F09 revenues on an EV/Sales basis, which is comparable to high growth software companies and industry leaders like RIM. We note the company is undergoing a fundamental transformation as it transitions to a software company (see initiating report for details) and it is hard to accurately predict the company's growth trajectory, revenue mix and margins. However, design wins with leading ODM's/OEM's (Quanta) and especially silicon vendors (Samsung etc) give us comfort that our projections are achievable and the implied growth warrants a premium multiple.

We believe that given ICS' strong management team, pending catalysts and potential for upside to expectations, our premium valuation is justified.

Risks to Outlook

Success Contingent on Soleus Design Wins: At present, ICS has six Soleus wins to its credit. The majority of the Company's eggs lie in the Soleus basket. As such, the Mobile Products Group is heavily reliant upon future wins and the shape of the feature phone segment. Though ICS has a healthy pipeline of potential licensees, future demand for the software is uncertain. Sales cycles have historically been lengthy and have fallen into the six to nine month range. Delays are a regular occurrence as customers ponder the expenditure and proceed with due diligence. Given the significant investment in R&D, it is critical for Soleus to generate revenue from design wins in a timely manner.

Technological Change: The software industry is constantly evolving. As such, ICS will have to improve existing products and develop new features in response. In a changing marketplace, there is no guarantee that the Company will be able to accomplish this in a timely fashion or at all. As well, there is no assurance that ICS will be able to compete with a competitor's improved technology which can potentially render its products obsolete.

The Emergence of the Smartphone: The sentiment that smartphones will continue to impact feature phone sales is widely held. It is therefore increasingly important for ICS to establish a stronghold on the HLOS market in order to solidify its position as the trend evolves. Conversely, there is also a possibility for players such as Symbian and Microsoft to move downstream and penetrate the feature phone space, potentially compromising ICS's market position.

Royalty Revenues: The company's transition to a software vendor depends on the level of royalty revenues and the pace at which these revenues accelerate. This depends on handset and electronic device shipments from ODM/OEM and silicon partners and timing of these shipments could impact the rate of royalty revenue increases.

Customer Concentration. This was an issue when the company was a pure services company with the top three customers accounting for over 40% of revenues. As Soleus related revenues ramp, this percentage should decrease.

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3. The analyst has visited the issuers Vancouver Head Office. No payment or reimbursement was received from the issuer for the associated travel costs.

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