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Embedded Growth

Layth Matthews speaks with Intrinsyc Software's

Derek Spratt and Rod Campbell

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MATTHEWS: Welcome to InvestorCanada.com. Today it's my pleasure to be speaking with Derek Spratt and Rod Campbell who are CEO and CFO, respectively, of Intrinsyc Software Inc. Welcome Derek, Rod.

SPRATT: Good morning.

MATTHEWS: First of all, Derek would you mind giving us an overview of Intrinsyc's products?

SPRATT: Sure. We deliver solutions for creating, linking and managing networks of internet devices. These are the new endpoints of the internet, so when you hear a lot about business to business e-commerce, we're pushing beyond the PC.

Our customers are typically the companies that build these products. We call them OEMs, the original equipment manufacturers, and they license our technology on a run time, licensing basis and it goes into their products as they push them into production.

MATTHEWS: So your products enable them to network their products?

SPRATT: Yes. Today you have a much more expanded universe and computers go well beyond the PC. About 98% of the actual computing devices are really not desktop or laptop PCs, many of those things are hidden. We allow them to seamlessly integrate with the computing systems at the desktop level enterprise, and most cases it's over the internet. We provide everything from the networking layers to the actual management of these network devices with the proper security that is required for plugging these devices onto the Net.

MATTHEWS: What industry represents the largest demand for Intrinsyc's products?

SPRATT: We've come out of the industrial automation and building automation marketplace, historically. This is an industry where industrialized PCs first appeared shortly after the IBM PC was introduce in 1982. They're familiar with the enterprise and they have a need to speak the same language and to have the top floor to shop floor connectivity.

But we've gone beyond that. We have worked in a number of exciting markets with key customers. We have worked with Eaton Corporation, which is a large sub-assembly manufacturer of truck components. For in-vehicle computing, we have done a truck PC platform them.

We've worked in the point of sale industry connecting all kinds of kiosks and ticket vending machines and point of sale terminals into the enterprise and over the internet and we are now increasingly driven towards general telecom applications. So we cover a very horizontal play.

MATTHEWS: What would you say is the most exciting new trend in the embedding of computers from the consumer's point of view?

SPRATT: Well consumers' experience with technology, certainly with PCs has been challenged. They have to deal with a fairly complex product that has required that there be a certain amount of training and education. And when it comes time to upgrade either the operating system or the application, there is usually quite a bit of effort and technical assistance that is required. And in the embedded space, we are really driving way beyond those paradigms to products that self-announce their presence on the network and they're automatically configured and automatically updated, remotely.

And you have to understand, many embedded products won't have a keyboard or a display or a typical user interface. So you can't carry the baggage of the desktop market with you.

And I think a lot of the good things that Intrinsic is doing with embedded devices will percolate up to desktop systems and you will find that computers will become friendlier. They will be less of a threat to less technical people. Business to business e-commerce is all about growing rapidly and if you have to hire engineers and technical people to deploy these systems and to support these new customers, it can be challenging.

Just think about an internet that's ten times the size of today's internet. When you start plugging all these embedded devices in

internet. When you start plugging all these embedded devices in and you have to simplify. So consumers are really going to see all the enriched capabilities that connecting these things together can provide, but they can do it without all the stress of having to maintain the support and deal with the administration of these devices.

MATTHEWS: Speaking of the internet, how much is your company's growth is dependent on the increasing bandwidth and pipeline of the internet capabilities?

SPRATT: Well, there's two real driving forces that are creating this industry. At Comdex this year, the theme for the whole computer show was 'Beyond the PC,' and it is driven by Moore's law, which creates very powerful, very inexpensive microcomputer chips that allow you to run complex software.

Also the internet is now through DSL and cable modems, it's starting to have quite a bit more bandwidth. We don't always need a big fat pipe going to these devices. We just need the actual connection and telephone lines are certainly used. We even use ethernet in many environments. So the actual end points of the internet are going to grow at a fast enough rate for us to see really substantial growth. You're going to see probably more internet appliances and embedded devices shipping next year, than PCs. So it's already overtaking the PC industry.

MATTHEWS: Would you mind giving us a brief history of Intrinsyc Software?

SPRATT: Sure. We incorporated in 1992. We've always focused on the development of "embedded software". This is the software that goes into these devices. In 1996 when Microsoft introduced embedded Windows at Comdex, we saw this as an opportunity to really help drive the desktop enterprise paradigm to these devices. We saw the inexpensive powerful chips and the internet creating a new opportunity.

So really in the last three years, it's been a development phase. We went through about $12 million in investment and since about the October timeframe, we built the sales front end. So we now have a world class sales and marketing team of more than 10 people that have joined, 30 engineers. And we now at about 50 staff.

MATTHEWS: Rod, how about a financial history of the company?

CAMPBELL: Sure. I would characterize the company's development as being in really a technology incubation mode for the last three and a half years. I started with the company a year ago. We had 25 on staff and one person in sales and marketing. Now we're ten people strong in sales and marketing, with some tremendous sales

leadership.

The revenue history has kind of followed the same path. Our revenues in 1997 were $60,000, and grew to $600,000 in 1998. At August year end 1999, we were at $2.25 million, and we're continuing to see strong growth in both our customer base and the number of clients that we're dealing with.

MATTHEWS: That is no doubt making you a favourite of the momentum crowd?

CAMPBELL: Yes. I think that as this market continues to expand, we demonstrate a lot of the characteristics that would be appealing. The information appliance market and this whole PC era is very, very large and growing rapidly. We've been talking about it for about three years, but it has only really been in the last six months that mainstream business publications, like Business Week and Wall Street Journal have acknowledged the information appliance market to be dwarfing the size of the desktop computer market.

MATTHEWS: I'm noticing a slowing trend in your revenue growth from 1,000% from '97 to '98 to only 300% or so from '98 to '99. What's your outlook for the future?

SPRATT: Our outlook for the future is probably enhanced by describing to you a little bit about how our business model works. There are three components to Intrinsyc's business model. We sell off-the-shelf development kits that include both the software and the hardware reference platforms and hardware solutions for our original equipment manufactures to get up and running and developing the technologies quickly.

We also provide engineering services to accelerate our customer's achievement of design wins. And the real blue sky potential for Intrinsyc is the fact that 60 days prior to shipping a commercial product, based on our technologies, our customers have to negotiate run time licensing or royalties. So we would collect a royalty fee for every device that is shipped by our clients that has part of our solution on board.

As a result, to really grow the company and to get kind of meteoric growth that the industry is experiencing, we're very focused right now on planting the right seeds that are going to lead to dramatic run time licenses in the future.

So we're very much focused on broadening the number of partnerships that we have, broadening the customer base, so planting additional seeds, expanding the revenues in a general sense and accelerating our development of alternate distribution channels. I've described a very robust direct sales force but we're

expanding that now to include value added resellers, systems integrators and bundling our software and solutions with OEMs directly.

MATTHEWS: Rod, how does Intrinsyc's revenue divide up between the three different products and services you described, and how do you see it developing in the next couple of years?

CAMPBELL: I think historically, if you look to the beginning of time at Intrinsyc we've had about $4 million dollars in revenue, of which $400, 000 approximately were license revenues. So historically it has been about 10% licensing, 90% services. In the most recent complete fiscal year of 1999 it was 85% services, 15% product and licensing.

This year we expect to be in the 75%/25% range. And we expect that that trend will continue, that an increasing portion of our revenue will come from the licensing component as we achieve more and more design wins and more and more of our products get commercially available.

MATTHEWS: Derek, your stock was recommended to us on February 17th by Allaster Maclean who manages the Scotia Canadian Small Cap fund. Why do you think he found Intrinsyc so attractive?

SPRATT: Well, Allaster has experience investing in a number of other companies that have gone before us into the public markets. The trend has been to recognize companies that have a strong downstream licensing potential.

So in the explosion of this internet infrastructure business model, he, I think, has quite correctly identified companies who are lower risk in terms of their providing up front pieces for this new puzzle that is being put together by the major OEMs and network operators. We had a good chat with him and we went through our business model in detail and he has proven to be very adept at understanding what we do.

MATTHEWS: Can you tell us a bit more about the competitive environment out there and other things that will impact on Intrinsyc's growth trajectory?

SPRATT: Yes. Traditionally we've had competition come from our customers themselves. They all have their own engineering organizations and the outsourcing business model, which in the last few years has taken favour in business schools and on Wall Street, is accelerating. But we still find a number of customers who have engineering groups who see us as a threat. It's a complex selling process that we actually take the conversation to the senior

executives in these corporations and convince them that a 'make versus buy' is the right thing to do.

It's really based on convincing them to focus on their value add versus dealing with the operating system or dealing with communications issues. And we've been quite successful in doing that. Now we really find our potential competition will come more from the operating system vendors themselves as they attempt to expand their networking capabilities of their own operating systems. We have the potential for competition from other companies that are systems integrators today, who may actually be licensing and distributing our products who see the opportunity themselves. And so some of your friends may become foes, or at least partially.

And finally, we really see ourselves as being able to address that competitive threat by having the ability to really understand our customers. Because services are really binding us to our customers, and helping us really understand our customers and how well our software performs on their products in their environment, we're able to really build on that relationship.

If you look at any one of our customers, whether it is a GE, Siemens, Eaton, even different groups of them, Microsoft and Intel, we've been able to take the conversation quickly from one group to the next and the next, across divisions. And so the barriers to entry for us are falling, and I believe it's one of the early adopter, first mover advantages that we have. We believe we have about an 18 months lead time.

MATTHEWS: Last but not least, Derek, what would be your advice to investors contemplating the purchase of Intrinsyc stock now that it's up trading around $9 a share?

SPRATT: First of all, everybody has to maintain a balanced portfolio. I'm not an investment advisor but I do believe that there is substantial upside obviously in our company. Certainly comparing us to others that have gone before us, there's a long way to go. Albeit I cannot speak to the issues of how the general public markets will behave over the next number of months.

I prefer that people who invest in Intrinsyc do so for the long term. I believe that the results of our efforts over the last number of years and the next few years will play out over a two to four year period. So I'd hope that the people that invest do so under the understanding that this is a journey and we will continue to execute and we will deliver on our promise and, as I say, I believe it's a strong investment opportunity for people.

MATTHEWS: Any plans to move the company to the TSE or the NASDAQ Rod?

CAMPBELL: I think that's a logical progression for companies that demonstrate our characteristics. It would give us access to a wider scope of potential investors and increase our awareness generally with the investing public.

MATTHEWS: Do you think that will happen in the next week or maybe next month?

CAMPBELL: Frankly, the securities laws are very strict on commenting on alternate exchanges, so suffice it to say that I think it would be logical progression for us as we continue to grow our business.

MATTHEWS: Well thank you very much for joining us today, and thanks for your insight into your fascinating company.

SPRATT: Thanks Layth. Our pleasure. Thanks very much.