

DivX, Inc

1Q08 Results: Solid, Guidance Upped; Adj Ests

DIVX, under a new leadership team, beat 1Q EPS expectations and upped 2008 guidance. Though 2008 is depicted as an investment year, the earnings power in the now-isolated licensing business (post Stage6) is clearer. Guidance factors in slowing DVD sales, so it appears to be conservative. We've upped estimates. Reiterate Overweight.

- **DIVX easily beat 1Q PF EPS expectations**, reporting \$0.18 EPS (up 50% y/y) on record sales of \$25.0mm (up 24% y/y) that aligned with consensus (JPMe \$0.15 EPS/\$25.5mm, Street \$0.14/\$25mm). Licensing (76.2% of total revenue) and media distribution both came in approximately aligned with our forecast, gross margins at 95.2% aligned, so the beat came from good expense discipline below the line.
- **Encouraging guidance.** DIVX, moving to full-year guidance henceforth (similar to Dolby) looks for 2008 PF EPS of \$0.52-\$0.58 on sales of \$95-\$100mm, which is ahead of our above-consensus EPS forecast, and underscores the earnings power in this licensing business (JPMe \$0.52/\$100mm, Street \$0.47/\$98.2mm). Even in an investment year, DIVX is tracking 08 PF operating margins of about 27%. Guidance, factors in slowing DVD sales and slow adoption of Blu-Ray players.
- **DIVX could become the de facto open standard for video compression**, storage, sharing and playback in the internet and on CE devices. DIVX's codecs, DRM, and interoperability software are securing design-wins that should fuel high-margin licensing growth on DVDs and other products. Premium content distribution, enabled by DIVX, could come to market in late 2008, spurring viral adoption.
- **Reiterate Overweight.** At an aftermarket indication of \$9.00, DIVX is trading at 11.3 times our 09 PF EPS of \$0.80, a 32% discount to the mean of our coverage. The stock is particularly compelling on an ex-cash multiple of 9.3 times our ex-interest income 09 PF EPS estimate of \$0.70.

DivX, Inc (DIVX;DIVX US)

	2007A	2008E (Old)	2008E (New)	2009E (Old)	2009E (New)
EPS (\$)					
Q1 (Mar)	0.10	0.01A	0.07A	0.12	0.14
Q2 (Jun)	0.03	0.05	0.04	0.10	0.09
Q3 (Sep)	0.02	0.07	0.08	0.12	0.11
Q4 (Dec)	0.11	0.08	0.10	0.16	0.16
FY	0.26	0.22	0.28	0.51	0.50
Revenues FY (\$ mn)	85	100	99	120	119

Source: Company data, JPM estimates. PF FY07A=\$0.57.

PF FY 08: 1QA=\$0.18, 2QE=\$0.10, 3QE=\$0.14, 4QE=\$0.16, FY08E=\$0.57 (prev \$0.52)

PF FY 09: 1QE=\$0.20, 2QE=\$0.16, 3QE=\$0.17, 4QE=\$0.22, FY09E=\$0.80 (prev \$0.78)

Overweight

\$7.74

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Applied Technologies

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Price Performance



	YTD	-1M	-3M	-12M
Absolute	-46.3%	9.3%	-48.7%	-57.2%

Source: RIMES, Reuters.



Company Data	
Price (\$)	7.74
Date Of Price	05 May 08
52-week Range (\$)	19.35 - 6.12
Mkt Cap (\$ mn)	273.66
Fiscal Year End	Dec
Shares O/S (mn)	35

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Review of DIVX's 1Q08 Results

DIVX beat 1Q PF EPS expectations, reporting \$0.18 EPS (up 50% y/y) on record sales of \$25.0mm (up 24% y/y) that aligned with consensus (JPMe \$0.15 EPS/\$25.5mm, Street \$0.14/\$25mm). Licensing (76.2% of total revenue) and media distribution both came in approximately aligned with our forecast, gross margins at 95.2% aligned, so the beat came from good expense discipline below the line. The company is also seeing momentum in new product categories such as mobile handsets (i.e. LG Viewty, LG Secret and Samsung F500) and Digital TVs (with over 80 LG and HP models).

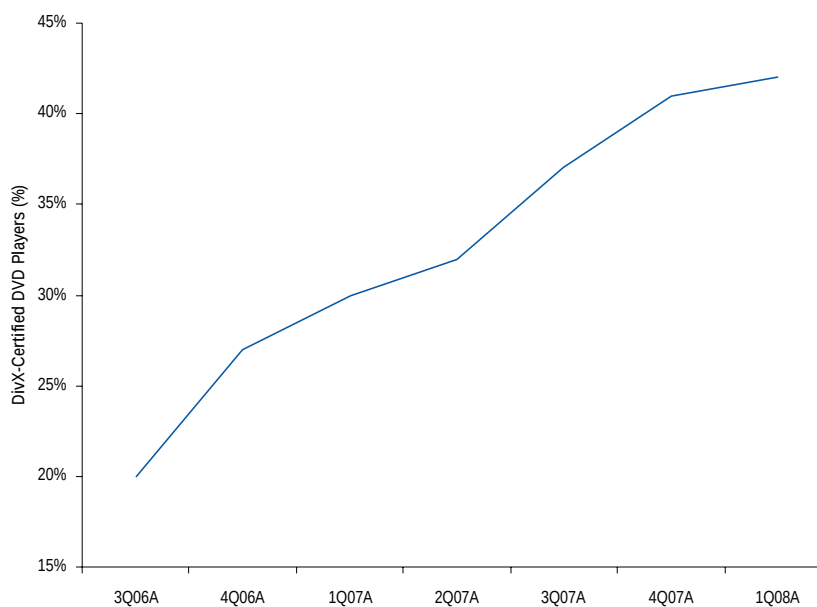
Table 1: Comparison of DIVX's 1Q08 Results vs. JPM/Street Estimates

	JPMe			Street			DivX Results & Guidance		
	1Q08E	2Q08E	FY08E	1Q08E	2Q08E	FY08E	1Q08A	2Q08E	FY08E
Revenue	\$25.5m	\$22.7m	\$100.3m	\$25.0m	\$21.5m	\$98.2m	\$25.0m	\$20.5-21.5m	\$95-100m
PF Gross Margin	94.5%	94.1%	94.4%	NA	NA	NA	95.2%	NA	95.0%
PF Operating Margin	30.0%	23.3%	27.1%	NA	NA	NA	31.0%	NA	NA
GAAP EPS	\$0.01	\$0.05	\$0.22	NA	NA	NA	\$0.07	\$0.03-0.05	\$0.24-0.30
PF EPS	\$0.15	\$0.11	\$0.52	\$0.14	\$0.07	\$0.47	\$0.18	\$0.09-\$0.11	\$0.52-0.58

Source: FactSet, JPMorgan estimates, Company reports.

Increasing penetration is offsetting DVD player weakness. Global penetration of DVD players with DivX-certification has grown from ~20% in Sept 06 to 42% in the latest quarter reported (see Figure 1). We believe DIVX can offset weakness in the standard definition DVD player market by increasing its penetration, as more OEMs look to use DivX-compatibility as part of a differentiating feature set.

Figure 1: DIVX's increasing global penetration is offsetting weakness in the DVD player market



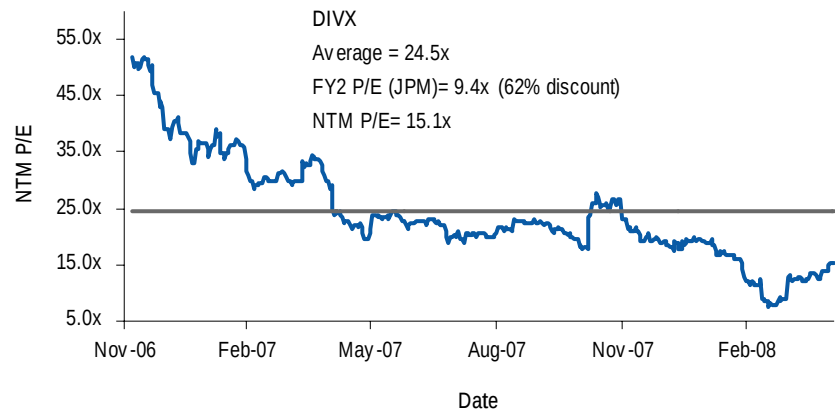
Source: Company reports, JPMorgan estimates.

Valuation and Rating Analysis

Reiterate Overweight. At an aftermarket indication of \$9.00, DIVX is trading at 11.3 times our 09 PF EPS of \$0.80, a 32% discount to the mean of our coverage. The stock is particularly compelling on an ex-cash multiple of 9.3 times our ex-interest income 09 PF EPS estimate of \$0.70.

In addition, we believe there is considerable longer-term upside to our EPS forecast owing to the multiple growth opportunities that DIVX is pursuing, justification in our view for a premium valuation multiple. We anticipate very high volatility in DIVX stock owing to uncertainties relating to the timing of market adoption of DIVX technology; however, we expect the stock to outperform the mean of our coverage universe in the next 1-2 years.

Figure 2: DIVX trades at a significant discount to its historical P/E ratio



Source: FactSet, JPMorgan estimates.

Risks to the Rating

We could become less constructive on DIVX's prospects for the following reasons:

- Termination of Stage6 may lead to loss of momentum in the core licensing business.
- CE Licensing growth falls short of expectations owing to lower rates of market adoption, or lower per-unit royalties.
- DIVX fails to become the de facto non-aligned MPEG4-based Codec standard owing to the viral emergence of an alternative, or alternatives.
- Apple and Microsoft establish hegemony as video compression standards in the consumer electronics industry, forcing out non-aligned Codecs, such as DIVX.
- DIVX becomes the target of patent disputes that slow adoption of the technology, or DIVX becomes involved in litigation related to copyright infringement or video piracy.

- The CE industry goes into a cyclical downturn and the rate of CE innovation diminishes, product cycles get longer, and DIVX's revenues fall short of expectations
- Google and YouTube force the adoption of an alternative Codec to DIVX.
- DIVX releases faulty software that damages its credibility in the CE industry.
- Controls at the company are still immature and there is the potential for execution mis-steps

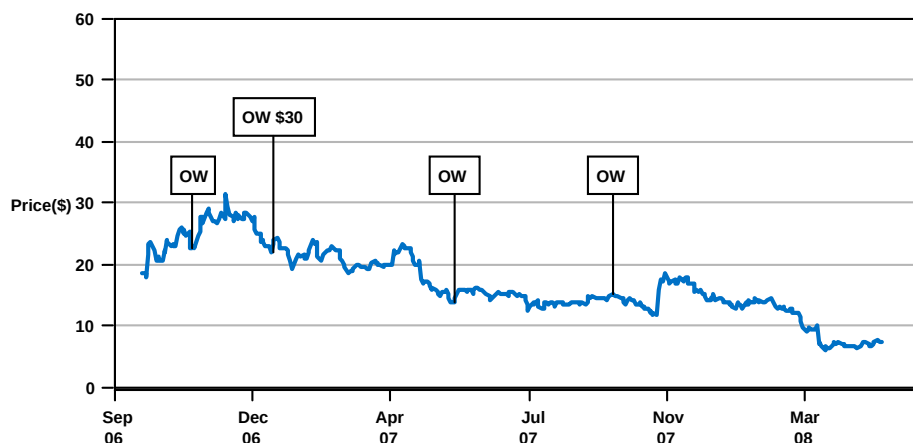
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DivX, Inc (DIVX) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
01-Nov-06	OW	22.84	-
04-Jan-07	OW	21.92	30.00
29-May-07	OW	13.95	--
01-Oct-07	OW	15.17	--

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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DivX, Inc: Summary Of Financials

Income Statement - Annual	FY07A	FY08E	FY09E	FY10E	Income Statement - Quarterly	1Q08A	2Q08E	3Q08E	4Q08E
Revenues	85	99	119	-	Revenues	25	21	24	29
Cost of products sold	4	5	5	-	Cost of products sold	1	1	1	1
Gross profit	80	95	113	-	Gross profit	24	20	23	28
SG&A	58	57	62	-	SG&A	16	12	13	16
R&D	19	23	26	-	R&D	5	6	6	7
Stock based comp.	-	-	-	-	Stock based comp.	-	-	-	-
Non-cash charges	-	-	-	-	Non-cash charges	-	-	-	-
Operating Income	0	11	22	-	Operating Income	1	2	3	4
EBITDA	16	24	36	-	EBITDA	4	5	7	8
Other income / (expense)	-	-	-	-	Other income / (expense)	-	-	-	-
Pre-tax income	8	16	28	-	Pre-tax income	4	2	4	5
Income taxes	(1)	6	11	-	Income taxes	1	1	2	2
Net income - GAAP	9	10	17	-	Net income - GAAP	2	1	3	3
Net income PF	-	-	-	-	Net income PF	-	-	-	-
Diluted shares outstanding	35	35	35	-	Diluted shares outstanding	35	35	34	34
EPS - GAAP	0.26	0.28	0.50	-	EPS - GAAP	0.07	0.04	0.08	0.10
EPS PF	0.57	0.57	0.80	-	EPS PF	0.18	0.10	0.14	0.16
Balance Sheet and Cash Flow Data	FY07A	FY08E	FY09E	FY10E	Ratio Analysis	FY07A	FY08E	FY09E	FY10E
Cash and cash equivalents	141	137	167	-	Sales growth	43.0%	17.1%	19.2%	-
Accounts receivable	10	11	12	-	EBIT growth	(26.0%)	69.9%	60.0%	-
Inventories	-	-	-	-	EPS growth	3.9%	0.3%	41.3%	-
Other current assets	8	1	1	-	Gross margin	94.7%	95.2%	95.5%	-
Current assets	159	150	180	-	EBIT margin	14.3%	20.7%	27.8%	-
PP&E	5	5	4	-	EBITDA margin	19.1%	24.3%	30.4%	-
Long-term portfolio investments	-	-	-	-	Tax rate	(11.8%)	37.9%	37.9%	-
Goodwill and intangibles	-	-	-	-	Net margin	100.0%	100.0%	100.0%	-
Total assets	201	211	242	-	Debt / EBITDA	0.0	(0.0)	(0.0)	-
Accounts payable	-	-	-	-	Debt / Capital (book)	0.7%	(0.0%)	(0.0%)	-
Deferred revenues	-	-	-	-	Return on assets (ROA)	11.0%	9.5%	12.4%	-
Total debt	0	(0)	(0)	-	Return on equity (ROE)	12.3%	10.9%	14.0%	-
Total liabilities	25	26	28	-	Return on invested capital (ROIC)	-	-	-	-
Shareholders' equity	175	186	214	-	Enterprise value / Sales	3.4	2.9	2.2	-
Net Income (including charges)	9	10	17	-	Enterprise value / EBITDA	17.6	12.0	7.2	-
D&A	2	3	3	-	Free cash flow yield	-	-	-	-
Change in Working Capital	(1)	7	1	-	P/E	29.8	27.2	15.6	-
Other	-	-	-	-					
Cash flow from operations	17	30	32	-					
Capex	(3)	(3)	(3)	-					
Free cash flow	13	27	29	-					
Cash flow from investing activities	(91)	(3)	(3)	-					
Cash flow from financing activities	3	(0)	(0)	-					
Dividends	-	-	-	-					
Dividend yield	-	-	-	-					

Source: Company reports and JPMorgan estimates

Note: \$ in millions (except per-share data). Fiscal year ends Dec