

DivX, Inc. (DIVX)

*“Rise in Web-Based Video Content and Viewers Should Drive Adoption:
Initiating Coverage with a HOLD based on Valuation”*

SUMMARY:

Rating: **HOLD**
 Current Price:(5/22/2008) **\$9.90**
 Intrinsic Value Est.: **\$10.61**
 52 Wk Range: **\$9.90-\$26.54**

QUICK FUNDAMENTALS:

Sector: Information Technology
 Industry: Software Services
 Asset Class: Small-Cap
 Index: N/A

Year	2007	2008e	2009e
Sales (Net) (In Mill HKD)	85	98	110
Earnings Per Share	\$0.20	\$0.28	\$0.61
Operating Profit Margin	3.6%	10.3%	23.3%
P/E Ratio	50.17	34.78	16.19
PEG Ratio	2.63	1.82	0.85
Price to Sales Ratio	3.97	3.42	3.05
Beta		1.5	
Dividend/Yield (%)		0.00%	
LT Sales Growth (%)		19%	
Shares Outstanding/ADR (mill)		34.00	
Market Cap (mill)		\$337	
FY Ends:		31-Dec	

CHART 1: STOCK PERFORMANCE HISTORY

Company Description: DivX, Inc., a digital media company, creates, distributes, and licenses digital video technologies. The company's digital media ecosystem enables users to compress, secure, and distribute digital video and participate in its digital media ecosystem. Its technologies are incorporated into various software product bundles, as well as software development kits that are licensed to hardware and software companies. DivX also offers certification services to software and hardware companies, and operates a digital media distribution system in which, it acts as an application service provider to third party content owners. In addition, the company offers a mobile media platform service, which enables users to discover video content from various sources using compatible handheld Internet-connected devices and provides access to manage accounts and favorites from a computer's browser. It markets its technologies to a range of integrated circuit manufacturers, original design manufacturers, original equipment manufacturers, and software developers worldwide. The company was incorporated in 2000 and is headquartered in San Diego, California.

RESEARCH UPDATE HIGHLIGHTS:

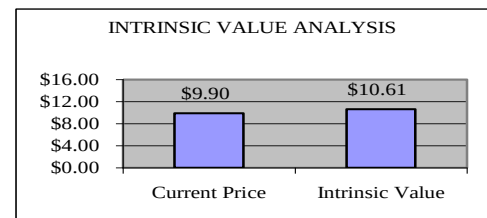
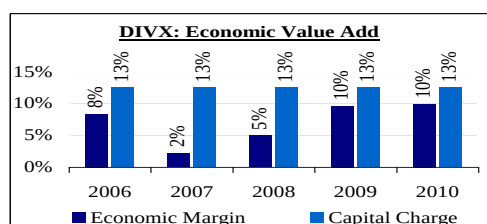
5/23/2008

We initiate coverage on the shares of **DivX, Inc. (DIVX)** with a **HOLD** rating and a \$10.61/share intrinsic value estimate. Based on our Shareholder Value Analysis, DIVX is trading at a 6.7% discount to our intrinsic value estimate. Our rating and valuation estimate is based on the following factors:

Licensing Partnership with Leading Manufacturers of DVD Players, HD Television and Mobile Phones to Support Long Term Growth and Profitability: DIVX continues to strengthen its partnership with leading market players in the three primary digital media areas, namely DVD players, HD-Television and Mobile handsets. The company said global penetration of its DivX solutions in the DVD market stood at 42%, up 27% in FY07 from FY06. Further, the company renewed its contract with Samsung and Philips to license its digital media solutions across multiple product categories, in addition to DVD players.

Acquisition of MainConcept AG to Expand DIVX Application Base: In November 2007, DIVX acquired MainConcept AG, a leading provider of H.264 video compression technology for broadcast, consumer electronics and software markets, for \$22 million in cash and stock. It also includes an earn-out of \$6 million if MainConcept completes certain developments goals and financial milestones. The deal will enable DIVX to include H.264, a video compression technology widely used to deliver and view high quality audio-visuals on mobile phones and consumer electronics, in its solution suite. We believe the acquisition should help DIVX to expand its market and further broaden its licensing base to drive long term profitable revenue growth.

Outlook: Based on the company guidance and our outlook, we expect DIVX to generate an annual average revenue growth of 11.0% and an annual average operating margin of 21.3% over the next five years. Any issues related to the integration of MainConcept and a slowdown in the consumer electronic sales are some of the key risks to our estimates. Currently, DIVX trades at a 35 times projected FY08 EPS of \$0.28 and at 16 times FY09 EPS estimate of \$0.61. The multiple implies a PEG ratio of above one based on our 5 year average EPS growth rate of 19%.

**CHART 2:
Shareholder
Value
Analysis
(See Exhibit V)**

**CHART 3:
Economic
Return
Analysis
(See Exhibit VI)**


Q1 FY08 Snapshot: DIVX reported Q1 FY08 revenue of \$25.0 million, up 23.8% from \$20.2 million in Q1 FY07. Revenue growth was led by a 14.2% y-o-y increase in technology licensing and a 69.1% y-o-y increase in services segments. Gross profit was up 24.6% y-o-y to \$23.8 million, as cost of revenue grew slower than revenue. Gross margin expanded by 70 bps y-o-y to 95.2%. Total operating expense grew 49.8% y-o-y to \$22.4 million resulting in a 66% y-o-y decline in operating income. Operating margin was hurt due to higher operating expenses and down sharply by 14.9 points y-o-y to 5.6% in Q1 FY08. As a result of the above mentioned factors, net income was down 32.2% to \$2.48 million from \$3.66 million in Q1 FY07. On a diluted basis, the company earned \$0.07 a share, down 32% from \$0.10 a share in Q1 FY07.

Q1 FY08 Cash Balance and Balance Sheet Snapshot: DIVX closed the quarter with \$113 million in cash and short term investments on its balance sheet and with no outstanding debt. The company's balance sheet remains strong with ample cash and we do not expect any liquidity issues over the near term. During Q1 FY08, DIVX generated \$4.01 million in operating cash flow, down 44% y-o-y from \$7.2 million in Q1 FY07.

Q2 FY08 and FY08 Outlook: DIVX expects Q2 FY08 revenue in the \$20.5 million - \$21.5 million range and EPS in the \$0.03-\$0.05 range. DIVX raised its FY08 EPS guidance to the \$0.24-\$0.30 range from \$0.14-\$0.22 range announced earlier. It maintained its FY08 revenue guidance of \$95 million-\$100 million range, which implies a 15% y-o-y growth from the midpoint of the guidance range. Q2 FY08 and FY08 guidance includes expenses related to stock-based compensation, stage6 expenses, impairment of intangible assets, and amortization of acquired intangibles.

INVESTMENT MERRIT

Market Leading Position Should Help Sustain Long Term Growth and Profitability: At the end of FY07, DIVX had a market share of more than 40%, up 27% y-o-y, in the global DVD player market. This reflects on the wide adoption of its solutions by the leading OEM manufacturers. Further, the acquisition of MainConcept should help DIVX expand its market footprint across multiple devices. We believe the market leading position should enable DIVX to sustain its double digit revenue and earnings growth over the near to medium to drive shareholder value.

Rise in Network Speed, Content Publishers, Content Viewers and Cross Platform Use Should Increase Adoption and Usage of DIVX Solutions: Network speed is growing at a rapid rate with users connected to fiber optic or cable. Nowadays content creation is not limited to studios with big budgets. With multiple popular websites to launch your content, video and audio visual content is on the rise. In addition, there has been a change in the way a content is viewed from the initial days, when the content was tied to display devices. Recent technology developments has helped to create a standard digital content, to deliver it to the viewer on multiple channels and to let the viewer decide to watch it on a computer, HD-television or mobile phone. We believe the above mentioned factors will help drive demand for digital content solutions and we expect DIVX, with its industry leading solutions, will benefit tremendously from such a development.

Expected Partnership with Multiple Hollywood Content Providers to Deliver Their Content on DivX format to Support Higher Adoption and Improve Long Term Outlook: We are encouraged by the company's strategy to cover all possible contents in the market and also help the end viewer by providing a seamless way to view contents from multiple channels on multiple platforms. DIVX is currently working with Hollywood content providers to offer its solutions for the secure distribution of its content using DivX format. It has already received a format approval from Sony Pictures Entertainment, which allows third party content distributors to offer the Sony library over DivX format. We believe Hollywood content remains a strong library in not only the U.S. market but also in the global market. Further, this should help DivX to improve adoption in the U.S. market.

INVESTMENT CONCERN

Successful Integration of MainConcept is Key in Realizing the Expected Cost Saving and Gaining Market Share Over Multiple Platforms: The successful integration of the recent acquisition is expected to drive cost down and improve scale. Although the acquisition was completed in Q4 FY07, the company continues with its efforts of integration. Also, the integration success also implies an increase in revenue and profitability with DIVX expanding its footprint on multiple platforms. The timely and cost efficient combination of the acquisition is critical and remains a near term risk to our estimates.

Stage6 Expenses, Acquisition Payouts and Related Amortization to Remain a Drag on Earnings on a GAAP Basis: The company reported Q1 FY08 GAAP diluted earnings of \$0.07 and adjusted EPS of \$0.18. The adjustments, which included primarily stage6 related expenses, and impairment and amortization of intangibles related to the acquisition. In February 2008, the company shutdown its video service website Stage6.com in order to focus on its core business. The video service website was a DivX video platform for content publishers and viewers. The company has moved the content to another video service website and has ceased its operations. However, the website related expenses is expected to remain a drag on its near term profitability.

Outlook: Based on the company guidance and our outlook, we expect DIVX to generate an annual average revenue growth of 11.0% and an annual average operating margin of 21.3% over the next five years. Any issues related to the integration of MainConcept and a slowdown in the consumer electronic sales are some of the key risks to our estimates. Currently, DIVX trades at a 35 times projected FY08 EPS of \$0.28 and at 16 times FY09 EPS estimate of \$0.61. The multiple implies a PEG ratio of above one based on our 5 year average EPS growth rate of 19%.

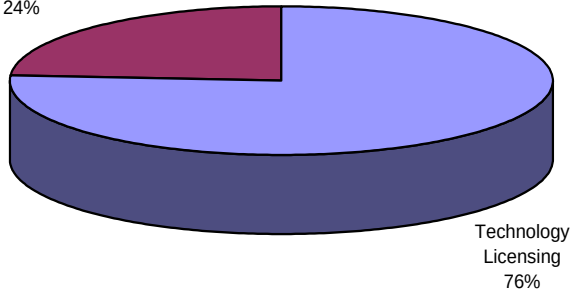
INVESTMENT RATIONALE

We initiate coverage on the shares of **DivX, Inc. (DIVX)** with a **HOLD** rating and \$10.61/share intrinsic value estimate. Based on our Shareholder Value Analysis, DIVX is trading at a 6.7% discount to our intrinsic value estimate. Its FY08 economic return of 4.5% is below our cost of capital estimate of 12.5%, implying shareholder value erosion. However, we expect the company to generate excess returns over our forecast period. We expect strong demand for DIVX solutions to drive revenue growth and margin expansion over the near and the medium term. We believe the stock price already reflects these expectations and currently it trades at a reasonable valuation with limited upside potential. Therefore, we rate it a **HOLD**.

Chart 4:

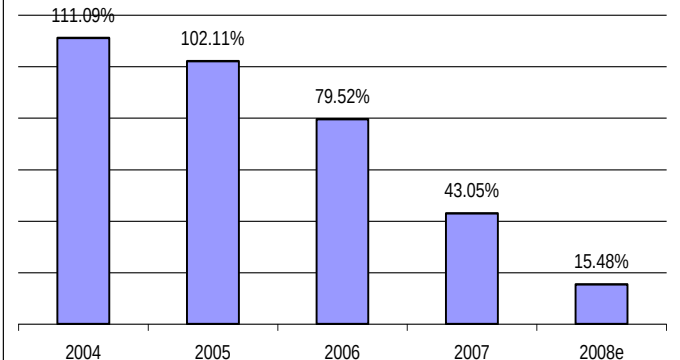
DIVX: Q1 FY08 Revenue Contribution by Segment

Media and other
distribution and
services
24%



Source: Company filings and BOE Research

Chart 5:

DIVX- Revenue Growth Trend

Source: Factset & BOE Research

RECENT QUARTER PERFORMANCE:

Table 1: (\$ 000's, except for per share figures)	Q1 FY08	% of sales	Q1 FY07	% of sales	Growth
<i>Technology Licensing</i>	19,078	76.2%	16,702	82.6%	14.2%
<i>Media and other distribution and services</i>	5,944	23.8%	3,516	17.4%	69.1%
Total Revenue	25,022	100.0%	20,218	100.0%	23.8%
<i>Cost of technology licensing</i>	1,036	4.1%	848	4.2%	22.2%
<i>Cost of media and other distribution and services</i>	172	0.7%	261	1.3%	-34.1%
Total cost of revenue	1,208	4.8%	1,109	5.5%	8.9%
Gross profit	23,814	95.2%	19,109	94.5%	24.6%
<i>SG&A expense</i>	15,977	63.9%	10,796	53.4%	48.0%
<i>Product development</i>	5,425	21.7%	4,156	20.6%	30.5%
<i>Impairment of acquired intangibles</i>	1,000	4.0%	0	0.0%	
Total operating expenses	22,402	89.5%	14,952	74.0%	49.8%
Operating income	1,412	5.6%	4,157	20.6%	-66.0%
<i>Interest income, net</i>	1,657	6.6%	1,903	9.4%	-12.9%
<i>Other income</i>	517	2.1%	0	0.0%	
Income before income taxes	3,586	14.3%	6,060	30.0%	-40.8%
<i>Income tax</i>	1,105	4.4%	2,400	11.9%	-54.0%
Net income	2,481	9.9%	3,660	18.1%	-32.2%
Diluted earning per share	0.07		0.10		-32.1%
Diluted outstanding shares	35,356		35,413		-0.2%

Exhibit I: Income Statement (in millions USD)

	2006	2007	2008e	2009e	2010e	2011e	2012e
Sales (Net)	59	85	98	110	121	132	143
Cost of Goods Sold	3	2	3	3	3	4	4
Gross Profit	57	83	96	107	118	129	139
SG&A	41	77	83	78	85	93	100
Earnings Before Interest, Taxes, & Depreciation	15	5	13	29	33	36	39
Depreciation & Amortization	2	2	3	3	4	4	4
Operating Profit	14	3	10	26	29	32	35
Other Revenues & Gains	0	3	0	0	0	0	0
Earnings before Interest & Taxes	14	6	10	26	29	32	35
Total Interest Income	0	0	6	6	7	8	9
Earnings Before Taxes	14	6	16	32	37	40	44
Total Taxes	1	-1	6	11	13	14	15
Income after taxes	13	7	10	21	24	26	29
Preferred Dividends	6	0	0	0	0	0	0
Net Income	7	7	10	21	24	26	29
Earnings Per Share	\$0.42	\$0.20	\$0.28	\$0.61	\$0.70	\$0.77	\$0.84
Shares Outstanding (Diluted)	18	35	34	34	34	34	34

Exhibit II: Balance Sheet (in millions of USD)

	2006	2007	2008e	2009e	2010e	2011e	2012e
Total Cash & Marketable Securities	149	141	148	167	188	212	238
Accounts Receivable	7	11	13	15	16	18	19
Other Current Assets	3	7	9	10	11	13	14
Total Current Assets	159	159	170	191	216	242	271
Gross Fixed Assets	8	11	14	17	21	25	29
Less: Accumulated Depreciation	4	6	9	12	16	20	24
Net Fixed Assets	3	5	5	5	5	5	5
Other Assets	2	36	36	36	36	36	36
TOTAL ASSETS	164	201	211	233	257	284	313
Accounts Payable	2	3	3	4	4	4	5
Other Current Liabilities	4	10	11	11	11	11	11
Total Current Liabilities	7	13	14	15	15	16	16
Total Long-Term Debt	0	0	0	0	0	0	0
Other Liabilities	2	1	1	1	1	1	1
Total Liabilities	8	15	15	16	16	17	18
Total Equity	156	186	196	217	241	267	295
TOTAL LIABILITIES & EQUITY	164	201	211	233	257	284	313

Exhibit III: Ratio Analysis

	2006	2007	2008e	2009e	2010e	2011e	2012e	5 yr. Avg
Sales Growth Rate (G) (%)	79.52	43.05	16.00	12.00	10.00	9.00	8.00	11.00
Change in Earnings Per Share (%)	NM	(52.85)	44.23	17.57	14.52	10.01	9.19	19.10
Cost of Capital (K) (%)	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50
Earnings Per Share	0.42	0.20	0.28	0.61	0.70	0.77	0.84	0.64
Free Cash Flow Per Share	(6.38)	3.60	(0.00)	0.32	0.38	0.42	0.46	0.31
Capital Expenditure Per Share	0.00	0.00	0.09	0.10	0.11	0.12	0.13	0.11
Sales Per Share	3.36	2.40	2.90	3.24	3.57	3.89	4.20	3.56
Book Value Per Share	8.85	5.26	5.77	6.38	7.08	7.85	8.69	7.15
Shares Outstanding	17.64	35.42	34.00	34.00	34.00	34.00	34.00	34.00
Gross Profit Margin (%)	95.56	97.24	97.25	97.25	97.25	97.25	97.25	97.25
Operating Profit Margin (P) (%)	23.12	3.59	10.25	23.25	24.25	24.25	24.25	21.25
Return on Assets or Investment (%)	7.96	3.48	4.59	8.94	9.27	9.23	9.14	8.23
Return on Equity (%)	8.39	3.75	4.94	9.59	9.89	9.82	9.68	8.78
Days in Receivables	43	48	49	49	49	49	49	48.50
Days in Payables	303	438	438	438	438	438	438	438.00
Days in Inventory	0	0	0	0	0	0	0	0.00
Fixed Asset Turnover	17.01	15.71	18.22	20.41	22.45	24.47	26.43	22.40
Debt/Total Capital (%)	0.32	0.08	0.08	0.07	0.07	0.06	0.06	0.07
Current Ratio	23.84	12.03	12.22	13.18	14.28	15.46	16.71	14.37
Working Capital	152	146	156	177	200	227	255	202.98
Price to Book Ratio	1.12	1.88	1.72	1.55	1.40	1.26	1.14	1.41
Price to Earnings Ratio	23.65	50.17	34.78	16.19	14.14	12.85	11.77	17.95

Exhibit IV: Cash Flow Statement (in million of USD)

	2006	2007	2008e	2009e	2010e	2011e	2012e
Net Income	13	7	10	21	24	26	29
Depreciation Expense (Funds)	2	2	3	3	4	4	4
Less: Non-Operating Profit	(0)	3	6	6	7	8	9
Funds from Operations After Tax	15	6	7	18	20	22	24
Less: Working Capital Consumption	(127)	121	(4)	(4)	(4)	(4)	(4)
Cash from Operating Cycle	(113)	127	3	14	17	18	20
Less: Fixed Capital Investment	0	0	3	3	4	4	4
Less: Additions to Goodwill & Intangibles	0	25	0	0	0	0	0
Add: Proceeds from Asset Sales & Other	(2)	(5)	0	0	0	0	0
Operating Cash Flow after Capex	(115)	98	(0)	11	13	14	16
Add: Non-Operating Income	(2)	(6)	6	6	7	8	9
Less: Dividends	6	0	0	0	0	0	0
Free Cash Flow	(123)	92	6	17	20	23	25
Cash Flow from Debt Financing	(1)	(0)	0	0	0	0	0
Cash Flow from Equity Financing	127	18	0	0	0	0	0
Net Cash Flow	3	109	6	17	20	23	25

Exhibit V: Shareholder Value Analysis

Year	Cash Flow	PV Cashflow	Cum PV Cashflow
2008e	(0)	(0)	(0)
2009e	11	9	8
2010e	13	9	18
2011e	14	9	26
2012e	16	9	35
2013e	16	8	43
2014e	17	8	51
2015e	18	7	58
2016e	19	7	65
2017e	19	6	71
2018e	20	6	76
2019e	20	5	82
PV of Residual Value			119
Cum. PV of Cash Flows and Residual Value			201
Total Marketable Securities			141
Long-Term Funding Asset			0
Investments in Stocks and Bonds			19
Corporate Value			361
Shareholder Value			361
Divided by Shares o/s			34
Shareholder Value per Share (PV)			\$10.61
Current Stock Price			\$9.90
Premium/Discount to Current Price			6.7%

PV Cashflow is calculated by discounting cashflows using the company's cost of capital.

Exhibit VI: Economic Return Analysis

	*Adjusted NOPAT	-	Capital Charge	=	Excess Returns	Economic Margin	-	Cost of Capital	=	Excess Returns
2006	13		20		(6)	8.4%		12.5%		-4.1%
2007	4		23		(19)	2.2%		12.5%		-10.3%
2008	10		25		(15)	4.9%		12.5%		-7.6%
2009	21		27		(6)	9.6%		12.5%		-2.9%
2010	24		30		(6)	9.9%		12.5%		-2.6%

Adjusted NOPAT: Net operating profit after tax

Adj Capital Base = Debt, Equity, and Min Int

Capital Charge: Cost of capital * Adj Capital Base

Economic Margin: Adjusted NOPAT / Adjusted Capital Base

Exhibit VII: Peer Group Analysis

Name	Current Price	Mkt Cap (In Millions)	FY P/E	Consensus EPS Growth Rate	EPS Revision 4 wks	Intrinsic Value Est.	Economic Returns	Cost of Capital	BOE Rating
Double-Take Software Inc.	\$9.90	\$2,710	22.05	18%	\$0.04	\$10.61	4.94%	12.50%	HOLD
RealNetworks Inc.	\$7.16	\$1,022	36.14	23%	(\$0.02)	NC	NC	NC	NC
NDS Group PLC (ADS)	\$53.81	\$3,131	17.51	22%	\$0.07	NC	NC	NC	NC
Apple Inc.	\$177.05	\$156,091	29.58	22%	\$0.35	\$187.03	24%	12%	BUY

NC= Not Covered, NA = Not Applicable

NM denotes Not Meaningful

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Rating	Distribution
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HOLD	37%
SELL	12%
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