InterVideo, Inc

Update Report

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Table of Contents

Price (September 13, 2005):	**$9.70**	**Shares Outstanding: (Millions)**	**15.4**
52 Week Range:	**$9.41 - $16.61**	**Average Daily Trading Volume (000s)**	**194**
Market Capitalization: ($ Millions)	**$ 149.4**	**Book Value Per Share:**	**$ 5.32**

	Year 2003					Year 2004					Year 2005
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1
Revenues ($ Millions)	$ 13.4	$ 13.1	$ 14.3	$ 16.3	$ 57.1	$ 18.8	$ 16.7	$ 18.5	$ 20.4	$ 74.4	$ 21.9
Net Income ($ Millions)	$ 1.6	$ 1.6	$ 2.3	$ 2.3	$ 7.8	$ 2.6	$ 1.1	$ 1.3	$ 3.8	$ 8.8	$ 2.6
Per Share Earnings (Fully Diluted)	$ 0.13	$ 0.13	$ 0.16	$ 0.15	$ 0.57	$ 0.17	$ 0.07	$ 0.09	$ 0.25	$ 0.58	$ 0.17

Summary

InterVideo is an independent applications software vendor for Wintel-based PCs. It specializes in Digital Media products for (1) watching video, (2) creating content, (3) recording media such as television programs, and (4) burning Digital Media and data onto blank DVDs. The most comparable competitor is Sonic Solutions, but Adobe Systems, Avid Technology, and CyberLink also have competitive product lines.

At present about 45% of sales are derived from WinDVD which is used for viewing DVD video playback on PCs. Another 12% is obtained from sales of VideoStudio which is produced by a newly acquired Taiwanese subsidiary named Ulead. The product enables consumers to edit video, typically, home movies, originally shot on camcorders. The remaining 43% is obtained from various other products for video creation, DVD burning, media recording, and (still) digital photography.

The company sells its products through three distribution channels: (1) OEM PC manufacturers, (2) brick & mortar retailers, and (3) various websites. For shareholder reporting purposes, management combines the sales through the last two sectors into a single line item.

During the June quarter almost 70% of revenues were derived from the OEM markets and the remaining (roughly) 30% from a combination of conventional retailers and websites. InterVideo has been reducing its reliance on the OEM channel through both internal efforts and acquisition. For example, OEM sales dropped from 85% of the total reported in the March quarter largely because of the Ulead acquisition.

While the company's, largest geographic market is in the United Sates with 43% of total sales in the June quarter, Japan is not far behind with 41%. Owing to its relatively large importance to InterVideo, investors are well advised to stay current on new Digital-Media-friendly hardware innovations in Japan. For example, new product introductions in Japan might importantly impact the company's revenues before the same products are introduced here in the States.

There are three important industry characteristics that may well significantly impact the company's performance: (1) Product Cycles, (2) Industry Consolidation, and (3) Technological Market Extension.

The first hardware product cycle that "kick-started" the company was the introduction of DVD drives for PCs. The second was the advent of the DVD-burner and it was this cycle that gave Sonic Solutions a foothold in the market. The next cycle that will begin to play-out during the next year or so is the high-definition DVD drive. One reason that InterVideo acquired Ulead is that the Taiwanese company has solid technical capabilities in the area of HD video. For example, Ulead developed the software reference tool for Toshiba's HD-DVD format which is one of the two leading competing standards for high-definition DVDs.

InterVideo's industry is consolidating, in part because the PC industry is itself consolidating. A few years ago the second and third largest industry factors combined when Hewlett-Packard acquired Compaq. More recently the erstwhile industry standard, IBM, sold its PC business to Lenovo Group which is the largest supplier of PCs in China. Similarly, a little over a year ago, Gateway Computer acquired eMachines.

As the ability of the semiconductor industry to place increasingly complex functions onto a single chip of silicon advances, there will be important implications for both the cell phone and consumer electronics appliance markets. Both will become more software intensive and emerge as potential markets for independent vendors of Digital Media software. For example, the company recently announced that they licensed Microsoft to use InterVideo technology in the playback of DVDs for the soon-to-be-released Xbox 360.

Aside from the fact that InterVideo is a comparatively small company in a rapidly growing industry, the prudent investor will recognize a number of other risk factors. Among them are (1) a recent change in auditors, (2) a number of points (discussed more fully in the "Risk Factors" section of this report) about InterVideo's internal controls from the previous auditor, (3) the integration of the Ulead acquisition, (4) OEM pricing pressures, (5) shifting DVD technology, and (6) customer concentration.

During the June quarter the company's financial performance fell short of the estimates provided by management in its "forward-looking statements" following the release of March quarter earnings. Management has provided an analysis indicating that nearly the entire shortfall was due to a number of non-recurring, non-operating, and acquisition related charges.

The company's balance sheet at the end of June appeared to be strong. The major exception was an increase in DSOs from 21 days at the end of March to 57 days at the end of June. Management indicates that the increase was partly

due to (1) the Ulead acquisition and (2) the fact that one major customer asked to be invoiced at the end of June. Ulead typically has longer DSOs than InterVideo *per se* because a larger percentage of its sales are into the retail channel. The large customer that asked for the June invoice paid it off before the end of July.

Company Description

InterVideo is a leading independent supplier of Digital Media software for Wintel-based personal computers. In an industry context, typical Digital Media programs involve: (1) recording & playing CDs, (2) recording & playing DVDs, (3) digital (still) photography manipulation, (4) video photography manipulation, and (5) downloading & organizing Digital Media files. Generally speaking, InterVideo is involved in the three middle categories.

It does not produce software merely to play & burn CDs because the technology is widely available and most consumers tend, by default, to use the Windows Media Player for such applications. That makes it a tough market in which to compete, as evidenced by the antitrust lawsuit against Microsoft from RealNetworks.

Today the market for software to download (or capture) and organize Digital Media is typically addressed by companies that are selling content over the Internet. Examples include the iTunes software by Apple Computer and the software clients from the Napster, Rhapsody (RealNetworks), and Yahoo Music Unlimited music subscription services. However, InterVideo is not completely absent from this category since it does sell software that will capture television and radio programming for multimedia PCs and home theater applications. Moreover, the capabilities are only discrete features in more integrated products.

The domestic competitor that is most comparable to InterVideo is Sonic Solutions. Other companies selling products that compete with various InterVideo products include, Adobe Systems, Avid Technology, and Cyberlink. Adobe competes primarily in digital still photography and video creation software. Avid's recently acquired Pinnacle Systems sells video creation software for the consumer market. Cyberlink is a Taiwanese company that is primarily a competitor in the market for DVD playback software.

Product Categories

Historically, InterVideo generated most of its revenues from software, termed WinDVD, used to play DVDs in Wintel computers. As indicated in the following table, WinDVD accounted for over 80% of revenues two-and-a-half years ago as compared to only 45% in the most recently completed June quarter of 2005.

Quarterly Revenue by Product Line
Millions $

	Year 2003					Year 2004					2005	
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2
WinDVD	$11.0	$10.9	$11.9	$13.2	$47.0	$14.7	$12.2	$12.2	$13.7	$52.7	$13.8	$12.5
VideoStudio												3.3
Other	2.4	2.2	2.4	3.1	10.1	4.1	4.5	6.3	6.7	21.7	8.1	11.8
Total Revenues	**$13.4**	**$13.1**	**$14.3**	**$16.3**	**$57.1**	**$18.8**	**$16.7**	**$18.5**	**$20.4**	**$74.4**	**$21.9**	**$27.6**

Quarterly Revenue by Product Line
Percentage Breakdown

	Year 2003					Year 2004					2005	
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2
WinDVD	82%	83%	83%	81%	82%	78%	73%	66%	67%	71%	63%	45%
VideoStudio												12%
Other	18%	17%	17%	19%	18%	22%	27%	34%	33%	29%	37%	43%
Total Revenues	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: SEC filings and Inside Digital Media calculations.

The reduced reliance upon WinDVD has been accomplished in two ways.

First, management has consistently sought to diversify its product line through internal development. In point of fact, until the June ’05 quarter internal diversification was the only vehicle for reducing the dependence upon WinDVD. Thus, internal developments had reduced the reliance upon WinDVD from 82% in the first quarter of ’03 to 67% two years later in the first quarter of this year.

Second, during the second quarter of this year InterVideo acquired an approximate 62% interest in a comparable company based in Taiwan named Ulead. Given that InterVideo now has controlling interest in Ulead, it reports consolidated financial statements with outside shareholders represented in the Minority Interest accounts. We estimate that Ulead increased the revenue base at InterVideo by at least one-third and accounted for nearly the entire drop in WinDVD percent-of-revenues contribution in the June quarter to 45% from the 63% recorded in the March ’05 quarter.

WinDVD. As noted, the company’s flagship product is a software program that is used to playback DVD videos. It is employed by software intensive devices, primarily PCs. Most console DVD players made by consumer electronics (CE) manufacturers, like Sony and Panasonic (Matshushita), do not use software and instead rely upon hardwired playback circuitry.

As general purpose devices, PCs can more economically provide media playback via software instead of utilizing the hardwired circuitry that is common in CE devices. Additionally, as CE devices become more software intensive there may well be an important market opportunity for WinDVD.

For example, during the June quarter InterVideo announced that WinDVD will be the DVD playback software used in the Microsoft Xbox 360. The Xbox 360 unit is a video game and entertainment console that will be on the market for the Christmas selling season this year. One of its features will be an integrated progressive scan DVD player. Additionally, InterVideo granted Microsoft certain derivative rights to key components of its DVD, audio, and video decoding technology. Management expects these agreements to generate significant revenue over the next several quarters.

InstantON. Sometimes PC owners only want to use their computers to watch a DVD. Normally this requires them to proceed through a lengthy Windows boot-up process before they can even put the DVD in the player's sliding tray. PC owners who *often* want to use their machines to watch DVDs, or for other media applications, are especially annoyed by the delays.

As a result, InterVideo has worked with a number of leading PC manufacturers to introduce new versions of PCs that have an "Instant On" switch for media applications. When the user pushes the "Instant On" switch, (or remote control) he is able to access his DVD drive in a matter of seconds. In order to bypass the Windows boot-up procedure, the PCs require a software program to be activated by the "Instant On" switch. Basically, InterVideo became the dominant supplier, naming its software product, InstantON.

InstantON is now shipping to twelve PC manufacturers including Hewlett-Packard, Sharp, Sony, and Toshiba. Presently it is exclusively an OEM product. In recent quarters it has been one of the most successful InterVideo products for diversifying the company's traditional reliance upon WinDVD.

Notably absent from the list of InstantON customers is Dell Computer. Significantly, on August 15th, InterVideo filed a patent infringement suit against Dell. While the specifics of the patent are esoteric, we believe the suit is connected to Dell's use of an "Instant On" application in certain lines of its computers. InterVideo has asked the Northern California District Court to enjoin Dell from the manufacture, importation, or sale of products that infringe upon its patent.

Video Creation Software. After DVD drives became more-or-less standard equipment on PCs, the manufacturers began to look for other devices to add as integral components. They wanted fresh capabilities which might motivate consumers to buy new PCs. The most evident candidate was the DVD-burner. With a DVD-burner families could shoot home videos, edit them on their computers, and output the finished content to blank DVDs. For example, a young family could shoot videos of their children and burn them to blank DVDs. Next they could send the burned DVD via postal mail to the grandparents who would be able to watch the home movies on their televisions via a conventional DVD console player.

This produced a demand for new OEM software to *create* DVD content. It was not enough that WinDVD would merely play DVDs. It was necessary that the PC manufactures find a vendor who could provide software to *burn* video content to blank DVDs, and perhaps provide some basic editing functions as well.

InterVideo responded by developing WinDVD Creator. Similarly, Ulead introduced VideoStudio. In the future, InterVideo plans to combine features from both WinDVD Creator and VideoStudio into a new version of a product called Media One.

The process of creating video content for DVD-burners typically begins with digital video camcorders, like the one illustrated below. They are steadily dropping in price and getting easier to use. All you have to do to create a basic video is simply point and shoot.

Source: Sony.

However, if you have ever played back what you shot and looked at it, then you know how hard it is to create *good* home video with nothing but a camera. Even if you are extremely careful when shooting, you usually end up with a lot of "junk" on the tape. When you play it back, it looks amateurish, disjointed, confusing, and has lousy sound.

Since most of us watch a lot of TV and see movies regularly, we unconsciously set fairly high standards when we watch anything in video. For example, most of us expect a title in the beginning and a set of “shots” cut together in a nice way to tell a story. A “shot” is a particular subject filmed from a specific angle. For example, a video of a child’s birthday party may string together a variety of “shots” that could include, one of the cake, one of the presents before they are opened, one of the guest children, one of the child blowing out the candles, and one of him unwrapping the presents.

Next time you watch TV, observe that it is rare for the camera angle to stay the same for more than 10 – 15 seconds. The director will cut between different angles to keep things interesting or to make different points. For example, the

screen might show a woman's face while she's talking for five seconds, and then switch to a shot of her hands holding a tissue (while the sound track continues uninterrupted with her talking) to show the emotion.

Creating videos with the kinds of features described above involves transferring the original recording to a computer. Providing extended family and friends with a convenient way to *watch* the videos involves publishing the finished material to media form factors that are widely available and standardized. The best example is the DVD player, either as a console unit at their televisions, or less conveniently, as an integrated unit in their computer.

The process of getting the home movie into the computer, edited, and ultimately to the burned DVD involves four steps that are summarized in the figure below.

Source: InterVideo

First, the video must be "captured" from the camcorder into the PC. Normally this is done by connecting the camcorder to an IEEE 1394 port in the PC using capture software like that provided by WinDVD Creator.

Second, the video may be edited. Here is where mistakes are removed and the essence of the video experience is optimized.

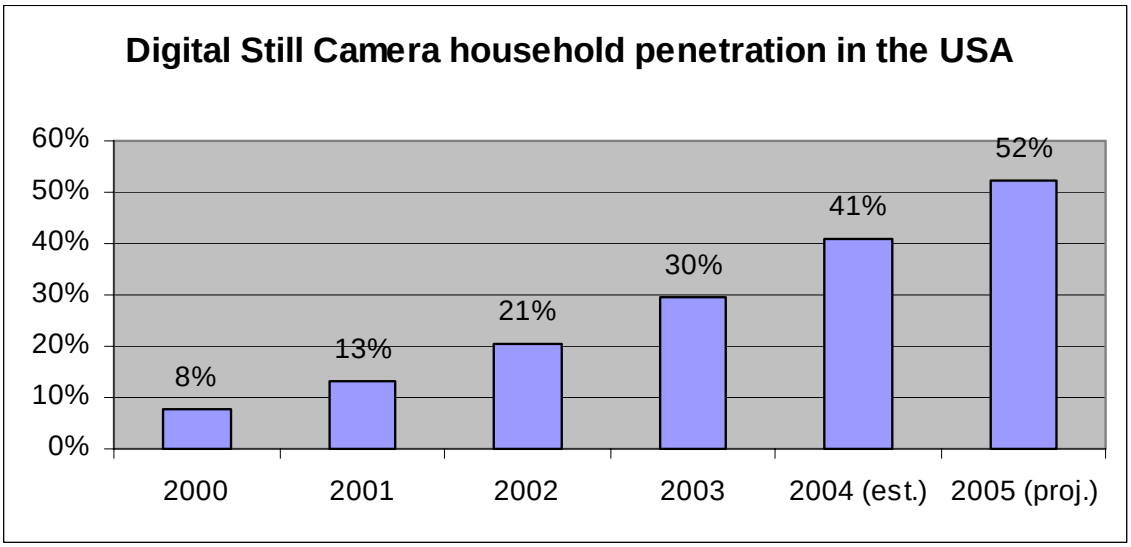
The third step, which is termed "authoring", permits the user to organize the video into chapters, provide menus at the beginning that enable viewers to go to different sections with the click of a remote, and otherwise customize the home movie.

The final step is to publish the finished video to an output medium. Two of the most popular ones are blank DVDs and blank CDs. While DVDs can be played conveniently in a DVD player readers should also be aware that with compression formats like DivX, videos on CDs can be played on PCs or any DivX enable playback device. Thus, CDs are not merely for music.

Another increasingly popular way to publish videos is to upload them to hosting servers where they can be made nearly instantly available over the Internet. One example is Streamload.com.

Digital (Still) Photography. As the figure below illustrates, digital still photography is rapidly encroaching upon the traditional film market. By the end of

this year the Photographic Marketing Association estimates that over half of U.S. households will have digital cameras. It is estimated that nearly 21 million digital cameras will be sold this year in the United States, as compared to only 0.4 million ten years ago.



Source: PMA Marketing Research

Many users of digital cameras prefer to store their pictures on computers. The memory cards that come with the cameras soon get filled up. Moreover, with the proper software, bad pictures can be edited to improve their appearance and entire slide shows of vacations can be organized. InterVideo provides such software and its major product is Photo Impact from Ulead.

Other. Finally, InterVideo and Ulead make a number of other Digital Media software products. In general they involve one, or a combination of, the following four applications: (1) watching video, (2) creating content, (3) recording media such as television programs, and (4) burning Digital Media and data onto blank DVDs.

Distribution Channels

As the table below indicates, InterVideo sells its products through three basic channels (1) OEM, (2) brick & mortar retailers, and (3) websites. For reporting purposes management combines the second and third categories into a single line item.

Quarterly Revenue by Distribution Channel Millions $

	2005	
	Q1	**Q2**
OEMs	$ 18.7	$ 19.0
Retail and Website	3.2	8.6
Total Revenues	**$ 21.9**	**$ 27.6**

Quarterly Revenue by Distribution Channel Percentage Breakdown

	2005	
	Q1	**Q2**
OEMs	85%	69%
Retail and Website	15%	31%
Total Revenues	**100%**	**100%**

Source: InterVideo SEC Filings

OEM. Traditionally the OEM markets have been the dominant revenue source for InterVideo. Prior to the acquisition of Ulead they accounted for 85% of total sales. Even after the Ulead merger they represent nearly 70% of the total.

The heavy reliance upon OEMs is explained by the company's evolution. In the late 1990s when the OEMs initially began to design-in DVD drives as integral parts of their computers, the PC manufacturers were in need of vendors for software programs that could drive the DVD players. Two leading contenders emerged, InterVideo and CyberLink.

Over time, InterVideo became the front runner. It has sold over 125 million copies of WinDVD. Customers include Hewlett-Packard, Toshiba, IBM (Lenovo), NEC, Sony, and almost all the major PC manufacturers. Although the company also sells WinDVD on some models of Dell computers, it is not the major vendor to Dell.

Recently it appears that Sonic Solutions has made some competitive encroachment in this turf with their software player named CinePlayer. Specifically, upon the announcement of their June quarter financial results on August 15th, Sonic disclosed that certain lines of Hewlett-Packard computers will henceforth ship with CinePlayer pre-loaded instead of WinDVD. Moreover, Sonic

management sounded optimistic that they will be able to gain additional OEM business for CinePlayer with other PC manufactures in the months ahead.

Owing to the fact that Sonic Solutions had software available for burning DVDs earlier than InterVideo, they became an indirect competitor when the first PCs were shipped with DVD-burner drives pre-installed four – five years ago. Later Sonic was able to interest the OEMs in their burning *and* authoring software. When InterVideo introduced WinDVD Creator the two companies became direct competitors in the Digital Media *creation* software market.

One reason that Sonic may be making competitive progress in the DVD software *player* market is because of their ability to integrate features of CinePlayer with their DVD creation technology. For example, users who have created DVD projects in related Sonic creation software can edit those projects directly from CinePlayer.

It remains to be seen whether Sonic will continue to gain market share in player software merely because their management thinks they can. However, InterVideo management readily acknowledges that they expect their business with Hewlett-Packard to decline starting in the fourth quarter of this year because H-P will no longer incorporate InterVideo products in certain future notebook computer models.

During the June quarter Hewlett-Packard and Toshiba accounted for about one-third of InterVideo's total revenues. H-P represented 25% of the total and Toshiba was 9%.

The convention for recording sales within the OEM sector relies upon a reporting procedure from the OEMs themselves. Basically, on a monthly or quarterly basis, InterVideo's OEM customers will report to the company the number of PCs shipped with the company's software pre-installed. When InterVideo receives the reports it invoices the OEM and recognizes the revenue. A favorable aspect of the practice is that the OEMs are essentially acknowledging the validity of the sales at the start of the process which tends to enhance collections. This is evidenced by the company's low DSOs which averaged only 21 days at the end of March.

The sharp DSO increase in June to 57 days was partly due to the acquisition of Ulead. The new subsidiary has a greater preponderance of sales through brick & mortar retail channels where DSOs are typically longer. It was also partially due to the unilateral decision by one sizeable customer to be billed late in the quarter. The large receivable has subsequently been paid-off.

In addition to favorable DSOs, the OEM business has low selling expense ratios. There are only a limited number of customers to sell and each one tends to buy in large quantities.

Although there are a number of favorable aspects to the OEM business, there are a couple of cautionary points as well.

First, the business is characterized by fierce price competition. Since the PC manufacturers are themselves under constant pricing pressure, they pass it along to their vendors. This has been a fact of life for InterVideo from the beginning.

Second, the Standard DVD is approaching the end of its life cycle. While the Standard DVD drives already purchased by consumers will work for decades to come, the manufacturers are finding that the volume of shipment growth is slowing and may soon decline. In order to re-stimulate growth it may well be necessary for High Definition DVD drives to enter the market. While early versions of such drives have been manufactured in competing formats, there is not yet an industry standard.

When such drives *are* shipped in large volume they will represent a discontinuity in product evolution. Classically, it is at such points of discontinuity where a shift in industry leadership can sometimes occur if the current front runners do not maintain technological leadership.

Retail. Typically InterVideo will offer premium versions with enhanced capabilities of its OEM software through familiar retail chains like Best Buy and CompUSA. For example some of the advanced features on WinDVD -7 Platinum include, support for Windows Media 9, high quality audio (DVD-Audio & HD-Audio), RealMedia, Quicktime, and MPEG-4. The Platinum version retails for about $70 whereas the basic version is typically priced to OEMs at a low single digit price point. Retail versions of WinDVD Creator are the Gold and Platinum editions. The Gold edition is $50.

Finally, the company offers a number of software programs, some of which are not widely available on an OEM basis, to (1) watch, (2) create, (3) record, or (4) burn Digital Media. In point of fact, there are over 20 editions of InterVideo software for the four functions. However, InstantON is presently only available on an OEM basis.

The Ulead acquisition increased InterVideo's exposure to the conventional retail channel. The new subsidiary generates a proportionately larger share of revenues through the retail channel. Among the leading products sold at retail are software for editing video and burning it to DVD, as well as a separate package for editing and burning digital still photography pictures. We estimate that about 80%, or more, of Ulead's sales are presently generated through a combination of conventional retailers or online sales at various websites.

Website. Although the revenue yield per unit in the conventional retail channel is much higher than in the OEM channel, it is also sometimes subject to returns and allowances that can be costly to InterVideo if the retailer fails to move the products. Additionally, there is a high selling expense ratio associated with the channel owing to the inventory requirements, shipping expenses, and multi-tier distribution characteristics of the industry. Thus, whenever possible, InterVideo probably prefers to make sales of its "retail" software (e.g. premium versions) directly online. It is probably most economical when the software is sold as a download, although sales for which the customer has asked for packaged software to be shipped at least eliminates the inventory risk attendant to the conventional retail channel. Since customers in this category typically buy with a credit card, there is virtual no credit risk either.

One way to generate sales at the website is to provide a direct way for users of the OEM product to upgrade should they choose to do so. Since the revenue yield per unit is high in this channel, InterVideo can offer to share a portion of the sale with the OEM that originally placed the product on the PC to begin with. In point of fact, we believe that a proven ability to generate after-market sales (with revenue sharing) of premium versions of OEM software is an important determinant of just which software vendor the OEM may choose. In our analysis, this area will be an important battle ground in the future between InterVideo and Sonic Solutions.

Geographic Territories

The table on the following page provides a summary of InterVideo's sales by geographic territory. It is significant to note that Japan is almost as important a market for the company as is the United States. During the second quarter Japan accounted for 41% of total sales as compared to 43% here in the United States. This is partly explained by the disproportionate share of business done by Ulead in Japan. However, even in the first quarter when Ulead had not yet been acquired, Japan still represented almost 30% of corporate sales which was about half as important as the near 60% share for the U.S. market.

Since the InterVideo's Japanese market is nearly as big as the U.S. one, investors would be well advised to stay current on industry developments in Japan as well as in the United States. It is not unusual for product innovations from manufacturers of PCs, mobile devices, and consumer electronics appliances to originate in Japan. Some of those innovations could impact InterVideo before we see them introduced into the U.S. market.

Quarterly Revenue By Geographic Region Millions of Dollars		
	Year 2005	
	Q1	Q2
United States	$ 12.8	$ 11.8
Japan	6.3	11.2
Europe	1.8	3.0
Other Asia	0.9	1.6
Total Revenues	**$ 21.8**	**$ 27.6**

Quarterly Revenue By Geographic Region Percentage Breakdown		
	Year 2005	
	Q1	Q2
United States	59%	43%
Japan	29%	41%
Europe	8%	11%
Other Asia	4%	6%
Total Revenues	**100%**	**100%**

Significant Industry Characteristics

There are three industry characteristics that will have an important bearing on InterVideo's future: (1) Product Cycles, (2) Industry Consolidation and (3) Technological Market Extension.

Product Cycles

One important way for the computer manufacturers to motivate consumers to buy more units is to add new features. It is not enough to merely keep lowering the price, because many of us don't care a great deal about whether we can do word processing and spreadsheets with lower priced units, even at faster speed. We are looking for new applications, and Digital Media is at the heart of our interest.

Accordingly, the PC manufactures are constantly searching for new devices which can be integrated into the units on a factory installed basis. Not only does it help stimulate consumer demand, but it also tends to help maintain, or even, increase the average selling price to the consumer. The table below summarizes the major product cycles that have importantly influenced InterVideo in the past along with a couple that could be important in the future.

DVD Product Cycles

DVD Technology	Year Introduced	InterVideo Products
Playback DVD Drives	1996	WinDVD
Recordable DVD Drives	2000	WinDVD Creator
High Defiinition DVD Drives	2006	Q4- 2005

Source: Inside Digital Media

When PC manufactures began to ship computers with DVD player drives pre-installed, InterVideo's WinDVD practically became an industry standard among the OEMs. Dell was the only significant exception as they dual sourced from CyberLink and InterVideo.

The introduction of the recordable DVD drive gave rise to a demand for Digital Media *creation* software. The concurrent rise in popularity for digital camcorders implied that family movies were likely to be the major source of content for burning onto the new blank DVD media. As noted earlier, Sonic Solutions was the first to obtain OEM contracts for DVD-burning software. Shortly thereafter, InterVideo introduced WinDVD Creator and the two companies have been battling one another ever since.

Today, the DVD industry is on the threshold of a similar transition. Increasingly, consumers are purchasing televisions that are capable of displaying High Definition video, but a single conventional DVD does not have enough data capacity to hold an entire High Definition movie. Accordingly, there is a trend toward the adoption of a new High Definition format for DVDs.

At present there are two competing standards. On one side is Sony's so-called Blu-ray technology, which handles more data and has more backers, including most of the consumer electronics world (Matsushita, Samsung, Apple, Dell, Hewlett-Packard, and Disney, among others). On the other side is Toshiba with its so-called HD-DVD standard. Toshiba's backers, though fewer, are potentially just as powerful since they include Microsoft, NEC and Intel as well as most of the Hollywood studios such as Paramount, Universal, and Warner Brothers. Toshiba's discs can also be manufactured on the same production equipment as is used for standard DVDs.

Although there have been reports in the press that the two opposing camps may join forces to hammer out a single standard so far this has not been accomplished. More recent reports suggest that the two sides may not be able to come to an agreement.

Whatever the outcome of the standards battle, once the manufacturers start to design-in High Definition DVD drives into popular models of PCs, it is likely that there will be significant demand for a successor product to the standard WinDVD. InterVideo hopes that it will retain, or improve, its market position in the High Def market by developing a successor product that soundly beats the competition. While its R&D staff has been working vigorously to achieve the objective, it was thought that the acquisition of Ulead would enhance their prospects. For example, Ulead developed the accepted laboratory reference tool for the Toshiba HD-DVD format.

During the shareholder briefing conference call on August 15th following the release of June quarter financial results, management stated that they expect to have High Def software products available in the fourth quarter of this year.

Industry Consolidation

The computer industry is consolidating. A few years ago the second and third largest industry factors combined when Hewlett-Packard acquired Compaq. More recently the erstwhile industry standard, IBM, sold its PC business to Lenovo Group which is the largest supplier of PCs in China. Similarly, a little over a year ago, Gateway Computer acquired eMachines.

Just as the OEM customers for multimedia software are consolidating, so also are the vendors of such software. Five years ago the market for multimedia PC-software was structured differently. At the time, Microsoft provided applications with only the barest video editing and CD-burning capabilities. As a result independent software vendors began to thrive in those markets. They segmented into two general categories (1) Video and (2) CD-burning.

It was clear that the providers of CD-burning software would have to rapidly evolve. The first movers could not sustain a significant technological advantage over latecomers. Moreover, Microsoft was likely to enhance the capabilities of its own media applications. All indicators pointed toward CD-burning becoming a commodity function.

Additionally, CD-burning was destined to become an integrated feature in other entertainment-centric programs like iTunes, MusicMatch and even the Windows and Real media players. As a result the suppliers of CD-burning software were likely to move into the video space. Clearly, the business was going to be more competitive even though it might grow rapidly. Market share, and the distribution relationships that went with it, were going to become important.

Five years ago video software suppliers included MSI, Ulead, InterVideo, Adobe, Pinnacle Systems, and Sonic Solutions, among others. Companies like Adaptec, Veritas, Nero, and Sonic Foundry were providers of CD-burning software. As

predicted, today there are dozens of CD-burning programs available from a wide variety of vendors.

Recognizing the market opportunity that was emerging, as well as the evolutionary trends that were likely to impact it, Adaptec decided to spin-off its CD-burning software line into a new independent company called Roxio. Adaptec was then, and remains today, primarily focused on providing computer storage devices. It was thought that the CD-burning software business would be more flexible to the changing market environment, and therefore perform better, as an independent company. The major product, *Easy CD Creator*, had the industry's leading market share at the time, on both an OEM and retail basis.

Almost immediately, Roxio began to move into the video editing software market. First, in 2001 it acquired a Canadian company called MSI which was a leading independent supplier. Second, a year or so later it began to integrate video editing and DVD-burning capabilities into the *Easy CD Creato*r line.

Sonic Solutions also began acquiring other companies. At the time, Sonic was focused entirely on the DVD market. So in 2002 it acquired the CD burning technology from Veritas Software. It was a minor line of business for Veritas which remains to this day primarily a supplier of storage and infrastructure software with about $2.5 billion in annual revenues. In July, Veritas was itself acquired by Symantec.

Last year, Sonic Solutions decided to take an even bigger step and acquire the entire line of Roxio software. Roxio was a willing seller because it had gradually evolved its business in an entirely new direction when it acquired the assets of Shawn Fanning's Napster out of bankruptcy. Roxio also acquired the legitimate digital music download business operated by Sony and Universal, named PressPlay.

With the PressPlay record label contracts and software engine, Roxio renamed itself Napster and started competing with a strong brand name in the rapidly growing legitimate digital music market. Accordingly, Roxio agreed to sell the entire Roxio software line to Sonic Solutions for a price of $80 million in cash and $10 million in stock. The deal closed toward the end of last year.

In April, the competition for market share intensified as Avid Technology announced plans to acquire Pinnacle Systems. To date, Avid is best known as a provider of video editing software and systems for professional markets like television and Hollywood post production companies. They are strong on technology and quite successful in their traditional markets. The Pinnacle acquisition appears to crystallize their long-speculated interest in moving into the consumer market, although Pinnacle also competes with, and now will complement, Avid in the professional markets.

During the period of merger activity noted above, Adobe was broadening its penetration into the mass consumer market as well. Originally its *Premiere* video editing software was available only in expensive versions mostly suitable for the professional or semiprofessional user. The package was priced at more than $500. Today Adobe provides a variety of video editing products at a range of price points. For example, there is a home edition termed *Premiere Elements* that retails for $100 whereas *Premiere Pro* sells for $700. Finally, Adobe is in the process of acquiring Macromedia in a $3 billion-plus transaction.

In short, the *industry* in which InterVideo competes is consolidating. As a result, InterVideo concluded that they too would be best advised to participate in the trend. They searched for a company with complimentary products and incremental technology, particularly in the High Definition area. The search resulted in the acquisition of controlling interest in Ulead.

Consider the complimentary aspects of the two companies from the point of view of (1) products, (2) technology, and (3) distribution.

In terms of products, InterVideo is *the* leading provider of DVD player software and among the leaders in consumer DVD authoring software. Ulead is a leader in photo-editing and high-end DVD authoring.

In part because Ulead became a front-runner in the professional end of the market, it acquired advanced capabilities in the High Definition arena as well. As noted, Toshiba selected Ulead's HD-DVD authoring tools as reference standard for the format.

While the ultimate outcome of the High Definition standards battle cannot be known, it seems likely that *some* standard will ultimately emerge. This may happen by either an agreement or on a *de facto* basis after one has established a dominant market share.

In terms of distribution, it is thought that InterVideo and Ulead have complementary strengths in the distribution channels. For example, InterVideo's market position is strong with top tier OEMs like Hewlett-Packard, Toshiba, and IBM (Lenovo), among others. InterVideo may be able to leverage these relationships and successfully sell complementary Ulead products as well. For example, Ulead has a photo-editing product line that InterVideo does not have.

Even as the market for multimedia software grows, it is clear that the retailers will not want to carry a wide variety of brands. Instead they'll likely devote shelf space to the best sellers and seek out vendors financially strong enough to provide generous promotional allowances.

Adobe has always enjoyed sturdy relationships with retailers. The fact that it has moved into lower priced multimedia software will make it an even stronger

contender. Avid is a successful and profitable company. Whether they will be able to use their good reputation in the professional markets to leverage the Pinnacle position in the consumer market remains to be seen. Pinnacle may well be a more robust competitor as part of Avid than as an independent company.

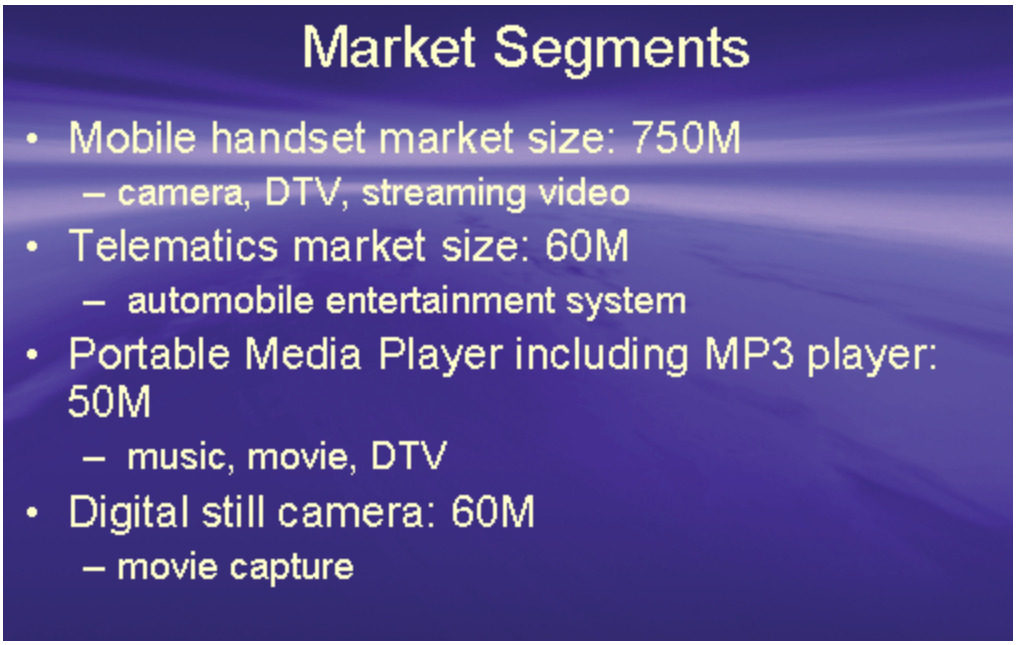
The fight for shelf space will be fierce because it is crucial. Both Sonic Solutions and InterVideo recognize the point. As noted in our discussion of the industry background, both, starting with Sonic, have sought to increase market share through acquisition.

Technological Market Extension

As computer technology becomes ever-cheaper and more compact, Digital Media is likely to invade new markets as familiar devices become increasingly software intensive. Two examples are: (1) future mutant forms of the cellular telephone and (2) consumer electronics appliances.

M**obile Device Opportunities.** Although the PC may not be at the end of its lifecycle, it is clear that the semiconductor industry's ability to place increasingly complex functions on a single chip of silicon means that computer-like capabilities will become common in a large number of devices aside from the PC. Many such devices will be mobile and communicate via wireless networks. In the future, it is thought likely that mobile devices will gradually become increasingly capable of media playback and record applications. For example, today it is quite common for mobile phones to contain low resolution digital cameras. As the resolution performance improves, there may well be opportunities for InterVideo to develop software to address the market.

InterVideo sees market opportunities in four product sectors as outlined in the figure below. First, there are about 750 million cell phones produced annually throughout the World. Many of them have low resolution cameras built-in, and also have the capability to receive streaming video. Second, the market for automobile entertainment systems is about 60 million units annually worldwide. As the entertainment systems become increasingly more software intensive, there will be a growing need for media applications software. Third, the portable music (e.g. MP3) player market is about 50 million units annually. The industry is starting to introduce models that display photos, and are capable of streaming video and DTV. Finally, there is the digital still camera market which totals about 60 million units annually. Many such cameras are capable, not only of still pictures, but also moving (video) ones as well. As such capabilities improve there could be a demand for higher performance media applications software.



Source: InterVideo

The movement toward media integration into mobile devices is going to be a complex industry transition. There are a lot of moving parts and no single company can cover all the handheld platform complexity. Put briefly, there are three dimensions to the complexity: (1) mobile controller, (2) operating system, and (3) codec. Consider each dominion individually.

First, there are three types of mobile controllers, (1) ARM, (2) Xscale, and (3) Texas Instrument DSP. Second, there are numerous operating systems for simple devices and smart ones. eSol applies to simple ones and smart ones are divided among Symbian, Linux, and Windows mobile. As for the codec, there are requirements for speech recognition, audio playback, and video playback. There is quite an alphabet soup of them numbering more than a dozen.

Owing to the complexity of the industry's transition toward media-enabled portable devices, InterVideo's strategy is to target a single tier-one OEM customer in 2005. The objective is to create a flagship effect that will attract other tier-one OEMs in 2006. Specifically, in 2005 InterVideo will seek to have media software installed on a 3 mega pixel Digital Video (DV) phone. They will focus on field trials in Japan and Korea.

Consumer Electronics Appliances. For decades popular consumer electronics appliances such as televisions and stereos have been analog systems. Moreover, they have been "dumb". That means they have been merely playback devices with no intelligence or memory functions of their own. Even digital appliances like DVD consoles and CD players have been "dumb'. They merely play-back the content of the discs through analog amplifiers and display screens.

Beginning with the TiVo, however, consumer appliances began to become more intelligent and software intensive. For example, the TiVo has memory for storing your selected programs so that you can watch them when it suits *your* schedule instead of waiting for the shows to be broadcast by the television stations.

Additionally, TiVo is “intelligent” in three ways. First, it has an easy-to-use interface that helps you find the programs that you want to record before they are broadcast. Second, it will monitor your viewing habits. If space is available on the disc it will automatically record programming that it “thinks” matches your interest. Third, it constantly maintains an up-to-date program guide that enables you to search for shows that you want to see up to two weeks before they are broadcast.

It is likely that future consumer electronics appliances will become even more software intensive. As they become so, they will need to cease relying entirely upon the analog domain. For example, the digital domain is superior for searching and indexing because of the use of metadata embedded in the media files.

In sum, as consumer electronics appliances become increasingly software intensive they will become ever-more reliant upon the use of Digital Media. This trend may well create opportunities for InterVideo to sell components of its playback, record, create, and burn software. The vendor relationship with Microsoft’s soon-to-be-released Xbox 360 is merely one example.

Risk Factors

There are a number of risk factors relating to InterVideo’s business that the reader should carefully evaluate. Among them are the: (1) change of auditors, (2) identification of control deficiencies, (3) significant change in the scope of the company’s operations as a result of purchasing controlling interest in Ulead, (4) pricing pressures in the OEM market, (5) potential shift from standard to advanced DVD technologies, (6) limited resources of the company compared to certain competitors, and (7) concentrated customer base.

Auditor Change

In June the company’s traditional CPA firm, KPMG, informed InterVideo that it would no longer continue to serve as the company’s auditor. Before the end of the month, InterVideo engaged Grant, Thornton as its new certifying accountant.

Since many aspects of the relationship between an accounting firm and its clients are inherently private, there can be no assurance that any outsider will know the full reasons when a relationship is terminated. However, in an 8-K filing with the SEC on June 17th, a letter from KPMG to InterVideo was included as an exhibit. Essentially KMPG basically stated that it had no major issues with the accounts

other than those previously disclosed (some of which are discussed below) by the company in earlier public filings.

Audit Report

Overview. As noted, until June 10th, InterVideo's auditors were KPMG and they were replaced by Grant, Thornton June 30th.

KPMG provided an unqualified opinion for the calendar year 2004 financial statements. However, as required by Sarbanes-Oxley, management conducted a review of their financial controls. They identified a number of financial control deficiencies that were reviewed by KPMG. The auditors agreed with the deficiency findings of the management review. Owing to Sarbanes-Oxley such deficiencies are required to be disclosed to shareholders. Since this is the first year of full Sarbanes-Oxley implementation, the matters are discussed in some detail.

Essentially "material weaknesses" were identified relating to InterVideo's internal controls over financial reporting. In plain language, a "material weakness" in the internal financial controls means that there is *more* than a remote risk that there was a material misstatement in the company's financial reports to shareholders in calendar 2004. This applies to both the full year and the interim periods of calendar 2004.

There were three basic problems.

Software Licensing. It was thought that InterVideo had inadequate controls to effectively identify and monitor software license agreements. It appears that there was "more than a remote" risk that accounting personnel "in the normal course of performing their activities" may not have been aware of changes in licensing agreements that would impact revenues recognized.

In response, during the March quarter of this year, InterVideo hired a full-time general counsel who will have a significant role in the contract review process. The company also hired a contracts administrator who is responsible for reviewing and monitoring all contracts.

Income Taxes. The review indicates that InterVideo did not have sufficient controls over the tax accounting practices, estimates, calculations, and required disclosures. As a result, for calendar 2004 material errors were identified in both the current and deferred taxes. The errors were corrected before the release of calendar 2004 financial results to the shareholders.

In response, in the March 2005 quarter InterVideo executed a new engagement with their external tax service provider. There will be meetings between management and the tax service provider at least bi-weekly. InterVideo also

plans to initiate communications whenever appropriate to update the tax provider on strategic initiatives and forecasted results.

IT Duty Segregation. The review disclosed that the company did not have adequate controls within the accounting and financial information systems relating to the access, segregation of duties, and monitoring of information systems. As a result, instances were identified whereby certain individuals had access and authority to initiate financial transactions that were not consistent with their respective roles and responsibilities. As a result, it appears that there was "more than a remote" possibility that a material misstatement of financial results could not have been detected or prevented.

To respond, during the December quarter of last year InterVideo hired a Director of Information Technology (IT) whose responsibility is to identify, design, and implement the necessary systems, controls, and procedures to ensure that the company's IT infrastructure is adequate to meet current and future needs. Under the IT Director, the company has implemented IT access limitations over certain individuals to be more consistent with their duties. The company has also purchased a software tool to provide an audit trail and log any unauthorized access.

Ulead Acquisition

Although management clearly envisions material benefits will result from gaining a controlling interest in Ulead, readers should be aware of potential risks as well.

First, Ulead is a company located in Taiwan, which is thousands of miles from InterVideo's headquarters in Silicon Valley and rooted in a different culture.

Second, at least initially, InterVideo will have minority shareholders in Ulead. It is possible that such shareholders may have interests that are not always consistent with those of InterVideo. Moreover, InterVideo acquired its shares in Ulead via open market purchases and a tender offer as opposed to a "friendly" negotiated transaction. This could imply that certain minority shareholders may be a source of disharmony. In short, there is a potential for conflict that cannot be determined by an outsider especially since the change in control at Ulead is so recent.

Third, Ulead is a comparatively large company for InterVideo to acquire. We estimate that it is about one-third the size of InterVideo in terms of revenues.

Fourth, InterVideo's distribution channels are strong with Tier One OEMs whereas Ulead derives most of its revenues from retail channels and Tier Two OEMs. While these are potentially complimentary strengths, they are also differences that must be managed.

OEM Pricing Pressures

Traditionally the OEM market has been characterized by steadily declining unit pricing. This applies particularly to established software products that do not improve much year-to-year in terms of features such as the basic WinDVD. Over the years, the OEMs have consistently negotiated ever-lower prices for WinDVD owing to (1) growing availability of competitive products, (2) constant pressure on the asp's (average selling prices) for computers and (3) growing unit volume shipments. While the rate of volume growth may attenuate thereby alleviating pricing pressure from that source, the other factors may continue to adversely impact pricing and they may even intensify.

Shifting DVD Technology

InterVideo became the near-standard DVD playback software for the PC market soon after PC manufacturers started offering computers with DVD drives. However, the next generation of DVD players will utilize new technologies such as HD-DVD and Blu-ray. Anytime there is a shift in technology there are discontinuities in the evolution of an industry. It is at such discontinuities that a leadership shift sometimes happens. Thus, there can be no assurance that InterVideo will be able to retain high market share it won with WinDVD in the developing High Definition (HD-DVD and Blu-ray) markets.

Limited Resources

Although the company is of similar size to its most comparable competitor, Sonic Solutions, it is quite small by comparison to other competitors like Adobe and Avid Technologies. To the extent that Mac's compete in the marketplace, it is also quite small in relation to Apple computer. Finally, it is *tiny* by comparison to Microsoft and readers should be aware that Microsoft could choose to enter most any applications software market unexpectedly at any time.

Customer Concentration

During the June '05 quarter almost 70% of revenues were derived from OEM customers which is a market typically characterized by high customer concentration. Fully one-third of sales were obtained from just two customers. Hewlett-Packard contributed 24% and Toshiba 9%.

While customer concentration is high in a conventional sense, it has been materially lowered as a result of the Ulead acquisition. For example, the two

largest customers in the first quarter (prior to the Ulead merger) represented nearly half of total sales instead of the one-third reported in the June quarter.

Second Quarter Financial Performance

The table below provides a summary of InterVideo's financial performance during each of the past ten quarters up through the June period of 2005.

Quarterly Financial Performance
GAAP Basis

	Year 2003					Year 2004					Year 2005	
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2
Revenues												
WinDVD	$ 11.0	$10.9	$11.9	$13.2	$47.0	$ 14.7	$12.2	$12.2	$13.7	$52.7	$ 13.8	$ 12.5
VideoStudio												3.3
Other	2.4	2.2	2.4	3.1	10.1	4.1	4.5	6.3	6.7	21.7	8.1	11.8
Total Revenues	**$ 13.4**	**$ 13.1**	**$ 14.3**	**$ 16.3**	**$ 57.1**	**$ 18.8**	**$ 16.7**	**$ 18.5**	**$ 20.4**	**$ 74.5**	**$ 21.9**	**$ 27.6**
Cost of Revenues	5.4	5.4	5.4	7.6	23.8	7.9	7.7	8.3	8.9	32.9	9.2	10.4
Intangibles Amortization												0.5
Gross Profit	**8.0**	**7.7**	**8.9**	**8.7**	**33.3**	**10.9**	**9.0**	**10.2**	**11.5**	**41.6**	**12.7**	**16.7**
% Margin	59.7%	58.8%	62.2%	53.4%	58.3%	58.0%	53.9%	55.1%	56.4%	55.8%	58.0%	60.5%
Operating Expenses												
R & D	1.7	1.9	1.9	2.1	7.6	2.3	2.6	2.3	2.7	10.0	3.0	5.4
Sales & Marketing	2.3	2.1	2.2	2.3	8.9	2.8	2.7	2.3	2.5	10.2	2.8	5.3
General & Administrative	1.0	0.9	1.0	1.5	4.4	1.7	2.0	3.1	2.3	9.1	2.9	4.0
Acquired In-Process R & D												4.8
Stock-Based Compensation	0.3	0.2	0.2	0.2	0.9	0.1	0.1	0.1	0.1	0.3	-	-
Total Operating Expenses	5.3	5.1	5.3	6.1	21.8	6.9	7.4	7.8	7.6	29.6	8.7	19.5
Operating Profit (Loss)	**2.7**	**2.6**	**3.6**	**2.6**	**11.5**	**4.0**	**1.6**	**2.4**	**3.9**	**12.0**	**4.0**	**(2.8)**
Non-Operating Income	0.1	0.1	0.1	0.3	0.6	0.2	0.3	0.2	0.3	0.9	0.3	(1.0)
Pre-Tax Income (Loss)	**2.8**	**2.7**	**3.7**	**2.9**	**12.1**	**4.2**	**1.9**	**2.6**	**4.2**	**12.9**	**4.3**	**(3.8)**
Income Taxes	1.2	1.1	1.4	0.6	4.3	1.6	0.8	1.3	0.4	4.1	1.7	0.7
% Rate	42.9%	40.7%	37.8%	20.7%	35.5%	38.1%	42.1%	50.0%	9.5%	31.8%	39.5%	
Minority Interest												0.3
Net Income	**$ 1.6**	**$ 1.6**	**$ 2.3**	**$ 2.3**	**$ 7.8**	**$ 2.6**	**$ 1.1**	**$ 1.3**	**$ 3.8**	**$ 8.8**	**$ 2.6**	**$ (4.2)**
Per Share Earnings												
Primary	**$ 0.64**	**$ 0.62**	**$ 0.21**	**$ 0.18**	**$ 1.07**	**$ 0.20**	**$ 0.08**	**$ 0.10**	**$ 0.28**	**$ 0.66**	**$ 0.19**	**$ (0.30)**
Fully Diluted	**$ 0.13**	**$ 0.13**	**$ 0.16**	**$ 0.15**	**$ 0.57**	**$ 0.17**	**$ 0.07**	**$ 0.09**	**$ 0.25**	**$ 0.58**	**$ 0.17**	
Shares Outstanding												
Primary	2.5	2.6	11.0	12.8	7.3	13.2	13.4	13.4	13.6	13.4	13.8	14.0
Fully Diluted	12.1	12.1	15.0	15.4	13.7	15.4	15.4	15.3	15.3	15.3	15.4	

Upon the release of its March quarter 2005 results on May 4, 2005, InterVideo management provided forward-looking estimates for the June quarter of this year. At that time they estimated second quarter revenues would be in a range of $27 - $30 million, and fully diluted per share earnings of $0.16 - $0.18.

As the preceding table indicates, the GAAP per share loss of $(0.30) did not measure-up to the projection. However, management points out that there were a number of non-recurring, non-operating, and acquisition-related charges that account for most of the discrepancy. The table below summarizes the charges and provides an "adjusted" per share earnings figure.

Second (June) Quarter of 2005 Adjusted Net Income Millions (Except Per Share Data)		
GAAP Net Income (Loss)		**$ (4.2)**
Adjustments		
Intangibles Amortization	$ 0.5	
License Settlement Fee	0.3	
In-Process R & D	4.8	
Merger Related Expenses	0.5	
Loss on Sale of Securities	0.3	
Write-off of Long Term Investment	0.7	
Early Lease Termination Penalty	0.2	7.3
Non-GAAP Operating Income		**$ 3.1**
Minority Interest on Non-GAAP Adjustments	(0.4)	
Tax Impact on Non-GAAP Adjustments	(0.6)	(1.0)
Non-GAAP Net Income		**$ 2.1**
Non-GAAP Per Share Earnings		**$ 0.15**
Shares Used		14.0

Source: InterVideo Press Release

In sum, the adjustments total $7.3 million. About two-thirds of the adjustments are due to R & D projects that were in-process at Ulead at the time of the merger but which are now being abandoned. The remaining one-third of the differential is due to various factors ranging from a non-recurring penalty that was paid to terminate a lease early to the write-off of a long-term investment.

The net result of the adjustments after taking into account their impact on the tax rate and income to be allocated to minority shareholders of Ulead, was a per share earnings figure of $0.15. This was still below the $0.16 - $0.18 provided by management in the May 4th forward looking statements. On the analyst briefing conference call following the release of the June quarter earnings, management identified two factors that may explain the remaining shortfall.

First, sales of the Ulead product for video editing into the retail channel were behind expectations. Second, Ulead sales into the Japanese market were weak owing to the fact that Japanese distributors were temporarily overstocked with Ulead product. Japan is an important market for Ulead. Although management is not providing revenue data on Ulead *per se* it is significant to note that sales in Japan for InterVideo on a consolidated basis during the June quarter totaled 41%

of aggregate corporate revenues. The comparable figure in the first quarter, which was prior to the Ulead acquisition, was only 29%.

Steps have been taken to improve the bottom line performance at Ulead. The head count has already been reduced by 20% and a management-by-objectives program has been put in place. InterVideo management has also resolved to place more emphasis on the most profitable Ulead products.

For the third quarter, management's forward looking statements (8-15-05) project revenues at $27 - $29 million, which *does* include some non-recurring revenue. On a GAAP basis, management estimates September quarter per share earnings of $0.15 - $0.17. The GAAP per share earnings estimates include charges for intangibles amortization of $0.6 million. *Excluding* those amortization charges, management estimates adjusted per share earnings of $0.18 - $0.20.

Financial Condition

The table below provides an abbreviated balance sheet for the company as of June 30, 2005. Overall, InterVideo's financial condition appeared to be sound. Current assets exceeded current liabilities by a ratio of over 3.3-to-1.0. Cash and short-term investments represented over 75% of Current Assets and nearly half of total assets.

Condensed Balance Sheet
30-Jun-05
($ Millions)

Assets			**Liabilities**		
Current Assets			Current Liabilities		
Cash & Short Term Investments	$ 71.0		Accounts Payable	$ 2.1	
Accounts Receivable	17.4		Accrued Liabilities	18.5	
Inventory	1.9		Deferred Revenues	7.8	
Prepaid Expenses & Other	3.2		Total Current Liabilities		$ 28.4
Total Current Assets		$ 93.5			
			L-T Deferred Taxes		6.6
Property, Plant, & Equipment (Net)		24.1	Other L-T Liabilities		1.2
Goodwill & Purchased Intangibles		16.8	Minority Interest		26.4
Deferred Tax Assets		5.6			
Other		4.6	Shareholder Equity		82.0
Total Assets		**$ 144.6**	**Total Liabilities & Equity**		**$ 144.6**

Source: InterVideo SEC Filings

Since InterVideo effected a major change in its corporate structure during the second quarter, for comparative purposes we have also provided a summary balance sheet for the first quarter ended March 31, 2005. Several important changes may be noted.

First, the Property, Plant, & Equipment account grew from under $3 million to over $24 million. This primarily reflects the fact that InterVideo gained controlling interest in Ulead during the quarter and Ulead owns its corporate offices in Taiwan.

Second, the Goodwill & Purchased Intangibles line item increased from $1 million to almost $17 million. The also reflects the Ulead acquisition and represents the amount paid in excess of book value for the acquired company.

Third, Accounts Receivable increased significantly from $5 million to over $17 million. This is discussed in more detail in our DSO analysis.

Condensed Balance Sheet
31-Mar-05
($ Millions)

Assets			**Liabilities**		
Current Assets			Current Liabilities		
Cash & Short Term Investments	$ 74.5		Accounts Payable	$ 1.2	
Accounts Receivable	5.0		Accrued Liabilities	13.1	
Inventory	0.6		Income Tax Payable	1.6	
Prepaid Expenses & Other	1.7		Deferred Revenues	3.1	
Total Current Assets		$ 81.8	Deferred Tax Liabilities	1.3	
			Total Current Liabilities		$ 20.3
Property, Plant, & Equipment (Net)		2.8			
Goodwill & Purchased Intangibles		1.0			
Deferred Tax Assets		5.4			
Other		15.9	Shareholder Equity		86.6
Total Assets		**$ 106.9**	**Total Liabilities & Equity**		**$ 106.9**

Source: InterVideo SEC Filings

Fourth, inventories increased from a negligible $0.6 million to nearly $2 million. We believe this also reflects the greater proportion of sales mix into the retail channel by Ulead than was the case at InterVideo.

Fifth, the June 30, 2005 balance sheet provides a line item on the “Liabilities” side for “Minority Interest”. This reflects the fact that InterVideo only acquired about 62% of the shares in Ulead. Since it has a majority ownership, the accounting convention requires that its financial statements be consolidated, but that the equity interests of the minority shareholders be represented as a Liability on the consolidated balance sheet. There is a similar line item for their share of the consolidated profits in the income statement.

As indicated the following table, InterVideo’s Days Sales Outstanding (DSOs) increased significantly from only 21 days at the end of the March quarter to 57 days at the end of the June quarter. This partly reflects the business characteristics of selling software into retail channels where Ulead has been

much more active than was InterVideo. Management also indicates that is partly reflects the fact that one large customer asked to be invoiced before the end of June. The customer has since paid-off the invoiced receivable.

DSO Trends

	Year 2003				Year 2004				Year 2005	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
End of Quarter Receivables ($ mil.)		4.4	6.9	5.5	9.5	7.0	8.0	5.7	5.0	17.4
Revenues ($ mil.)	13.4	13.1	14.3	16.3	18.8	16.7	18.5	20.4	21.9	27.6
Average Days Sales Oustanding (DSOs)		**30**	**43**	**30**	**45**	**38**	**39**	**25**	**21**	**57**

Source: SEC Filings and Inside Digital Media Calculations

For comparative purposes, the table below shows the DSO trends at Sonic Solutions which may be the most comparable public company. Prior to acquiring Roxio, the DSOs at Sonic Solutions were running rather high. Presumably, the OEM business at Roxio has brought the ratio down to where it was 34 days at the end of June. The discrepancy in DSOs between InterVideo and Sonic Solutions indicates that the prudent investor will continue to monitor the DSO trends at InterVideo.

Sonic Solutions DSO Trends - Fiscal Years Ended March 31st

	Year 2004				Year 2005				2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
End of Quarter Receivables ($ mil.)	5.3	4.5	8.9	9.4	7.0	9.5	14.8	12.8	13.6
Revenues ($ mil.)	12.0	12.7	14.8	17.3	17.9	17.4	19.7	35.6	35.5
Average Days Sales Oustanding (DSOs)	**40**	**32**	**54**	**49**	**35**	**49**	**68**	**32**	**34**

Source: SEC Filings

OEM business in InterVideo's industry sector should normally exhibit low DSOs. Typically, revenues are recognized only after the OEM has already shipped the product. In point of fact, the OEM normally is the first party in the contract to acknowledge the sale. This is because the OEMs first report their shipments to the supplier (e.g. InterVideo) and only then does the vendor (e.g. InterVideo) recognize the revenue from those shipments.

The following table provides a summary of InterVideo's Deferred Revenue trends. Essentially, deferred revenue represents sales for which the company has already been paid but has not yet recognized as revenue. In general, the higher the ratio of end-of-period Deferred Revenue to the revenues actually reported during the period on the income statement, the more predictable the revenues for the ensuing quarter. As may be observed, during the past eight quarters, Deferred Revenue ranged between 9% and 28% of revenue reported on the income statement for the same period. The ratio at the end of the June quarter of '05 was the highest since InterVideo has been public.

Deferred Revenue Trends

	Year 2003				Year 2004				Year 2005	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
End-of-Period Near-Term Deferred Revenue ($ Mil.)		$ 1.2	$ 2.6	$ 3.4	$ 3.7	$ 4.1	$ 3.4	$ 4.0	$ 3.1	$ 7.8
Total Revenue ($ Mil.)		$13.1	$14.3	$16.3	$18.8	$16.7	$18.5	$20.4	$21.9	$27.6
Deferred Revenue As % Of Total Revenue		**9%**	**18%**	**21%**	**20%**	**25%**	**18%**	**20%**	**14%**	**28%**

Source: SEC Filings and Inside Digital Media Calculations.

Conclusion

InterVideo's management is positioning the company to be ready for the next major product and technological cycles that will impact the market for Digital Media software. One major focus is to be a leader in the emerging market for high-definition DVD drives on PCs once such drives become commonly available on the market. Management believes that the acquisition of Ulead will materially aid this effort. During the investor briefing conference call following the release of the June quarter financial results, management indicated that they expect to have their first HD products available by the fourth quarter of this year.

The company also foresees the possibility of extending their technological capabilities into new markets such as mobile telephones and software-intensive consumer electronics appliances. For example, they recently announced that Microsoft's new Xbox 360 will be using InterVideo technology for the playback of DVDs.

While management is taking cogent steps to address new market opportunities, they also face important challenges. For example, Sonic Solutions appears to be raising its profile as a competitor after entering the market when the DVD-burner product cycle came into play. The new battleground for high-def Digital Media software will be an intense one. There is not yet a standard, but the stakes are high because the conventional DVD is becoming a mature product.

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