

VirnetX Holding Corporation (ASE/VHC)

Neutral **Not standing pat on patents**

VirnetX holds patents and technology for secure real-time communications

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Investment Highlights

1) VirnetX is progressing with its patent litigation against Apple, Cisco, et. al. – The Markman hearing for VirnetX’s patent litigation against Apple (Nasdaq/AAPL/Not Rated), Cisco (Nasdaq/CSCO), Aastra and NEC was completed in early January, and the next step is expected to be the filing of the Markman ruling by Judge Davis. While this process can take up to six months in a major case (as was the experience with VirnetX’s litigation against Microsoft), Judge Davis has another significant patent case on his schedule set to begin in early February, and it is very possible that the Judge will want to publish his ruling on *VirnetX vs. Apple et. al.* in an abridged version as early as the end of next week. If the Markman ruling is favorable toward VirnetX’s position, all sides could begin settlement negotiations this quarter; if not favorable or if Apple, Cisco and the other defendants prove stubborn regarding settling then the case could go to trial, meeting up with the other defendants (Siemens, Avaya and Mitel) later this year. The Siemens-Avaya-Mitel Markman ruling is scheduled for July 2012; the trial date for both cases will most likely occur in November 2012.

2) VirnetX is also making progress on other fronts – VirnetX’s action against Apple with the US International Trade Commission (ITC) filed in November 2011 is advancing within the system. First, an evidential hearing date has been set for September 2011, followed by an early December deadline for a determination or recommendation to be completed by the hearing examiners, with a final decision expected by April 2013. Meanwhile, VirnetX has not been standing pat regarding its patent portfolio, having recently been awarded a new patent (#8,051,181 - *Method for Establishing Secure Communication Link Between Computers of Virtual Private Network*) by the USPTO. This patent (the “181 patent”) was the basis for the recent ITC filing against Apple and was also included in the ongoing patent litigation against Apple et. al. The Company’s patent portfolio now includes 20 U.S., 20 international patents and over 100 pending applications. Finally, VirnetX had its key ‘180 patent upheld by the USPTO in late

Current Price **\$24.20**

Price Target **N/A**

Estimates	F2009A	F2010A	F2011E
Revenues(\$000s)	\$26	\$200,068	\$10
EPS	(\$0.35)	\$0.84	(\$0.29)

Stock Data	
52-Week Range	\$11.02-\$41.77
Shares Outstanding (mil)	50.4
Market Capitalization (mil)	\$1,219.7
Enterprise Value (mil)	\$1,154.4
Debt to Capital (9/11)	0.0%
Book Value/Share (9/11)	\$1.43
Price/Book	16.9 x
Average Trading Volume (10-Day)	1,020,000
Insider Ownership	18.9%
Institutional Ownership	26.9%
Short interest (Million shares)	12.2
Dividend / Yield	\$0.00/0.0%



Price target and ratings changes over the past 3 yrs:
 Initiated - December 2, 2009 - Buy -Price Target \$6.00
 Updated - March 1, 2010 -Price target raised to \$8.00
 Updated - September 8, 2010 -Price target raised to \$12.00
 Updated - November 22, 2010 -Price target raised to \$18.50
 Updated - May 31, 2011 -Rating lowered to Neutral

December, following a re-examination requested in October 2011 by litigation defendant Cisco.

3) The Company continues to maintain significant financial resources in order to continue its patent litigation strategy while awaiting potential settlements and/or technology licensing agreements – At the end of the most recent fiscal quarter, ending September 30th, VirnetX had a little over \$65 million in cash or equivalents on hand, with no long-term liabilities. For the first nine months of the year, the Company used approximately \$8 million in cash on administrative costs, R&D and outside services (primarily legal), offset to some extent by proceeds from the exercise of options and warrants from earlier financings completed at much lower prices.

Conclusion

VirnetX's shares have bounced around considerably since our most recent update in mid-2011, ultimately settling at the present near the mid \$20's price indicated at the time of our update. Despite progress made by VirnetX over the past six months in the patent litigation area, investors may not desire to push these shares higher in the near-term in the absence of a patent licensing agreement or Markman ruling in the most imminent Apple, Cisco litigation, and thus we are maintaining our Neutral rating on VHC shares, although we would reconsider our recommendation should these shares revisit last year's low levels around \$15.

Stock Valuation/Comparables

We have compiled a six-stock comparison group for VirnetX, including both small and large providers of communications equipment and services. Some of the companies in our comparable table are competitors in the internet security space, including SBC providers Acme Packet (Nasdaq/APKT/Not Rated) and AudioCodes (Nasdaq/AUDC/NR), while others in our group are potential partners such as Qualcomm (Nasdaq/QCOM/NR) and VeriSign (Nasdaq/VRSN/NR), and the remaining pair, Broadcom (Nasdaq/BRCM/NR) and InterDigital Communications (Nasdaq/IDCC/NR) simply compete in related markets. Our valuation on VirnetX is compiled through a part-by-part valuation analysis considering the following components:

- 1) **Cash on hand;**
- 2) **Recently filed litigation (Apple, Cisco, et.al.);**
- 3) **Potential new litigation;**
- 4) **Potential licensees; and**
- 5) **Potential revenue streams and contribution from Gabriel/SDNI.**

For further documentation related to our earlier price targets, please refer to our most recent update with a Buy rating, published on March 29, 2011.

Catalysts/Investor Timeline

- 1) Licensing Agreements – Ongoing, upfront fee plus royalties – 2012
- 2) Filing of additional patent litigation – 2012
- 3) Markman ruling for Apple/Cisco, et al. patent litigation – early to mid-2012
- 4) Trial dates for Apple/Cisco, et al. patent litigation – fall 2012
- 5) Markman ruling and trial dates for Siemens/Mitel and additional potential patent litigation – late 2012-2013

Risk Factors

We believe an investment in VirnetX involves the following risks:

- **Lack of profitability** – VirnetX has not generated earnings or positive operating cash flow, or substantial revenues, since its inception in 2005 and since the Company went public in 2007. Furthermore, our projections show that the Company is not expected to be profitable (not including litigation settlements) over the next several years as well even if initial revenues begin to accrue. While VirnetX has significantly bolstered its balance sheet following the settlement closing, there can be no assurance that the Company will be able to raise additional funding in the future if operating cash flow fails to turn positive.
- **Reliance on partnership agreements** — VirnetX's current strategy is to leverage its strong intellectual property portfolio and seek and sign partnerships or licensing agreements with leading participants in the internet and communications industries. To date, VirnetX has not established manufacturing capacity, service departments, or significant sales infrastructure with which to sell products and services directly to telecommunications companies. Should few or no partnerships be executed by the Company in the future, VirnetX would be required to spend considerable capital and energy to establish its own infrastructure to sell directly.
- **Need to defend patents and other intellectual property** – VirnetX has successfully concluded its patent litigation with Microsoft (Nasdaq/MSFT/Not Rated), however, VirnetX is relying on the strength of its patents to assist in signing partnerships with other companies, and there can be no assurance that other large players in the industry will not challenge or simply ignore the Company's patents in the future in developing secure networks, particularly if future patent litigation is unsuccessful.
- **Lack of consistent dividend** – Although VirnetX has issued dividends in the past, there can be no assurance when and if the Company will do so in the future; therefore investors who are seeking income from an investment in VHC shares may be disappointed.
- **Lack of Management depth** – At present, VirnetX has less than 15 employees, and operations could suffer substantially if one or more key executives or employees was required to leave the firm permanently or even for any length of time. Given the highly technical nature of the Company's patent litigation and research and development, its future prospects could be diminished with the permanent or even temporary loss of key employees.

VirnetX Holding Corporation
Consolidated Statements of Income
 (in \$000s, except EPS)

FYE December	2006	2007	2008	1Q09 March	2Q09 June	3Q09 Sept	4Q09 Dec	2009	1Q010 March	2Q10 June	3Q10 Sept	4Q10 Dec	2010	2011E
Revenues	\$0.0	\$74.9	\$133.7	\$3.2	\$7.2	\$3.2	\$12.7	\$26.3	\$20.8	\$200,023.4	\$15.5	\$8.5	\$200,068.2	\$10.0
Expenses														
Research and development	554.2	684.3	845.3	221.7	220.6	215.2	206.6	864.1	522.2	1,227.7	192.6	469.6	2,412.1	1,000.0
General and administrative	853.5	8,040.9	11,510.0	3,186.7	3,715.0	2,412.1	2,936.3	12,250.1	3,955.9	24,455.1	2,256.5	3,096.7	33,764.2	14,000.0
One-time and other	0.0	0.0	0.0	0.0	0	0	0	0.0	0.0	59,239.3	0.0	(32.5)	59,207	0.0
Total operating expenses	1,407.7	8,725.2	12,355.3	3,408.4	3,935.6	2,627.3	3,142.9	13,114.1	4,478.1	84,922.0	2,449.1	3,566.3	95,383.0	15,000.0
Loss from operations	(1,407.7)	(8,650.3)	(12,221.6)	(3,405.2)	(3,928.3)	(2,624.1)	(3,130.1)	(13,087.8)	(4,457.4)	115,101.4	(2,433.6)	(3,557.8)	104,685.2	(14,990.0)
Interest and other income, net	6.3	(41.8)	149.4	2.2	1.2	1.4	0.2	5.1	1.3	(33,988.4)	279.8	(29,561.0)	(63,268.2)	200.0
Net income (loss)	(1,401.3)	(8,692.2)	(12,072.2)	(3,403.0)	(3,927.1)	(2,622.8)	(3,129.9)	(13,082.8)	(4,456.0)	81,113.0	(2,153.7)	(33,118.8)	41,416.9	(14,790.0)
Basic and diluted income (loss) per share	(\$0.08)	(\$0.36)	(\$0.35)	(\$0.09)	(\$0.11)	(\$0.07)	(\$0.08)	(\$0.35)	(\$0.11)	\$1.72	(\$0.04)	(\$0.58)	\$0.84	(\$0.29)
Basic and diluted shares outstanding	17,087	24,312	34,875	37,017	37,370	37,264	37,911	37,911	40,095	47,266	51,772	57,136	49,067	50,400
Key ratios:														
Cash Flow/share	(\$0.07)	(\$0.32)	(\$0.32)	(\$0.07)	(\$0.09)	(\$0.05)	(\$0.06)	(\$0.27)	(\$0.09)	\$1.73	(\$0.03)	(\$0.57)	\$0.92	(\$0.21)
EBITDA/share	(\$0.07)	(\$0.32)	(\$0.33)	(\$0.07)	(\$0.09)	(\$0.05)	(\$0.06)	(\$0.27)	(\$0.09)	\$2.45	(\$0.03)	(\$0.05)	\$2.20	(\$0.21)

Balance Sheets

(\$000s)

Assets:	12/31/10	9/30/11
Cash and equivalents	\$78,091.3	\$65,231.0
Accounts receivable, net	2.7	0.0
Prepaid expenses & other	1,821.8	10,416.0
Total current	79,915.8	75,647.0
Property & equipment, net	25.5	28.0
Intangibles	108.0	72.0
Deferred offering costs	1,644.8	29.0
TOTAL ASSETS	\$81,694.1	\$75,776.0
Liabilities:		
Accounts payable and accrued expenses	\$519.0	\$1,012.0
Income tax liability	7,357.8	0.0
Current portion of long-term debt		
Derivative liability	14,364.4	2,739.0
Total current	22,241.2	3,751.0
Long-term obligations	0.0	0.0
Stockholders' equity (deficit)	59,453.0	72,025.0
TOTAL LIAB & EQ	\$81,694.1	\$75,776.0

Investor Catalyst Timeline

Markman Ruling/Microsoft
 Trial
 Settlement
 Receipt of funds

2010 **2011** **2012E**
 March
 May
 June

Markman Ruling/Apple, Cisco et. Al.

Hearing
 Ruling

January
III

Licensing Agreements on Patent Portfolio

X

Additional Lawsuits

X X

GABRIEL Software Development Kits

Initial License Fees
 Ongoing sales royalties

X
 X

Secure Domain Name Registry

Initial License Fees
 Ongoing sales royalties

X
 X

Secure Domain Name - Master Registry and Conversion Service

Initial License Fees
 Ongoing sales royalties

X
 X

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



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 Updated - November 22, 2010 -Price target raised to \$18.50
 Updated - May 31, 2011 – Lowered rating to Neutral

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- 1) **Buy:** the analyst believes the price of the stock will appreciate and produce a total return of at least 20% over the next 12-18 months;
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	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Buy	16	64%	6	38%
Neutral	8	32%	5	63%
Sell	1	4%	0	0%
Total	25	100%	11	44%

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