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VirnetX Holding Corporation (ASE/VHC)

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BUY Microsoft settles; Phase II begins

VirnetX holds patents and technology for secure real-time communications

Investment Highlights

1) **VirnetX has completed the first phase of its corporate history** – settling a long-ongoing patent litigation with Microsoft for \$200 million just weeks before a final hearing with the US District Court judge. After deducting attorney’s fees, a 35% royalty to SAIC (after costs) and taxes (after a \$40-\$45 million net loss carry forward), we estimate that the Company will net approximately \$100 million in cash, perhaps as early as next month. More importantly, VirnetX has turned Microsoft from a foe into a friend, and eliminated any hesitancy that previously may have been experienced by potential partners (even large ones) for new secure domain names pilot programs. Also worth watching is original technology developer SAIC, which could use its soon-to-be-delivered litigation bonanza to fund a joint venture with VirnetX to address the government agency market for secure domain name registry services.

2) **Q1/2010 financial results were released quietly by VirnetX** earlier this month, along with the first quarter 10Q. The Company showed royalty revenues of \$20,000 and a net loss of \$4.5 million, or (\$0.11) per share. Research and development costs were \$522,000 for VirnetX during the quarter, up from \$220,000 in the prior year, due to product development engineering work, while selling, general and administrative expenses rose to \$3.9 million from \$3.2 million in Q1/2009, primarily due to increased legal fees and salary increases and bonuses. For the quarter, VirnetX used nearly \$6 million in cash in Q1/2010, or an average of \$2 million per month, which was more than offset by \$8.6 million in cash garnered from the net proceeds of warrant exercises. At the end of March, VirnetX had over \$4.5 million in cash on hand and no debt. It was a busy quarter for VirnetX, particularly on the Microsoft litigation front, although late in March the Company did extend its letter of intent with VeriSign for a secure domain name registry pilot program.

Current Price \$5.92

Price Target \$8.00

| Estimates | F2008A | F2009E | F2010E |
|------------------|----------|----------|----------|
| Revenues(\$000s) | \$134 | \$26 | \$511 |
| EPS | (\$0.35) | (\$0.35) | (\$0.34) |

| Stock Data | |
|---------------------------------|---------------|
| 52-Week Range | \$1.20-\$7.99 |
| Shares Outstanding (mil.) | 43.0 |
| Market Capitalization (mil.) | \$254.6 |
| Enterprise Value (mil.) | \$250.1 |
| Debt to Capital (3/10) | N/A |
| Book Value/Share (3/10) | N/A |
| Price/Book | N/A x |
| Average Trading Volume (10-Day) | 726,000 |
| Insider Ownership | 28.6% |
| Institutional Ownership | 4.9% |
| Short interest (Million shares) | 2.3 |
| 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

3) Up next for VirnetX is a June 4th annual meeting and deadline for VeriSign letter-of-intent – Late in March, VirnetX and VeriSign extended their original letter-of-intent from December 2009 again to June 4th; however, in light of recent events at VeriSign we would not be surprised for the letter of intent to be extended again or even allowed to lapse. Although the original letter-of-intent did not specifically define which VeriSign division the LOI was with, domain name registry services or the authentication group, which is to be sold to Symantec, our guess is that both areas were interested in VirnetX's patents but that the pending sale would delay a final agreement. Not to worry, however, for there still remains a large number of potential partners for the 4G secured network pilot, including now Symantec and an alternative security/domain registry firm, in addition to an integrated circuit manufacturer, wireless service provider and possibly more, even Microsoft and/or VeriSign. So the bad news to come is that the June 4th deadline for the pilot may come and go; the good news is that when the pilot does begin there could be a larger number of major players involved.

4) What to do with all the incoming cash? Another issue that may be resolved at the upcoming annual meeting could be what VirnetX will do with its pending settlement cash from Microsoft. The Company has a number of options available, including an acquisition of a small security services provider or domain registry firm, a special cash dividend, or perhaps the funding of a joint venture with one or more partners. With the settlement proceeds in hand near-term capital will not be a problem, but we might also see further warrant exercises this year given the in-the-money price of many of these securities.

5) VirnetX is also working to achieve its real, longer-term business objective: to become a profitable, growing leader in the secure real-time communications market and operator of an exclusive secure domain name registry. Key to this objective is the completion of the GABRIEL connection technology beta test, started in early December 2009 and now nearly 6 months in progress: investors can anticipate some news flow from GABRIEL as soon as the June annual meeting but more likely in Q3/2010. Also coming up and perhaps even piggy-backing on the completion of the GABRIEL beta test is the final determination of the participants in the 4G secure network pilot and initiation of this project, most likely in the second half of 2010.

6) Not to be forgotten now that the high-profile Microsoft litigation has settled is **VirnetX's portfolio of 12 US, 8 international, and other pending patents**, only 3 of which were involved in the Microsoft case. In addition to potential patent litigation against other major telecomm companies spearheaded by an already successful (and well-fortified) McKool Smith legal team, VirnetX has not yet unleashed its intellectual property consultant ipCapital, which has more ammunition and fewer political objections in its efforts to obtain patent licensing agreements now that Microsoft is on board. We could see positive news flow related to VirnetX's patent portfolio as 2010 progresses.

Conclusion/Valuation

We are maintaining our Buy rating and 12-18 month \$8 price target on VirnetX shares, citing the several reasons stated above why investors have more positive developments to look forward to from the Company in the coming quarters. VirnetX will soon have additional cash resources to grow its business, a strong patent portfolio with one major defense under its belt and more potential upside developing, as well as an exciting beta test and pending pilot program which could establish a long-term revenue model for the Company going forward.

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 over the next several years as well even while initial revenues begin to accrue. While VirnetX has been successful in raising capital in the past and may be able to raise capital in the future, or alternatively sign licensing agreements including upfront payments, there can be no assurance that the Company will be able to raise additional funding before operating cash flow turns positive.
- **Reliance on partnership agreements** — VirnetX's current strategy is to leverage its strong intellectual property portfolio and seek and sign partnerships 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** – Although VirnetX has settled its patent litigation with Microsoft, there can be no assurance that the Company will prevail in other litigation against industry participants, many of which are much larger with greater resources. Likewise, 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 current and future patent litigation is unsuccessful.

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

Robert M. Wasserman

| FYE December | 2006 | 2007 | 2008 | 1Q09 | 2Q09 | 3Q09 | 4Q09E | 2009E | 1Q010 | 2Q10E | 3Q10E | 4Q10E | 2010E | 2011E |
|---|-----------|-----------|------------|-----------|-----------|-----------|-----------|------------|-----------|-----------|-----------|-----------|------------|------------|
| | | | | March | June | Sept | Dec | | March | June | Sept | Dec | | |
| Revenues | \$0.0 | \$74.9 | \$133.7 | \$3.2 | \$7.2 | \$3.2 | \$12.7 | \$26.3 | \$20.8 | \$25.0 | \$130.0 | \$335.0 | \$510.8 | \$12,000.0 |
| Expenses | | | | | | | | | | | | | | |
| Research and development | 554.2 | 684.3 | 845.3 | 221.7 | 220.6 | 215.2 | 206.6 | 864.1 | 522.2 | 500.0 | 475.0 | 500.0 | 1,997.2 | 2,200.0 |
| 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 | 3,750.0 | 3,500.0 | 3,750.0 | 14,955.9 | 17,500.0 |
| One-time and other | 0.0 | 0.0 | 0.0 | 0.0 | 0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 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 | 4,250.0 | 3,975.0 | 4,250.0 | 16,953.1 | 19,700.0 |
| 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) | (4,225.0) | (3,845.0) | (3,915.0) | (16,442.4) | (7,700.0) |
| Interest and other income, net | 6.3 | (41.8) | 149.4 | 2.2 | 1.2 | 1.4 | 0.2 | 5.1 | 1.3 | 3.0 | 1,000.0 | 950.0 | 1,954.3 | 3,500.0 |
| 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) | (4,222.0) | (2,845.0) | (2,965.0) | (14,488.0) | (4,200.0) |
| 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) | (\$0.10) | (\$0.06) | (\$0.07) | (\$0.34) | (\$0.09) |
| Basic and diluted shares outstanding | 17,087 | 24,312 | 34,875 | 37,017 | 37,370 | 37,264 | 37,911 | 37,911 | 40,095 | 43,000 | 44,000 | 44,500 | 42,899 | 45,000 |
| Key ratios: | | | | | | | | | | | | | | |
| Cash Flow/share | (\$0.07) | (\$0.32) | (\$0.32) | (\$0.07) | (\$0.09) | (\$0.05) | (\$0.06) | (\$0.27) | (\$0.09) | (\$0.08) | (\$0.05) | (\$0.05) | (\$0.26) | \$0.00 |
| EBITDA/share | (\$0.07) | (\$0.32) | (\$0.33) | (\$0.07) | (\$0.09) | (\$0.05) | (\$0.06) | (\$0.27) | (\$0.09) | (\$0.08) | (\$0.07) | (\$0.07) | (\$0.30) | (\$0.08) |

Balance Sheets

| | (\$000s) | |
|--|------------------|------------------|
| Assets: | 12/31/09 | 3/31/10 |
| Cash and equivalents | \$2,011.5 | \$4,551.7 |
| Accounts receivable, net | 6.8 | 12.6 |
| Prepaid expenses & other | 43.9 | 71.0 |
| Total current | 2,062.2 | 4,635.4 |
| Property & equipment, net | 23.4 | 22.2 |
| Intangibles | 156.0 | 144.0 |
| Deferred offering costs | 0.0 | 0.0 |
| TOTAL ASSETS | \$2,241.6 | \$4,801.5 |
| Liabilities: | | |
| Accounts payable and accrued expenses | \$4,478.3 | \$2,165.2 |
| Current portion of notes & obligations | 40.0 | 36.0 |
| Total current | 4,518.3 | 2,201.2 |
| Long-term obligations | 120.0 | 84.0 |
| Stockholders' equity (deficit) | (2,396.7) | 2,516.4 |
| TOTAL LIAB & EQ | \$2,241.6 | \$4,801.5 |

Investor Catalyst Timeline

| | 4Q09 Dec | 2010E | 2011E |
|--|-------------|-------|-------|
| Patent Portfolio - Declaration of secure patents for 3GPP into 4G | X | | |
| Markman Ruling/Microsoft | | | |
| Trial | | | March |
| Settlement | | | May |
| Receipt of funds | | | June |
| Licensing Agreements on Patent Portfolio | | X | X |
| GABRIEL Software Development Kits | | | |
| Initial License Fees | | | |
| Ongoing sales royalties | | X | X |
| Secure Domain Name Registry | | | |
| Initial License Fees | | X | |
| Ongoing sales royalties | | | X |
| Secure Domain Name - Master Registry and Conversion Service | | | |
| Initial License Fees | | | X |
| Ongoing sales royalties | | | X |

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:

Initiated – December 2, 2009 – Target \$6.00

Upgraded – March 1, 2010 – Target \$8.00

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| Ratings Distribution | Company Coverage | | Investment Banking | |
|----------------------|------------------|------------|--------------------|-------------|
| | # of Companies | % of Total | # of Companies | % of Totals |
| Buy | 9 | 64% | 4 | 44% |
| Neutral | 5 | 36% | 4 | 80% |
| Sell | 0 | 0% | 0 | 0% |
| Total | 14 | 100% | 8 | 57% |

Information about valuation methods and risks can be found in the “CONCLUSION/ VALUATION” and “RISKS” sections of this report.

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