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MOVERS & SHAKERS

By Lauren Keyson

Telephony Is Hot

Interactive Intelligence Moves into Voice over IP

Exclusive TTB Interview with Donald E. Brown, M.D.
Chairman, President and CEO, Interactive Intelligence

Interactive Intelligence Inc. (ININ) is an outgrowth of Dr. Donald Brown's previous company that he started in the mid-1980s, called Software Artistry. It was one of the early CRM companies – it sold software that customer service agents used. It made use of artificial intelligence to help customers deal with issues and answer questions without resorting to more expensive experts.

Its customers, including **Bank of America (BAC)** and **United Parcel Service (UPS)**, started to ask Software Artistry if its applications could integrate with their phone systems, so that when a call was sent to an agent, the software would pop pre-filled forms with information about that customer. That was Dr. Brown's first exposure to the world of telephony. After Software Artistry went public in 1995 and was sold to **IBM (IBM)**, he incorporated Interactive Intelligence. The idea with Interactive was to take a new approach to telephony. Instead of all of those standalone proprietary devices like PBXs, call recorders and call distributors, his company created a single, open server-based platform designed to replace them.

Lauren Keyson (The Tech Briefing): Who are your customers?

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KEEPING UP

By John Filar Atwood

Yahoo! Pays for Widespread Investor Pessimism

Earnings reports have been mixed so far this season, but **Yahoo! (YHOO)** learned the hard way that investors are prepared to bail out at the first sign of bad news. YHOO reported slowing revenue and user growth, which sparked a huge sell-off of its shares. Analysts are taking a longer view and have yet to abandon those companies, such as YHOO, whose long-term fundamentals appear to be in tact. Here's a look at their view of recent earnings reports and other news from around the industry.



Internet Software and Services

Yahoo! (YHOO) shares tumbled after the company released its second-quarter numbers. The company reported slower revenue growth, user growth and revenue per user. While the near term will be choppy for YHOO, Scott Devitt of Stifel Nicolaus still thinks it is a well-managed company in a growing industry. He believes YHOO will generate more than \$1.8 billion in free cash flow in 2007 and rates it a Buy for long-term-oriented investors.

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TECH POINTS

Fundamental Outlook

While we don't believe higher oil prices will be positive for economic growth and stock price performances, we think that \$80/bbl. oil will not aggravate the expected economic slowdown or our forecast for its impact on core inflation.

S&P analysts expect one of the S&P 500 industries – semiconductor equipment – to post year-over-year increases in Q2 operating earnings in excess of 80%. The semiconductor equipment industry is forecast to show a 98% increase.

S&P 500 Sector	Jun	% Change YTD	2005
Information Technology	-1.7	-6.2	0.4
S&P Composite 1500	0.0	2.1	3.8
S&P 500	0.0	1.8	3.0
S&P MidCap 400	-0.1	3.6	11.3
S&P Small Cap 600	-0.1	7.2	6.7

Source: Sam Stovall, Chief Investment Strategist, Standard & Poor's



TECH SPOTLIGHT

By Shannon Swingle

Verigy could head off cyclical headwinds

The semiconductor cycle may be waning, or, as some analysts believe, as good as over, but that doesn't mean that some stocks aren't worth looking at.

Take **Verigy (VRGY)**, for example, which spun off from **Agilent (A)** when it went public on June 13 of this year. Agilent still owns 50 million shares but plans to distribute its entire interest in Verigy to Agilent shareholders in late October via a one-time dividend. Verigy is Agilent's former automated test equipment (ATE) business and accounted for about 10% of Agilent's revenues. Verigy – incorporated in Singapore and with a market cap of about \$877 million – designs, manufactures, markets and supports ATE used for a broad range of advanced semiconductor devices in the U.S., Singapore and Japan.

The company's test products are designed to test system-on-a-chip (SOC), system-in-a-package (SIP), and memory devices used in MP3 players, digital TVs, set-top boxes, PCs, gaming consoles, cell phones, and other electronic products.

The automated test equipment segments are expected to grow significantly between 2005 and 2009, with an estimated compound annual growth rate of 11%. And analysts believe Verigy is well positioned to take advantage of this growth, as it has taken steps to increase its total addressable market to make it less susceptible to the industry's cyclicality.

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MOVERS & SHAKERS

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Don Brown (Interactive Intelligence): We have customers across every conceivable industry segment – basically any type of organization that has to deal with its own customers by phone, fax, e-mail or other means of communication. Our biggest customer to date is actually **Microsoft (MSFT)**. We also have pharmaceutical companies, insurance companies, law firms, health care organizations, banks – you name it.

LK: I noticed you had VEGAS.com as a client. How does it use your software?

DB: VEGAS.com uses our software in its customer service center, as does **Harrah's Entertainment (HET)**, also in Las Vegas. That's the case for most of our customers. They typically have hundreds, and sometimes thousands, of agents taking calls for reservations or whatever customer service they might be offering. That has kind of been our bread and butter, although, more recently, we've been selling to companies that use us for their entire phone system. So, for example, Microsoft is actually replacing all of its old PBXs with our software as its main phone system.

LK: What makes your company stand out from your competitors?

DB: Well, we've moved heavily into voice over Internet protocol (VoIP), which is a hot-button area in telephony these days. Voice calls are routed over a company's data network, effectively converging two networks onto one. The big claim to fame that we have is we do all of this on a single Windows server, which we call a 'converged communications application approach.' So companies can get everything they need for business communications with one server package, and just turn on features with license keys, instead of going out to **Nortel (NT)** or other traditional vendors and buying different boxes and hooking them together to achieve a comparable effect. As customers demand more interaction channels, and with compliance becoming an increasingly important business issue, our simplified, all-in-one suite has a major competitive advantage over these multi-box portfolio offerings.

LK: So how is Interactive going to do for the rest of the year?

DB: At the beginning of the year, we said that we expected our business to grow roughly 15% over the previous year in terms of our revenue, and to more than double in terms of profitability.

LK: What do you think of IT in general as a place for investors to put their money for the rest of the year?

DB: I think it's a good place, but you have to choose judiciously. IT spending has slowed down in a number of areas, so you have to be sure your expectations are aligned with the particular IT segment in which you're investing.

LK: So what are some of the IT segments that you think are going to pick up?

DB: Fortunately for us, IP telephony is about the hottest industry segment out there. I was talking to a financial analyst just a couple of days ago, and you know back in the heyday a few years ago, it was common to talk about a 50% to 75% growth rate. Now, within most IT segments, if you get 10% growth, you're doing well. IP telephony is still up in the 25% range. It's a rapidly growing area.

LK: What are some of the areas that you don't think are going to see such growth through the rest of the year?

DB: Well, database and enterprise applications, CRM, ERP – there are a number of slow areas like that. There is just a lot of consolidation taking place and not nearly the same level of investment that there was a few years ago.

LK: So what can we expect for 2007? Do you think tech will still be hot next year?

DB: Well, again, I think it's going to vary by the specific sub-sector of tech. So VoIP is projected to be hot for the next five years or so, because it's a fairly new area. A lot of companies are trading out their old phone systems for IP-based systems, which is helping to drive this trend. So I don't see any huge changes next year. ♦

Donald E. Brown, MD, co-founded his third software company, Interactive Intelligence, in October 1994 and has served as Chief Executive Officer since April 1995 and President since inception. Dr. Brown also serves as Chairman of the Board, a position he has held since July 1998. Dr. Brown has been a director since the company's inception. In March 1988, Dr. Brown co-founded Software Artistry, Inc., a developer of customer support software, which went public in March 1995 and was subsequently acquired by IBM in January 1998. At Software Artistry, Dr. Brown served as CEO and director from inception through September 1994. Dr. Brown's first software company was acquired by Electronic Data Systems (EDS) in September 1987. Dr. Brown graduated from the Indiana University School of Medicine in 1985. He also holds two additional degrees from Indiana University, an MS in computer science and a BS in physics.

THE TECH BRIEFING
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Publisher

Lauren Keyson
KeysonPublishing@aol.com

Editorial

John Filar Atwood, Editor-in-Chief
Shannon Swingle, Senior Editor
Peter Moore, Feature Writer
Turner Savard, Editorial Assistant

Production & Design

Laura Medley, Internet/Production Manager

Advisory Board

Marc Gerstein,
Research Director, Reuters
James Condon,
Editor, Barclays Capital

Marketing Director

Anne Steinberg
Anne@kitchenpr.com

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For Questions or Comments:

KeysonPublishing@aol.com

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Keyson Publishing,
23 W. 73rd Street, Suite 1506,
New York, NY 10023

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KEEPING UP

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Semiconductors

Intel (INTC) reported Q2 revenue of \$8 billion, which fell short of consensus estimates, and EPS of \$0.15, which slightly exceeded expectations. A slow PC market and tighter competition hurt the company in the quarter.

SYSTEMS SOFTWARE

At an analyst day in New York, **Oracle (ORCL)** discussed its operating strategy, which is focused on expanding its database business. The company said that its applications unlimited program is driving a resurgence in applications license revenues. The company also is considering entering the market for Linux support services, according to Kevin Buttigieg of A.G. Edwards. He maintained his Hold rating, noting that ORCL did not adequately address the question of whether its technology business is being hurt by the macroeconomic environment.

John Lau of Jefferies & Co. believes INTC is in position to gain market share in the second half of 2006, with several new product offerings. Significantly, **Advanced Micro Devices (AMD)** is not likely to have a 65nm product to compete with INTC's new offerings in this market. Lau rates INTC a long-term Buy, with a 2007 EPS of \$1.17.

Computer Hardware

IBM (IBM) came in a penny ahead of Street expectations in the latest quarter, despite weakness in its services and hardware businesses. The company's software segment picked up some of the slack, as did some productivity initiatives. Cindy Shaw of Moors & Cabot continues to recommend IBM over a 12- to 24-month timeframe. She noted that the stock is trading at the low end of its historical range. She also likes the company's leadership in shifting work to low-cost regions around the world.

Communications Equipment

Second-quarter revenue was in line for **Juniper Networks (JNPR)** at \$567 million, but the full report was not released, pending the outcome of an investigation into options-issue practices and goodwill writedowns. JNPR also announced that it will begin a \$1 billion stock buyback later this year. Susquehanna Financial's Joe Chiasson believes that routing competition is holding down revenue growth and driving up operating costs. He provides a Neutral rating on the stock, based on operational challenges and a valuation slightly above its peer group.

Electronic Equipment Manufacturers

Weakness in its government systems business is holding down the revenues

of **FLIR Systems (FLIR)**. The company reported in-line Q2 results, despite strong growth in its commercial vision systems and thermography segments. Needham's James Ricchiuti maintained his Buy rating, based on valuation and his belief that government systems orders will gradually improve. The company did not adjust its EPS guidance, but Ricchiuti lowered his fiscal 2007 estimate to \$1.40 from \$1.45.

Semiconductor Equipment

Teradyne's (TER) Q2 revenue of \$391 million was up 8% over the first quarter and ahead of analysts' expectations. Total bookings rose 11%, with particular strength in Japan and Korea. The company's guidance for the coming quarter was lower than Street estimates, based on slowing orders at the outset of the current quarter. David Duley of Merriman Curhan Ford maintained his Buy rating, based on TEK's attractive valuation and improved operating model.

Electronic Manufacturing Services

Sanmina-SCI (SANM) pre-announced Q3 estimates well below previous guidance, based on a number of issues, including lower-than-expected profits in its computing business. The company was also hurt by program delays in its defense and aerospace division. Brian White of Jefferies & Co. maintained his Hold rating on SANM and lowered his earnings estimates and price target. He is concerned about the company's market-share position, and that SANM continues to execute poorly in a slowing economic environment.

Home Entertainment Software

June console software sales rose 15% over last year in a surprise turnaround for sales in this industry. Next-generation software sales increased \$113 million during the month. Wedbush Morgan's Michael Pachter continues to think that summer software sales will be volatile due to the upcoming console transition. However, he believes declining sales of current-generation software will be offset by next-generation sales. He said that it is a good time for investors to opportunistically add to positions in **Electronic Arts (ERTS)**, **Activision (ATVI)** and **THQ (THQI)**.

Computer Storage and Peripherals

Rising inventory levels and weakness in Europe could spell trouble for **Network Appliance (NTAP)**. A resurgence in **Sun Microsystems' (SUNW)** storage business also could hurt NTAP, according to Shebly Seyrafi of Kaufman Bros. He said that SUNW is using aggressive pricing to cut

into NTAP's storage market share. With respect to NTAP's European operations, he noted that the July quarter is usually weak for NTAP, but he believes it is more pronounced this year. He reiterated his Hold rating, with a \$35 price target.

IT Consulting and Other Services

The government IT services industry remains strong, given the nation's defense spending in Iraq and elsewhere around the world. Delays in the funding bill have slowed contract awards, but the industry still should see revenue growth through the end of 2006, says Timothy Willi of A.G. Edwards. He thinks recent price declines present an opportunity for investors to buy into this industry. His favorite company is **ManTech International (MANT)**, which is expected to generate industry-leading organic growth this year.

Technology Distributors

InfoSonics (IFO) restated its first-quarter earnings in June, and the stock has dropped nearly 50% since then. The company's fundamentals have not changed, says SooAnn Roberts of Kaufman Bros., who expects IFO to land major contract wins in Latin America in the coming year. She forecasts EPS of \$0.59 in 2007, up from an estimated \$0.33 this year, and revenue growth of 77% in 2007. She reiterated her Buy rating and \$12 price target on IFO.

Application Software

Stock prices in this sub-sector have fallen steadily for two months, and investors are pessimistic about business conditions going forward. Things are not as bad as they seem, says Needham's Richard Davis, who believes that software demand is not collapsing. He was surprised that **Kronos (KRON)** missed its latest-quarter projections, but Davis thinks it was poor execution by KRON and not an industrywide problem. Given the recent drop in valuations, he upgraded **Autodesk (ADSK)** to Strong Buy from Buy. He likes the company's solid long-term fundamentals.

Data Processing and Outsourced Services

First Data (FDC) announced that it has entered into an agreement with Discover to provide processing services to merchants for Discover payments. It might not be a significant near-term catalyst, according to Timothy Willi of A.G. Edwards, but it presents a long-term revenue growth opportunity. He also thinks the deal might help differentiate FDC in the small-business market as the only processor offering full service on Discover payments. He maintained his Buy rating on the stock. ♦

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TECH SPOTLIGHT

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Douglas Reid of Thomas Weisel Partners believes that Verigy will likely see 15% year-over-year revenue growth from 2004 to 2009, based on three growth drivers. He says there are "inherent advantages in the company's test platform architecture that enable low-cost, flexible, scalable testing." He also points out "accelerating growth in SOC, SIP and high-speed test – core areas of Verigy strength." And finally, Reid sees "steady penetration of the memory test market based on new product enhancements that will expand Verigy's served addressable market."

James Covello of Goldman Sachs believes that Verigy has a 20% upside potential to his 12-month target price of \$18. He thinks that even though Verigy may see declining orders in the near term, the stock is far "too attractively valued to pass up." In addition, Covello likes Verigy's position within the industry, citing its "exposure to fast-growing NAND flash and multi-chip package applications; its solid product and technology offerings; and management's focus on driving meaningful full-cycle profitability."

Recently, Verigy was selected as a "10 Best" ATE supplier in the annual VLSI Research Customer Satisfaction Survey, according to a company press release. Customers represented 95% of the worldwide chip production market. The company also received an overall "Five Star" rating, based on the 2005 Customer Satisfaction Survey.

"We are pleased to receive such a strong endorsement from our customers," said Keith Barnes, Verigy's president and CEO. "Verigy's selection to the '10 Best' and overall 'Five Star' supplier rating reinforces our commitment to deliver the best products and services to meet the rapidly changing needs of our customers."

The endorsements don't stop with customers. Analysts who follow Verigy tend to look favorably on the company and its prospects. Even those analysts who are neutral on the company like its longer-term prospects.

Verigy does face risks. The semiconductor industry is highly cyclical, and competitive pressures are always an issue. Those risks are mitigated by the fact that Verigy is a spinoff and is an established and respected business rather than a new and unproven IPO. Other factors affecting the shares are the large potential overhang from the late October distribution of shares to Agilent shareholders, as well as the company's ongoing restructuring. And the addition of new senior management in the last few months can be perceived as a risk.

Still, Verigy's business prospects appear compelling, as does its valuation. Recently, Verigy has received July 24 initiations of coverage at Outperform from Credit Suisse and Cowen & Co. Credit Suisse listed a target price of \$20. On that same day, Thomas Weisel Partners initiated coverage with a Peer Perform. On July 23, Goldman Sachs initiated coverage with a Buy rating and a price target of \$18. Recently, Verigy shares traded at \$14.95. ♦



TECH NEWS BITES

By Turner Savard

'Net Services, Tech Formats Expand – and Compete

Sony (SNE) could be facing financial strain when its new Playstation 3 machine comes on the market. At \$600, it is a relatively expensive game console, something that will likely price it out of many consumers' price range. The company also will lose more than \$150 on each console that it does sell. Analysts believe Sony stands to lose \$2 billion in its first year. Historically, Sony has relied on its gaming revenue for a significant share of its profits, although recently that has changed due to the high development costs of the console.

http://www.businessweek.com/globalbiz/content/jul2006/gb20060720_962759.htm?chan=top+news_top+news

Intel (INTC) is starting to respond effectively to **Advanced Micro Devices (AMD)**, a relatively new challenger in the field

of microchips. Intel is coming out with a new range of dual chips that compete directly with the equivalent chips offered by AMD. AMD's response has been to slash its prices on its chips to retain its competitiveness.

<http://www.upi.com/Hi-Tech/view.php?StoryID=20060719-025011-3041r>

The huge popularity of the Firefox explorer cut deeply into the numbers for **Microsoft's (MSFT)** Internet Explorer, forcing the company to scramble to release something more relevant. Their answer was Internet Explorer 7. Luckily for Microsoft, the new Firefox 2 doesn't differ wildly from its previous incarnation, granting Microsoft some breathing room.

<http://www.informationweek.com/news/showArticle.jhtml?articleID=190500041> ♦



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TECH FEATURES

By Peter Moore

Savannah Is Emerging as Unlikely High Tech Center

Savannah, GA business leader Chris Miller is the definition of innovation. Miller, the 15th executive ever hired at Mindspring (later Earthlink), once led a 3,000-person team that spanned five states. But now he is a strong advocate for telecommuters who are coming to Savannah – one of the nation's cultural centers and an overwhelmingly tech-friendly city.

"This place has 33,000 miles of fiber-optic cable," Miller said. "It's just up to its armpits in dark fiber. There are 571 WiFi hotspots in a downtown area a half-mile by two miles. It turns out [Savannah is] just loaded with technology."

After spending more than 20 years off and on in Atlanta, watching the city's quality of life decline into heavy traffic, smog and an overly hectic lifestyle, Miller decided a smaller, more soulful community was far preferable to the crowded, busy,

day-to-day existence led by most people in big cities. His computer proved especially helpful, and he became almost an instant telecommuter.

In addition to enjoying a much-reduced cost of living, Miller spends his days as executive director of the Creative Coast Initiative. Through a program called "Bright Flite," Miller encourages business owners and executives to relocate to Savannah. He's worked with graphic designers, Web entrepreneurs and even quirky inventors. One of his recent clients invented "Scratch n' Sniff PC," which allows one to control air scents emanating from a special device connected to the computer with a standard PC mouse.

"I wanted to live in a community where people are known for who they are and where there's connective-ness – not a French fry row," Miller said. "But it still has to have culture."

Savannah is home to several colleges. Its cultural impact lies in hosting the nation's largest art and design school, Savannah College of Art and Design, and the Georgia Institute of Technology.

Miller said that the \$350,000 he said he would have put toward a "shoebox" apartment in Atlanta, bought him a 5,500 square-foot mansion in Savannah.

In addition, the U.S. Census Bureau's latest studies have indicated Savannah's population of 25- to 35-year-olds has increased by 7% per year, despite the nation's overall decline. Since young people are often the most tech friendly and tolerant, Miller said, the city has taken on a very modern, diverse and hip atmosphere.

"My job is to help get them plugged in," he added. ♦



TECH UPS AND DOWNS

The following companies received ratings changes between July 10 and July 21:

Upgrades

Company	Consensus Rating	Consensus Target Price
Xilinx (XLNX)	Outperform	\$29.81
Baidu.com (BIDU)	Hold	\$83.00
Western Digital (WDC)	Outperform	\$25.27

Downgrades

Company	Consensus Rating	Consensus Target Price
Digitas (DTAS)	Outperform	\$15.73
Computer Sciences (CSC)	Hold	\$54.35
Yahoo! (YHOO)	Outperform	\$39.00

Source: Reuters Estimates