

# IT Security Sector Report

September 26, 2003

UPDATA CAPITAL

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Recently Announced  
Update Security Deal

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Web Filtering Software



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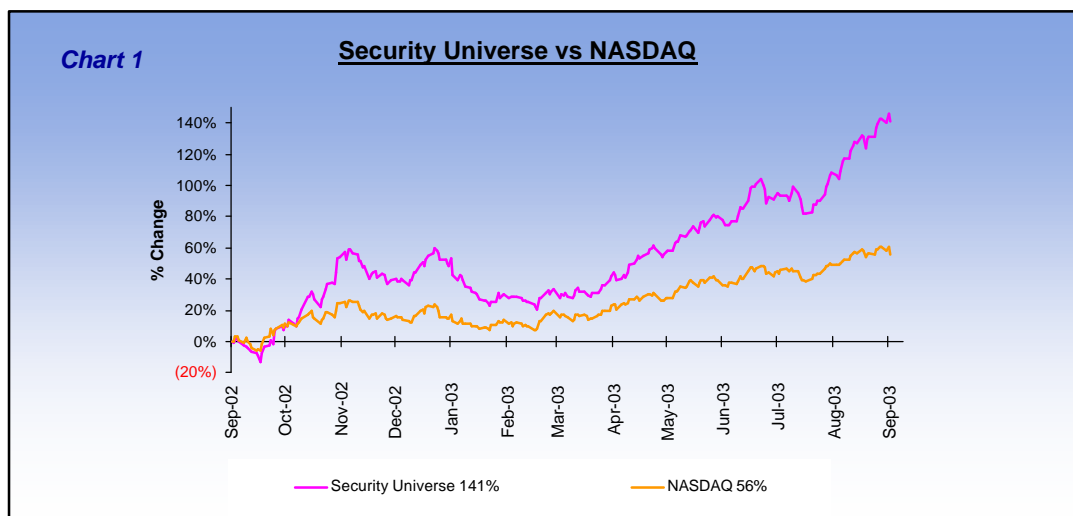
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## Security's Hot Summer

IT Security's recovery gained steam over the just-ended summer. The Updata share price index of 30 pure play U.S.-traded security stocks climbed 40% from June to September 24, outstripping NASDAQ's 16% rise. Over the past year, the index has soared 141% versus 56% for Nasdaq (*Chart 1 below*). Stocks trade on average at 83% of their 52-week high. Mean trading multiples have also widened significantly (*Chart 2 below*), though remain well below their historical peak.

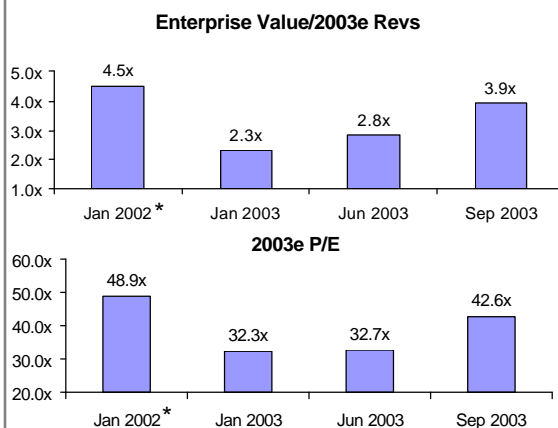


Broadly strengthening fundamentals drove much of the gain – most recent quarter revenues grew 15% on average over the prior year (9% median). Heightened mainstream media coverage of security issues also helped (*Table 1 below*).

Summer also saw rising investment activity (*Chart 3, next page*). Since June, 46 companies announced private investments totaling \$386 million (*Table 2, next page*), including 15 A rounds. This compares with 30 fundings totaling \$255 million during the summer of 2002. Investment stage distribution and average investment size (\$9 million) remained virtually unchanged over last year (*Chart 4, next page*).

On the M&A front, companies announced at least 17 transactions aggregating more than \$125 million since June (*Table 3, page 4*). Number of deals were up from 15 in the prior year period. At least 28 deals have been announced year-to-date, versus 24 in the same time last year, although deal volumes declined due to fewer large deals so far in 2003.

### Chart 2 Trading Multiples Recover



\* Jan 2002 multiples are based on estimated 2002 results

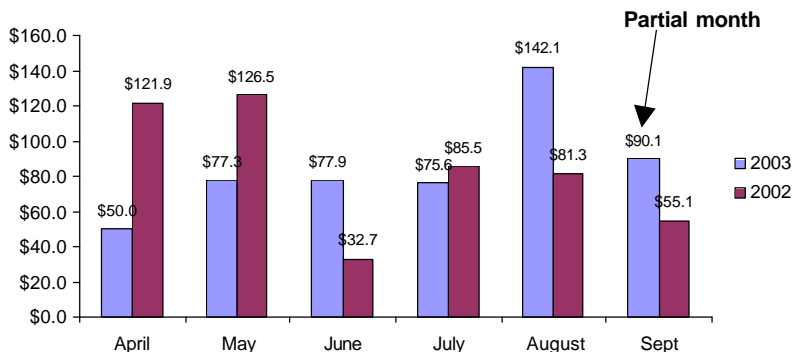
### Table 1

#### Summer Security Headlines

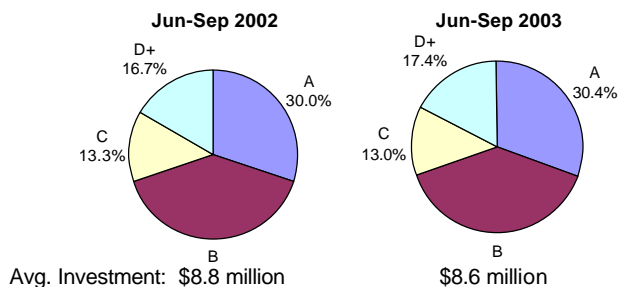
- **Antivirus** – Microsoft enters the space
- **Cyberterrorism** – Ridge cites vulnerability
- **Cyberporn** – High Court ok's school filtering
- **Government IT Spending** – big increase
- **Piracy** – Hollywood sues downloaders
- **SoBig** – history's broadest e-mail virus hits
- **Spam** – exceeds 50% of corporate e-mail
- **Identity Theft** – hits record levels

## Security Investment Overview

**Chart 3 Security Investment Volumes**



**Chart 4 Investments by Stage**



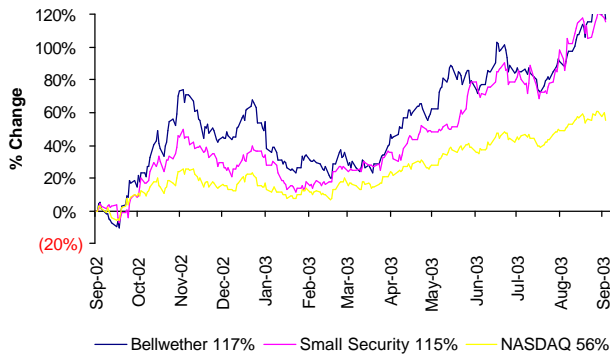
**Table 2 Recent IT Security Private Investments**

Date of Round	Company	Description	Amount Raised (\$MM)	Round
Sep-03	IS3	Security management systems, services	\$9.1	B
Sep-03	CoVi	Video surveillance security software	\$16.0	A
Sep-03	Postini	Anti-spam service	\$10.0	D
Sep-03	Lumeta	Network security visualization	\$3.5	C
Sep-03	IntelliVid	Video surveillance security software	5.5	A
Sep-03	iCognito	Web filtering	\$3.1	B
Sep-03	Utimaco	Authentication and encryption solutions	\$13.4	Pipe
Sep-03	TopLayer	ASIC-based intrusion prevention	\$14.5	G
Sep-03	SecureInfo	Patch management	\$10.0	A
Sep-03	Secure Elements	Patch management	\$5.0	A
Aug-03	Kryptiq	E-mail encryption for healthcare	\$7.9	A
Aug-03	Netilla	SSL VPN	\$2.0	C2
Aug-03	Digimarc	Digital watermarking technology	\$23.5	Pvte Plcmt
Aug-03	Fortinet	Content security appliance	\$30.0	D
Aug-03	Network Intelligence	Content security appliance	\$5.0	B
Aug-03	MailFrontier	Antispam	\$10.0	B
Aug-03	FrontBridge Technologies	E-mail security and antispam	\$8.0	C2
Aug-03	MessageGate (Boeing spin-out)	Antispam and message compliance	\$5.1	A
Aug-03	Reactivity	Web services firewalls	\$10.3	B
Aug-03	SRD	Security/fraud analytics software	\$11.0	A
Aug-03	Arxan	Software anti-tampering	\$8.3	B
Aug-03	Trusted Computer Solutions	Security policy enforcement	\$3.0	A
Aug-03	Cavium Networks	Network Security Processors	\$18.0	C
Jul-03	Lurhq	Managed security services	\$3.0	A2
Jul-03	Solutionary	Managed security services	\$13.0	A/B
Jul-03	Reflex	Intrusion prevention	NA	A
Jul-03	Cernium	Video security software	\$2.8	B
Jul-03	Solsoft	Network security policy management	\$12.0	D
Jul-03	Addamark Technologies	Event data correlation	\$9.0	B
Jul-03	Proofpoint	Anti-spam	\$7.0	A
Jul-03	Tripwire	Integrity assurance software	\$8.3	D
Jul-03	Voltage Security	Encryption products	\$4.0	A
Jul-03	Bladefusion Technologies	Blade server security	\$2.5	B
Jul-03	KaVaDo	Web application security	\$10.0	C
Jul-03	NetContinuum	Application firewall appliance	\$4.0	D
Jun-03	Omniva	E-mail security policy software	\$4.0	C
Jun-03	System Detection	Behavior-based Intrusion Detection	\$4.5	B
Jun-03	Cloakware	Developer Application Security Tools	\$4.2	B
Jun-03	Vsecure	Network Intrusion Protection	\$3.4	B
Jun-03	Xactional	Online data security	\$2.6	A
Jun-03	Trusted Network Technologies	Identity-based Access Control	\$6.0	A
Jun-03	WebCohort	Web application and database security	\$12.0	B
Jun-03	WebCohort	Database Security	\$12.0	B
Jun-03	PreventSys	Security Policy Compliance Auditing	\$9.2	B
Jun-03	Sigaba	Secure messaging solutions	\$8.0	B
Jun-03	Permeo	Application Security Suite	\$12.0	B

## Equity Market Analysis

A rising market has lifted virtually all security stocks. In the past 12 months, large and small-cap security stocks rose at similar rates (*Chart 5 below*). However, companies with market capitalizations greater than \$500 million trade at 5.3x enterprise value/LTM revenue on average, versus 3.2x for small-caps. Higher multiples are mostly attributable to the benefits of scale: four-fifths of large security firms are profitable versus a third of small ones.

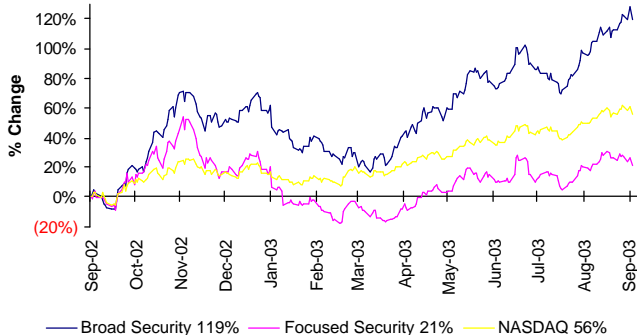
**Chart 5 Bellwether vs Small Security**



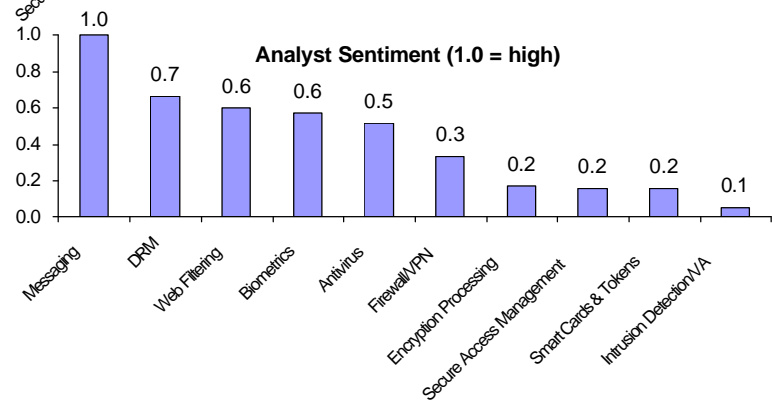
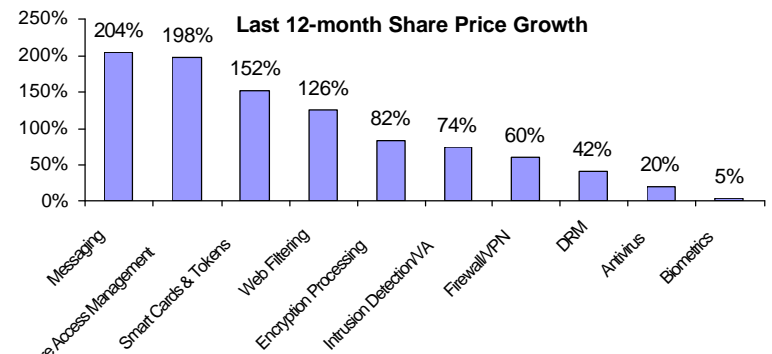
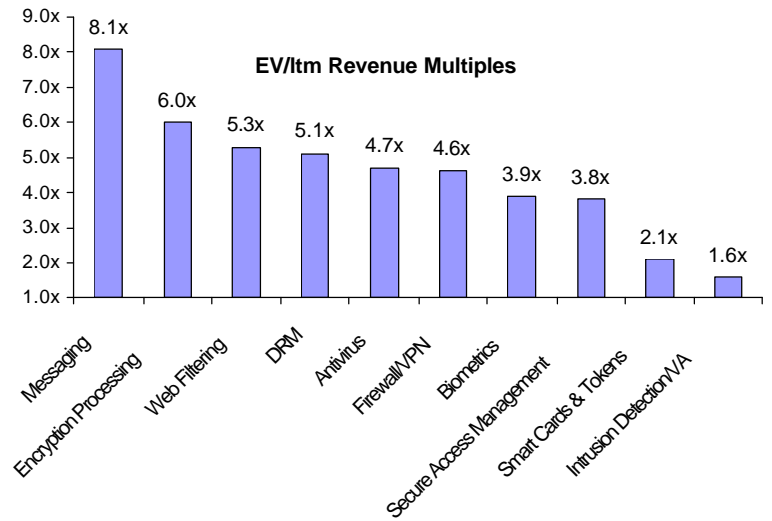
Within security, valuations and price performance vary widely by segment. *Charts 6 - 8* on the right (*and Table 4, page 5*) rank 10 segments by mean revenue multiples, share price growth, and equity analyst sentiment. Messaging security ranks #1 in all three criteria. Messaging is the dominant internet activity, and arguably the least secure. Web filtering ranks top 5 in each of the criteria, reflecting growing recognition of problems posed by undesirable websites. Beaten-down areas like encryption and access management have strongly recovered price-wise, aided by increased government business. Digital rights management and antivirus remain highly valued. Share prices of smart cards/tokens, and intrusion detection vendors have recovered with the market but analysts remain tepid about growth current prospects.

**Broad vs Focused Security**

**Chart 9**



**Charts 6-8 Segment Equity Performance Indicators**



Notes: Data are segment means. Individual company data is on *Table 6, page 6* Relative analyst sentiment ranges from 1.0 (buy) to -1.0 (sell).

In what is perhaps the most notable trend, prices of leading multi-segment vendors (Network Associates, Netscreen, RSA, Secure Computing, Symantec) grew 119% in the past 12 months, versus 21% for larger single-segment focused companies (Check Point, Identix, Internet Security, Trend Micro, Websense) (*Chart 9, left*). This divergence may reflect enterprises' growing preference for platform over point solutions, for simplicity's sake and to counter blended threats that standalone products can't stop. Accordingly, this year most single-segment vendors have launched or announced plans to offer multi-function platforms through development or partnership.

## M&A Market Analysis

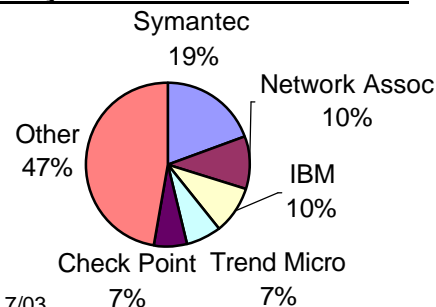
Buoyant equity markets have been accompanied by strong M&A activity over the summer. At least 14 acquisitions valued at more than \$120 million were announced in Q3 2003, versus 16 deals announced in Q1 and Q2 combined. However the security universe cannot quite be described as consolidating.

While the industry is concentrated at the top – five vendors account for 53% of security product spending (*chart 10, right*) – the market as a whole remains fragmented. The total number of vendors is not declining meaningfully and there are really no entrenched market leaders, as Netscreen's rise in the established firewall/VPN segment attests. In antivirus, where three vendors control more than two-thirds of the server and desktop market, Microsoft acquired an antivirus vendor and may bundle its software with Windows. Also, large private companies like Sophos and others with blended offerings are gaining share.

In short, the \$14 billion security market remains up for grabs. This fact, together with the industry's ever-evolving technologies and solution paradigms, attract considerable ongoing investment that has thus far counteracted consolidation. To illustrate, four intrusion prevention vendors were acquired in the past year for almost \$400 million. During this time, 18 *other* intrusion prevention technology firms raised \$183 million. Similarly, five antispam and web filtering acquisitions over the past year valued at \$53 million were offset by eight investments totaling \$54 million in competing vendors. Since June, while 17 security firms were acquired, 15 raised institutional funds for the first time (31 raised later stage investment).

This consolidation-deconsolidation balance will change markedly when the long-predicted industry merger wave hits. Though timing is uncertain, a string of

**Chart 10 Security Product Market Share 2002**



Source: Gartner 7/03

public mergers may occur as early as Q4 2003 or Q1 2004, due to building performance pressures, greater shareholder support for M&A and available currency (public security firms have \$8 billion of cash on hand; Microsoft and others have much more). Check Point has endured two years of flat revenues and its franchise is threatened by appliance and SSL VPN vendors. Internet Security's revenues have similarly lagged as the company struggles to leverage its IDS leadership through technology upgrades and partnerships. Symantec and Network Associates derive much of their revenues from consumer antivirus, where pricing is eroding and Microsoft, in Forrester Research's words, "will eventually monopolize the business." Segment leaders like Identix and RSA are constrained by the size of the segments they lead. Cyberguard, SonicWall, TippingPoint and Intrusion offer solid products but are too small to stay standalone in the highly competitive appliance market where average product prices, IDC says, declined in early 2003. All the while Cisco, IBM, telcos and other behemoths cast shadows as they become directly competitive with the pure-play vendors. (*Table 5 on page 5 lists some of the challengers.*)

Several large public-public mergers would likely trigger a spate of others in short order, ratcheting pressure on the mass of smaller vendors to find strategic acquirors.

**Table 3**

### Recent IT Security M&A Activity

Ann't Date	Seller	Buyer	Deal Value (\$ MM)	LTM Rev (\$ MM)*	Mult of LTM Rev	Description
Sep-03	ActiveState	Sophos	\$23	NA	NA	Anti-spam software
Sep-03	TruSecure	Cogentrix	NA	NA	NA	Security risk management software
Sep-03	Elron Software	Zix	\$7	\$8	0.9 x	Web filtering software
Sep-03	Baltimore - OmniRoot	Betrusted	\$3	\$1	3.3 x	SSL solutions
Aug-03	Chrysalis-ITS	Rainbow Technologies	\$20	\$9	2.2 x	Encryption hardware
Aug-03	ZoneLabs	IMSecure	NA	NA	NA	IM client security
Jul-03	Aurora Biometrics	Dicom	\$1	NM	NM	Facial biometrics IP
Jul-03	N2H2	Secure Computing	\$19	\$12	1.6 x	Web filtering software
Jul-03	Baltimore - Managed Services	Betrusted	\$2	\$2	1.2 x	Managed security services
Jul-03	Veridicom (assets)	Alpha Virtual	NA	NA	NA	Fingerprint biometrics
Jul-03	Vacman (Vasco asset)	SecureD	\$3	\$2	1.6 x	Single sign-on
Jul-03	SecureNet	Betrusted	\$30	\$25	1.2 x	Managed security services (Australian)
Jul-03	Information Security (TruSecure)	TechTarget	NA	NA	NA	IT Security magazine
Jul-03	Baltimore - SelectAccess	Hewlett Packard	\$14	\$1	11.9 x	Web-based single sign-on
Jun-03	Defcom Information Security	NetSec	NA	NA	NA	Security consulting services
Jun-03	GeCAD Software Srl	Microsoft	NA	NA	NA	Anti-virus software
Jun-03	Network-1 firewall IP assets	TrendMicro	\$0.4	NM	NM	Host-based firewall

## New Opportunities Ahead

The coming merger wave will concentrate the market and tilt the playing field in favor of large vendors. However, nimble innovators will still draw investment and enjoy bright prospects. The greatest opportunities are in security's "breakout" areas – high growth, potentially large and unsaturated segments that are less likely to be affected by looming public consolidation.

Wireless security, while functionally intertwined with established segments like firewall, VPN and antivirus, is a big breakout segment. Industry experts estimate that only 1% of 20+ million handheld computing devices have virus protection. Rapid proliferation of hotspots and unprotected laptops, PDAs and phones have created a growing, largely unmet need for a range of access, application, data and communication security products designed for the mobile environment.

Preventative patch management and vulnerability scanning solutions also present breakout opportunities. Though interest is rapidly growing in these areas, the field remains open. Less than a quarter of organizations

have implemented proactive measures to protect their IT infrastructure. At congressional hearings this year, agencies and experts agreed that preventative measures are critical to mitigating software vulnerabilities. Proactive management is the best means of shielding systems from virulent viruses and new blended threats.

Security is as much process as product, and users are often the weakest link. Yet most organizations, even those with big security budgets, lack security policies and means to enforce them. Recent surveys show that companies lack controls over their mobile devices, have weak access control systems for internal data, do not update product configurations and fail to monitor regulatory compliance. Ernst & Young recently found two-thirds of companies do not even know whether they are compliant with infosec requirements. Human policy management, security training and compliance monitoring therefore represent attractive opportunities. More established related areas such as password provisioning, single sign-on and web access management also have enhanced growth prospects.

Table 4

**Public Security Performance by Segment**

	at 9/24/03 Segment	Companies in Segment	% of 52 Week Hi	Revenues LTM	P/E CY2003	Projected Growth	Analyst Rating	12 month Price Growth	% of Total Market Cap
<b>Access Management</b>	Biometrics	2	77.0%	3.9x	NM	35%	0.57	5%	2%
	DRM	2	87.5%	5.1x	26.5x	24%	0.66	42%	4%
	Encryption Processing	2	89.9%	6.0x	52.8x	25%	0.17	82%	2%
	Firewall/VPN	5	79.8%	4.6x	35.7x	21%	0.21	60%	23%
	Secure Access Management	2	92.9%	3.8x	NM	21%	0.00	198%	2%
	Smart Cards & Tokens	6	85%	2.1x	47.9x	23%	0.33	152%	9%
<b>Threat Management</b>	Antivirus	3	82.2%	4.7x	32.1x	16%	0.51	20%	49%
	Intrusion Detection/VA	4	71.9%	1.6x	27.3x	18%	0.05	74%	5%
	Messaging	2	88.9%	8.1x	NM	NA	1.00	204%	1%
	Web Filtering	2	86.4%	5.3x	46.4x	22%	0.60	126%	3%

Table 5

**Select Security Challengers and non Pure-play Vendors**

Sectors	Examples	Areas of Interest	Rationale
<b>Telcos</b>	AT&T, BT	Managed Security	Voice/Data Convergence; hosting expertise
<b>System Integrators</b>	EDS, Unisys	Managed Security	Outsource more IT functions for clients
<b>Network Gear</b>	Cisco	Everything	Integrate with existing products
<b>NSM</b>	CA, HP, IBM	Everything	Opportunistically complement network management, existing security offerings
<b>Desktop Software</b>	Microsoft	Antivirus, Firewalls	Integral to offering; leverage ubiquity
<b>Storage</b>	EMC, Veritas	Data security, Access Management	Integral to offering; leverage ubiquity
<b>Database</b>	Oracle	Data security, Access Management	Integral to offering; leverage ubiquity
<b>Wireless</b>	Nokia	SSL VPN, Wireless Security	Integral to offering; leverage ubiquity

## New Opportunities Ahead (cont'd)

Security event management (data aggregation, correlation, analysis and visualization) remains a critical, largely unmet need in larger organizations. According to E&Y, more than a third of companies admit to having a "less than adequate" ability to know whether they are under attack and how to respond. Event management ties to broader demand for business activity monitoring solutions that provide decision makers with actionable IT system performance data.

Other promising sectors include video surveillance software, telco (voice data) security applications, blade-based security, Linux hardening solutions and new-generation content scanning technology.

Attractive but crowded emerging areas in various stages of consolidation include anti-spam, web filtering, SSL VPN, biometrics, managed security services, secure messaging, intrusion prevention and application level firewalls.

**Table 6 Security Company Data**

(at 9/24/03; \$ in millions except per share data)		Current	% of 52	Market	Enterprise	Revenues		EBIT	P/E	Projected	Analyst	
Company		Price	Week Hi	Cap	Value	LTM	CY2003	CY2003	CY2003	Growth	Rating	
<b>Access Management</b>	<b>Biometrics</b>											
	IDENTIX	\$ 6.00	82.8%	\$ 514.0	\$ 474.0	5.1x	4.8x	NM	NM	35%	0.57	
	VIISAGE	4.16	71.2%	84.7	98.5	2.8x	2.4x	NA	NA	NA	NA	
						Mean	3.9x	3.6x	NA	NA	35%	0.57
						Median	3.9x	3.6x	NA	NM	35%	0.57
	<b>DRM</b>											
	DIGIMARC	\$ 16.49	94.3%	\$ 296.8	\$ 261.5	2.9x	2.8x	79.2x	86.8x	23%	0.60	
	MACROVISION	19.33	80.6%	952.9	815.7	7.4x	6.8x	15.4x	26.5x	25%	0.71	
						Mean	5.1x	4.8x	47.3x	26.5x	24%	0.66
						Median	5.1x	4.8x	47.3x	26.5x	24%	0.66
	<b>Encryption Processing</b>											
	HI/FN	\$ 8.18	85.7%	\$ 88.1	\$ 45.4	2.5x	NA	NA	NM	20%	0.00	
	SAFENET	38.00	94.0%	500.1	461.1	9.6x	7.2x	36.6x	52.8x	30%	0.33	
						Mean	6.0x	7.2x	36.6x	52.8x	25%	0.17
						Median	6.0x	7.2x	36.6x	52.8x	25%	0.17
	<b>Firewall/VPN</b>											
	CHECK POINT	\$ 16.98	76.5%	\$4,333.3	\$2,866.0	6.7x	6.7x	11.1x	17.9x	13%	(0.18)	
	CYBERGUARD	9.64	90.1%	199.6	187.5	5.7x	NA	NA	48.2x	NA	NA	
	NETSCREEN	23.92	87.7%	1,947.4	1,632.3	7.6x	6.3x	25.6x	40.9x	32%	0.66	
	SONICWALL	6.39	87.4%	432.3	198.4	2.2x	2.3x	NM	NM	18%	0.10	
WATCHGUARD	5.14	57.1%	165.0	80.1	1.0x	1.0x	NM	NM	21%	0.25		
					Mean	4.6x	4.1x	18.3x	35.7x	21%	0.21	
					Median	5.7x	4.3x	18.3x	40.9x	19%	0.18	
<b>Secure Access Management</b>												
ENTRUST TECHNOLOGIES	\$ 5.25	92.1%	\$ 332.9	\$ 231.2	2.5x	2.5x	NM	NM	28%	(0.50)		
NETEGRITY	11.21	93.7%	385.8	345.9	5.2x	4.6x	NM	NM	15%	0.50		
					Mean	3.8x	3.6x	NM	NM	21%	0.00	
					Median	3.8x	3.6x	NM	NM	21%	0.00	
<b>Smart Cards &amp; Tokens</b>												
ACTIVCARD SA	\$ 7.95	66.3%	\$ 318.4	\$ 72.6	1.6x	NA	NA	NM	35%	0.17		
ALADDIN	6.96	87.2%	89.2	73.2	1.4x	1.3x	29.9x	38.7x	20%	1.00		
GEMPLUS	3.61	92.6%	1,093.1	694.3	0.9x	NA	NM	51.6x	NA	(1.00)		
RAINBOW TECHNOLOGIES	9.81	92.8%	263.2	204.0	1.6x	1.5x	13.0x	22.3x	20%	1.00		
RSA SECURITY	15.00	94.6%	880.5	829.2	3.4x	3.3x	43.8x	78.9x	16%	0.47		
VASCO DATA SECURITY	2.46	76.9%	69.7	78.2	3.8x	NA	NA	NA	NA	NA		
					Mean	2.1x	2.0x	28.9x	47.9x	23%	0.33	
					Median	1.6x	1.5x	29.9x	45.1x	20%	0.47	
<b>Threat Management</b>	<b>Antivirus</b>											
	NETWORK ASSOCIATES	\$ 14.55	70.3%	\$2,405.8	\$2,049.8	2.2x	2.3x	17.7x	26.5x	17%	0.28	
	SYMANTEC	63.76	96.6%	9,691.5	8,383.0	5.7x	5.2x	19.9x	35.4x	16%	0.74	
	TREND MICRO	21.10	79.6%	2,764.1	2,380.1	6.4x	5.5x	16.0x	34.4x	NA	NA	
						Mean	4.7x	4.3x	17.9x	32.7x	16%	0.51
						Median	5.7x	5.2x	17.7x	34.4x	16%	0.51
	<b>Intrusion Detection/VA</b>											
	INTERNET SECURITY	\$ 13.36	49.9%	\$ 674.0	\$ 448.4	1.8x	1.9x	11.3x	27.3x	19%	(0.17)	
	INTRUSION	0.79	65.8%	16.3	10.2	1.5x	NA	NA	NA	NA	NA	
	BINDVIEW DEVELOPMENT	2.99	100.0%	140.2	102.6	1.6x	NA	NA	NA	NA	NA	
	NETIQ	12.98	71.7%	740.2	426.8	1.4x	1.4x	15.8x	NM	17%	0.27	
						Mean	1.6x	1.6x	13.6x	27.3x	18%	0.05
						Median	1.6x	1.6x	13.6x	27.3x	18%	0.05
	<b>Messaging</b>											
	TUMBLEWEED	\$ 6.85	99.0%	\$ 214.3	\$ 189.1	8.1x	6.3x	NM	NM	NA	1.00	
	ZIXIT	7.89	78.9%	179.1	171.5	66.0x	NA	NM	NM	NA	NA	
						Mean	8.1x	6.3x	NM	NM	NA	1.00
						Median	8.1x	6.3x	NM	NM	NA	1.00
	<b>Web Filtering</b>											
	SECURE COMPUTING	\$ 12.77	92.5%	\$ 411.2	\$ 389.0	5.5x	5.1x	68.2x	60.8x	21%	0.85	
WEBSense	23.06	80.2%	521.5	364.6	5.1x	4.5x	15.9x	32.0x	23%	0.36		
					Mean	5.3x	4.8x	15.9x	46.4x	22%	0.60	
					Median	5.3x	4.8x	15.9x	46.4x	22%	0.60	

Outliers excluded from means/medians. 2003 estimates are calendarized and based upon Street analyst estimates. Analyst ratings represent relative consensus analyst recommendations. 1 = Buy and - (1) = Sell. Many companies compete in several segments; however, for this chart each was classified in one segment.

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