

MARCH 15, 2005

# Sonic Foundry, Inc.

NasdaqNM: SOFO

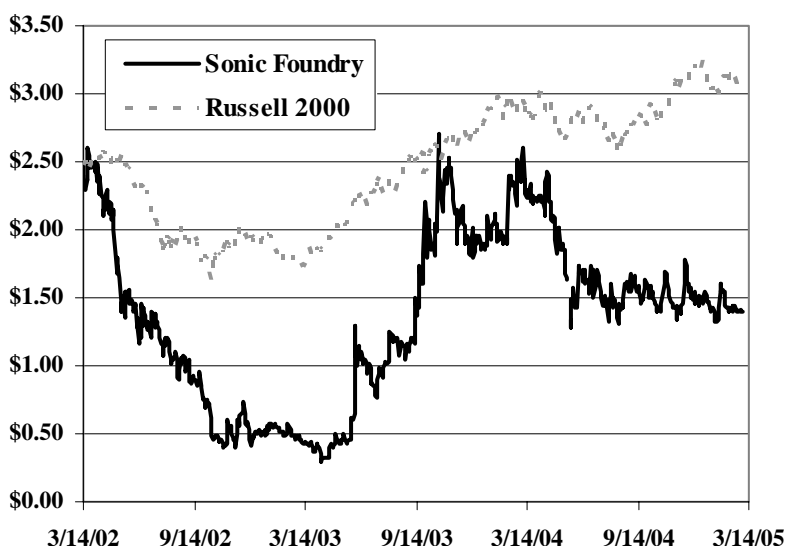
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Price	\$1.36	Shares (mils)	30
P/E Ratio (ttm)	NA	Market Cap (mils)	\$41.30
P/S Ratio (ttm)	8.1 X	52 Week Range	\$2.51 -\$1.20
Sales/share (ttm)	0.17	Ave. Daily Vol.	47,136
Price/Book	2.6 X	Short Interest	424,668
Book Value	\$0.52	Gross Margin	66.3 %
Cash/share	\$0.21	Oper. Margin	-90.9 %
Quick Ratio	4.71	Insider Ownership	14 %
Debt to cap ratio	0.17 %	Inst'l Ownership	25 %

Price Target	\$3.00
Rating	BUY
Risk	High
Disclosures	10, 11, 12



Sonic Foundry, Inc.'s (Nasdaq: SOFO) Mediasite presentation recorders provide an elegant solution for distributing "one-to-many" rich media content for educational institutions, corporations and government organizations for live or on-demand viewing over the Internet, intranet or recording to physical media.

- Revenues up 77% 1Q05 over 1Q04, with gross margins expanding to 66.3%.
- The company sold 92 recorder units in 1Q05, more than double the 44 units sold in 1Q04.
- Customers purchasing multiple units increased to 48% in 1Q05 compared to 35% in 2004.

We are initiating coverage of SOFO with a Buy rating and a price target of \$3 per share, or 4x our estimate of sale per share of \$0.75 for fiscal 2006, and 5.8x current book value of \$0.52 per share.

Earnings Per Share					
	Q1: Dec	Q2: Mar	Q3: Aug	Q4: Sep	Annual
2007E	\$ 0.06	\$ 0.07	\$ 0.09	\$ 0.11	\$ 0.33
2006E	\$ (0.00)	\$ 0.01	\$ 0.03	\$ 0.04	\$ 0.07
2005E	\$ (0.05)	\$ (0.04)	\$ (0.03)	\$ (0.02)	\$ (0.14)
2004A	\$ (0.04)	\$ (0.04)	\$ (0.05)	\$ (0.05)	\$ (0.18)

Corporate Officer  
Contact Person  
Corporate Address  
Website

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**Investment Thesis**

We believe that Sonic Foundry, Inc.'s (Nasdaq: SOFO) Mediasite presentation recorders may accomplish on the Internet what InFocus' (Nasdaq: INFS) line of projectors did to transform conference room presentations. SOFO provides an elegant solution for "one-to-many" multimedia presentations, simply and conveniently combining production and publishing activities, creating rich multimedia communications leveraged over the Internet for live or on-demand audiences. We also believe SOFO may expand the capabilities of its recorders, moving beyond providing ancillary archiving solutions, to become a leading name in "rich media" search and retrieval capabilities through its Publisher product and related expertise.

Convenience is an attractive feature for presenters who may be institutionally unable or unwilling to tolerate or understand complicated technology. Complicated aids or devices may distract them from their presentation. In addition, audiences are becoming increasingly demanding of higher levels of rich media, both live or on demand. For example, picture a technically challenged professor, salesperson, or corporate executive, aspiring to communicate critical information in the best channel the latest technology may allow, to an audience of distracted students, unforgiving customers, or unmotivated employees.

SOFO's Mediasite presentation recorders provide an economical solution for organizations wanting to improve and increase communications to a large or distant audience. This has been impeded by the relatively high cost of developing, training and sustaining teams of information technology (IT) personnel to orchestrate a complex production workflow process. This process has now been reduced to the simple press of the record and stop button by the presenter with no authoring or post-production work required. The process is simple for the viewer as well; no proprietary software other than standard Windows media and Internet Explorer is required.

Mediasite combines leading media technologies to reduce an otherwise complex production process into a seamless and audience friendly communication. The "Rich Media" solution provided by Mediasite combines graphics, text, video, audio and metadata in a single data file, for economical, timesaving and easy-to-use rich media communications. Mediasite conveniently compiles multiple media feeds from a variety of presentation devices and combines them into an Internet "stream". This stream can be distributed live to remote users, as the presentation is occurring, thereby eliminating the entire authoring process. Following the creation of the presentation, the stream is accessible on-demand.

SOFO's Mediasite products enhance communication for a broad variety of communications for business, government, and education, ranging from executive briefings, product marketing, and sales presentations, to public safety/emergency management and community outreach, to online lectures and distance learning. The company has found that the devices are particularly helpful in transmitting technical information.

One of the most immediate opportunities for SOFO is colleges and universities that could benefit from the economies of capturing and archiving online lectures and materials. In addition, these institutions are becoming increasingly interested in establishing distance learning programs to increase revenues at low marginal costs. In anticipation of academics and others creating an ocean of rich media, the company is working on R&D efforts to index rich media for search and archiving of unique proprietary content.

Likewise, outbound communications from corporate entities is essential to reach key employees, partners and customers. Other organizations also have a need to capture multimedia information as an alternative to written notes or other documentation such as the capture of content presented in meetings, records of court proceedings, or the results of electronic test equipment used in certifying new products. All organizations are potential customers for functional duties such as channel communications, sales training, product support and customer and dealer training.

## Company Background

Sonic Foundry, Inc., founded in 1991 and incorporated in 1994, is headquartered in Madison, Wisconsin. With its initial public offering, the company was listed on the American Stock Exchange under the symbol "SFO," and on April 24, 2000, began trading on the Nasdaq under the symbol "SOFO." Until late fiscal 2003, SOFO was engaged in three businesses – Media Services, Desktop Software and Rich Media.

On May 16, 2003, SOFO completed the sale of the Media Services business to Deluxe for approximately \$5.6 million. Media Services operations were the result of several acquisitions, primarily Sonic Foundry Media Services, Inc. and International Image Services Corporation, Inc. Media Services provided format conversion, tape duplication, film restoration and other services to the media, broadcast and entertainment industries, including translating audio and video media into various compression and Internet streaming file formats. In fiscal 2002, Media Services business generated revenue of \$9.4 million, or approximately 36% of SOFO's total revenues.

In July of 2003, SOFO completed the sale of its Desktop Software business to a subsidiary of Sony Pictures Digital for approximately \$19 million. The Desktop Software business designed, developed, marketed and supported software products for digitizing, converting, editing and publishing of audio, video, and/or multimedia content. The Desktop Software business included a number of mature products such as Sound Forge, ACID and Vegas. In 2002, annual revenue from the Desktop Software business was \$15.9 million, or approximately 61% of SOFO's total revenues.

### ***Rich Media: Mediasite and Publisher***

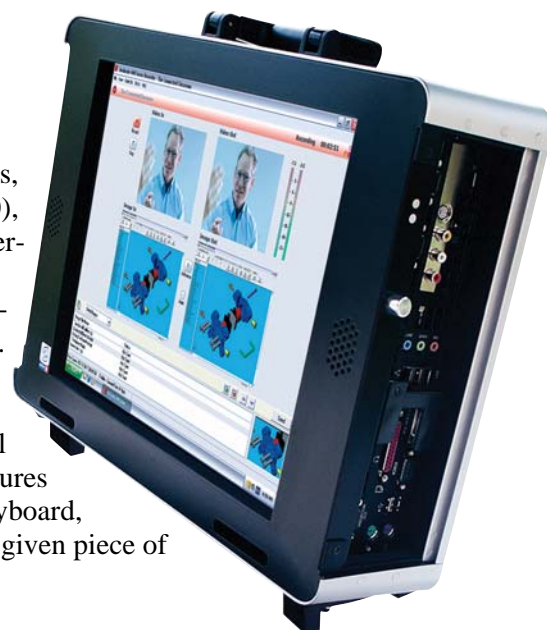
The Rich Media business was formed in October 2001, when SOFO acquired Mediasite, Inc., providing the underlying technology of their existing Mediasite and Publisher products for a total of \$9.1 million. Rich Media combined internally developed software code with acquired systems technology, including advanced publishing tools and media access technologies capable of operating across multiple digital delivery platforms. The technology evolved from a four-year Carnegie Mellon University (CMU) research effort funded by major government (DARPA, NSF, NASA) and private (CNN, Intel, Boeing, Microsoft, Motorola, Bell Atlantic) organizations. Simultaneously with the acquisition, SOFO entered into a non-exclusive license agreement with CMU for the core technology.

## Products

### **The Main Event: Mediasite Presentation Recorders**

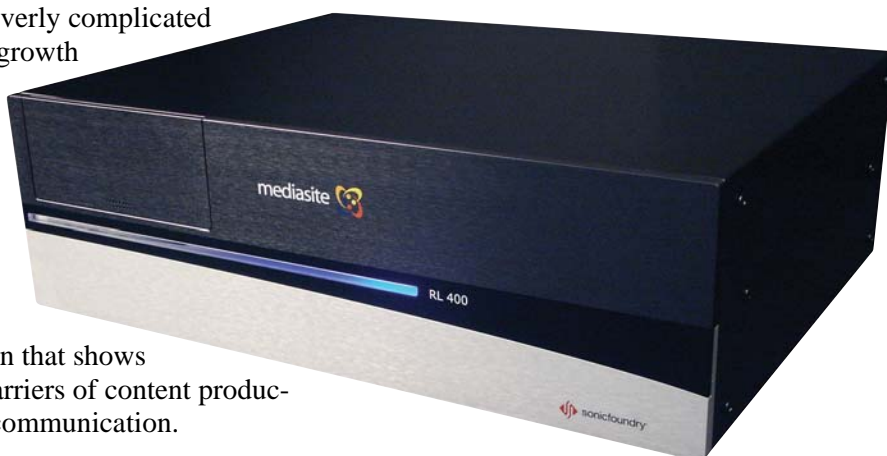
SOFO's core product is the family of Mediasite presentation recorders. These include a rack version (RL400), for fixed location use in lecture halls, conference rooms and other wired locations, and a mobile version (ML400), for use in multiple locations and remote capture of events. To increase operability and convenience, SOFO released the RL400 in late fiscal 2004, which included touch panel control operability, enhanced security and non-Windows operating system compatibility with third party Flash publishing.

Mediasite Live ML is a full-featured portable recording appliance based on a 3.06GHz, HyperThreaded Pentium 4 CPU that comes in a sturdy, well designed suitcase that weighs slightly more than 26 lbs. The Live ML features an integrated, 17-inch LCD flat-panel monitor, with storage space for a keyboard, mouse and many cables and dongles that you may need to interface with a given piece of equipment.



*From the Engineering Perspective:*

SOFO's engineering focus is eliminating an overly complicated production process that has restricted market growth and expansion, by providing a much needed solution for technical integration, not easily accomplished, much less understood. For example, technologies involved in their products include streaming, database integration, video and graphic capture and Internet viewing, which solves a very complex workflow integration problem. We believe Mediasite delivers an elegant, easy to implement solution that shows the promise of breaking through traditional barriers of content production and providing a new form of automated communication.



Rich media production can be a complex proposition, usually requiring a significant investment in "audio/video" (AV) production and post-production equipment, plus additional personnel with the skill sets necessary to capture and integrate multimedia elements. SOFO simplified this process, obviating the need for much of that AV expertise with its Mediasite recorders.

Mediasite leverages Microsoft technology for its video and audio capture, which is based on Windows Media encoders. One potential problem, particularly with regard to the higher education market, is a number of compatibility issues with Apple Macintosh systems. To maintain Mac playback compatibility, the current Mediasite Live configuration must use Windows Media 8 encoders.

Audio capture setup is fairly easy, as Mediasite Live offers a pair of connection options. Prior to the presentation, users can select between audio on the Osprey card via the Osprey capture card's dongle and the unit's onboard Realtek97 card. Video capture setup is just as simple. Once users have chosen the video input selection on one panel, they can then move to a different panel and choose between YC and composite inputs.

Mediasite's administration tools need to be installed on a Windows 2000 Server running the Internet Information Server services. Using a Web-based tool, users can fill in details, choose the level of interactivity, and pick the presentation mode - live broadcast, archived local content or download for on-demand playback later. For live presentations, the audience can provide feedback, send questions or respond to a preconfigured poll.

*From the Presenter's Perspective*

Mediasite provides significant versatility and flexibility to capture virtually any kind of multimedia content from any presentation device including notebook PC, document camera or smart board. Mediasite Live instantly turns this raw material into Web-based interactive rich media content.

The system requires relatively little training and only rudimentary technical expertise. Once the system is set up, presenters simply plug their computers in and start to present. Rich media presentation content, such as PowerPoint® presentations, live or canned audio and video, and any other accompanying graphics, are instantly synchronized, stored, or alternatively streamed over the Web. Captured information is immediately archived and made available for convenient on-demand playback. This content can also be burned to CD or DVD.

One interesting feature is Mediasite's ability to efficiently capture only as much video information as is needed. By analyzing variations between previous frames and the current frame, Mediasite Live can capture only those frames that vary significantly from previous frames. Users can control the sensitivity of these settings with a slider bar. This tool waits until the motion in the screen image has stabilized before capturing a frame.

*From the Audience Perspective:*

The delivery of content generated through Mediasite is managed through a synchronized server process that simultaneously delivers a Windows Media stream, audio, associated graphics and thumbnails and various metadata to provide a viewing experience over a standard browser. No download or custom applets are required to view the content. The user is able to start, stop, decode and display video and synchronized slides in fixed positions on a user's screen. It also permits the user to advance through the session and to link to external resources.

MediaSite is presenter-friendly and suitable for manifold applications in both corporate and educational networks.

Thanks to the use of smart technology in the recording appliance, the finished content it produces meets the highest standards of the most demanding Web-based business and academic audiences.

Related products and services include server software applications and customer support, installation and training services. The company offers their customers support through annual maintenance contracts. The contracts are usually obtained at the time the Mediasite product is purchased, at a price of approximately 18% of the Mediasite list price. This includes an extension of the hardware warranty from the standard 90-days to one year, system upgrades, advance replacement, unlimited technical support, and access to product hot fixes. The company also offers additional fee-based services including installation, training and consulting.



***Other Products: Indexing, Captioning, Search***

SOFO is also involved in advanced research related to the interpretation and further enhancement of rich media. A significant portion of this research is based on the integration of speech, language and image processing (ISLIP). This provides the capability of extracting and creating metadata from time-based media including constructing meaningful indices enabling efficient search and retrieval of rich media. The company believes its technology may make content more navigable and searchable, compared to non-indexed media content, thus making it more valuable.

Without indexes for cross-referencing, viewing or searching through data for specific information can be very inefficient and time-consuming. While certain indexing technologies are built into commercial films, accommodating efficient search of publicly produced video, SOFO is developing technology that is intertwined in the workflow of Mediasite recorders, allowing automated and semi-automated processes that index, categorize and embed rich information and essentially increasing the value of its content and creating a barrier for later entry of competitive recording devices. This may also allow information produced by Mediasite recorders to be available to feed Google, Yahoo!, and Microsoft search engines.

Another patented technology is “video skimming,” which provides users the capability of reviewing rich media faster than real-time. The company anticipates continued funding from government entities, and is actively researching and developing further commercialization of these technologies into products with broad market opportunities. SOFO is currently working on a project to examine how state and local law enforcement agencies can better process and manage audio and video media, financed by a \$496,000, 18-month research grant from the United States Department of Justice.

The company is planning to develop a set of media analysis software components that will form the foundation for addressing multiple law enforcement applications related to media, such as the indexing and cataloging of media, data mining and electronic surveillance in 2005. The company plans to apply for additional funds to further advance the research efforts performed for the Department of Justice. We believe that while this is not the current object of our investment thesis, it may provide a unique opportunity in the area of Homeland Security. The company believes that these efforts may ultimately lead to commercialization of “meta-tagging” (identification and extraction of audio, visual and textual cues) as well as “video mining” technology.

### **Market Potential**

The rack version RL 400 retails for \$22,250 and the mobile version ML400 retails for \$24,950. The Mediasite presentation recorder is most economic for either larger organizations or organizations with consistently active demands to transmit rich media in real-time or on demand. For these reasons, SOFO has specifically targeted entities which have more than 500 employees, multiple offices, and have found service provider solutions in conferencing more costly.

The company has found that larger institutions recognize the benefits of reduced time and effort by using one or several Mediasite products relative to the need to maintain the expense of sustaining and educating IT staff. The functionality of compatibility among operating platforms and types of digital media allows for the full exploitation of leveraging the Internet. For this reason, the company believes the range of potential users can grow quite broadly. The company estimates the market size for rich media to be approximately \$1 billion.

The company believes its Mediasite presentation recorder, unlike an InFocus projector limited to the confines of a screen, has the characteristics of an Internet projector. They believe their Mediasite presentation projectors may have a similar rate of adoption. InFocus projectors entered the market at a price of about \$20,000, were most economical in large lecture rooms, and over time with improved economies of manufacturing were found in conference rooms. Eventually, its projectors became economical enough to allow presenters to take the device between presentations, which became a common practice across a wide range of organizations. The company believes the market for A/V presentation equipment is about \$2 to \$5 billion.

Videoconferencing is another potential use that has intuitively provided similar opportunities for the Mediasite presentation recorder, also limited by the economics of IT staff assimilating complex and changing fragmented technology into cost effective systems. Despite this handicap, the video conferencing market for hardware and services is estimated to be approximately \$2 billion, having penetrated less than 10% of an estimated 25 million conference rooms worldwide.

While videoconferencing is not the most immediately available application, the company believes the web presentation and webcasting markets will expand far beyond the established videoconferencing market. Because SOFO's products have similar target markets and the ability to offer increased functionality, the company has pursued the A/V reseller channel as its primary distribution partner.

**Marketing**

SOFO focuses its marketing efforts through a sales force that manages a reseller channel of value-added retailers, system integrators, consultants and distributors. The company believes these third party representatives are specialized and have good understanding of both A/V systems and IT networking. The company also maintains a database of potential customers in the government, education, and corporate prospects.

The company's primary focus has been on customers in the United States identified as having the greatest potential for high use: presenters, trainers, lecturers, marketers and leaders who have a routine need to communicate to many people in higher education, government, the health industry and certain corporate markets. The company has found that some of their largest customers are government entities and large corporations that often require long testing and approval processes before making a decision to purchase their products. As of the end of 1Q05, SOFO sold through 40 resellers, and had sold to 269 total customers. In its latest conference call, the company highlighted sales to the following organizations, which we consider impressive in quality and reach.

The company reports that most customers will buy a single system, often a mobile unit, to test the full capability of the system. Larger enterprises and facilities have followed up with multiple unit orders following a test of the capabilities of the system. On its latest conference call, management reported that one-third of sales included more than one unit, more multi-unit purchases are being quoted and sold, and the average sale amount is increasing. The company reports that 35% of buyers were repeat customers in 2004, increasing to 48% in 1Q05.

<b>Customer Highlights in 1Q05</b>		
<b><u>Corporate</u></b>	<b><u>Government</u></b>	<b><u>Education</u></b>
IBM Research Raytheon British Aerospace General Dynamics	Ohio DOT City of West Palm Beach WEAC State of Wisconsin Hygiene	Arizona State Georgia State Florida State Wallace State Wayne State Central Michigan Penn State Vanderbilt University of Texas Wake Forest (Baptist Medical Center)

As of the end of fiscal 2004, nearly half of the company's revenues were realized from the education and distance learning markets. Corporations lag education users in adoption, but have grown in 2004 to approximately 30% of revenues, as market awareness of web presentation and conferencing solutions expand. The company is seeing expanded interest from government, associations, legal, medical, engineering and marketing organizations.

SOFO's two largest customers were 11% of revenues each in 2004. No individual customer was over 10% of revenues in 2003. The company's two largest customers were 29% and 25%, respectively, in 2002. In addition, while SOFO's primary attention is on the North American market, reseller and customer interest outside of North America include Japan, Australia, New Zealand, the Middle East, Europe, Africa and South America. Billings outside North America totaled 13% in 2004.

Marketing efforts include tradeshow, web page information, webinars, brochures, direct mail, print advertisement and white papers. Due to the nature of the company's product, the company's website and related communications contain numerous testimonials and, by way of the Internet, demonstrate the characteristics of the product making apparent numerous applications.

**Competition**

SOFO believes it has a unique product offering. It sees potential competition from Webex, Placeware (Microsoft), and Raindance, which offer collaboration and web conferencing applications, while Microsoft, Macromedia and Accordent provide authoring capability. SOFO views the competitive landscape as follows:

Competition				
Method	Player	Advantages	Disadvantages	Distribution
Authoring	Accordent	Costs, Formats	Not turnkey, not room-based, lack of enterprise components	Target production people, software distributors, direct
Authoring with system purchase	Tegrity	Learning focused and designed	High training costs, poor integration with existing infrastructure, spotty performance, slow processing.	Targets educators and students, direct sales
System	Envivio	MPEG-4. RGB, works well with broadcast signals	Licensing cost, less user access, poor publishing, no database, not an enterprise application	Broadcast distributors, corporate production
Web collaboration and web conference	Webex, Microsoft Net Meeting, Macromedia Breeze	Group-based settings control, good for application sharing and collaboration	Cost, no instant publishing, or archive, Audio only, PowerPoint or pre-assembled content required	Direct, on-line, software distribution
Video conference	Tandberg and Polycom	Synchronous with multiple participant capability, security over private networks, existing footprint	Difficulty of use, Narrow access, lack of distribution of content to enterprise, archiving	A/V and Network VARs
Rich Media Presentation	Sonic Foundry	Cost, Quality of Presentation, Open Standards, Database publishing, Turnkey, One button record, Windows	No authoring or collaboration. Not for synchronous two-way conversations	A/V and Network VARs
Source: Sonic Foundry				

The company may also face competition from foreign suppliers and competition from LMS (learning management system) or education IT companies. They may also compete with other video services vendors as well as web conferencing vendors, and/or current and potential customers who may develop software or perform application services internally. The company reports that existing customers, while able to aggregate existing off-the-shelf technology, later admitted that they could not complete engineering at a similar quality or cost while sustaining an IT staff. For this reason, we believe that they may come to dominate the “one-to-many” niche with its elegant “push to play” recorders. The company believes the following factors are the principal competitive factors in its market, which we list in our opinion of priority.

1. Functionality, quality and performance
2. Ease of use, reliability, scalability and security of services
3. Customer service and support
4. Establishing a significant base of customers and distribution partners
5. Ability to introduce new products to the market in a timely manner
6. Ability to integrate with third-party offerings and services
7. Pricing
8. Evolving as an enterprise application

The primary competitive advantage of SOFO’s Mediasite device is the functionality and ease of recording and the ability to reach a wider audience. For this reason, the price of the device, relative to going without a more-costly internally developed system, is not considered to be an immediate competitive risk, but one of the devices greatest advantages. SOFO’s primary barrier to entry to other competitors is being first to market. Key to its strategy is attracting customers who require high quality recorders ahead of the entry of competition and subsequent pricing pressure.

***Intellectual Property Protection:***

The company currently has four patent applications pending in the United States, none of which have been issued. They have also filed for five U.S. trademarks, of which three are registered and one foreign country trademark, which is also registered. SOFO also requires employees to enter into confidentiality and nondisclosure agreements.

***Future Technology Advantage:***

While we see SOFO’s current protection in the market primarily being able to deliver and support the highest quality solution available, we eventually see the company’s higher margins and returns from aggregation of off-the-shelf technology inducing competition. We believe SOFO’s anticipated advancements and commercialization of the indexing, captioning and search technologies as eventually providing a unique and indispensable functionality, with high technical barriers to entry.

In 1990 Carnegie Mellon took an interest in extracting integration of ISLIP (speech, language and image processing) from digital media and relating it to a timeline for archiving and retrieval. The rapid increase in digital information was ripe for development of an algorithm that could search and locate embedded information among a rapidly growing ocean of digital content.

SOFO acquired this technology when it acquired Mediasite in 2001. Currently, there are two other companies with similar technology which attempts to automate indexing. Convera, a Washington based company in cooperation with Intel, is working in this area of digital media. Autonomy, through its acquisition of Virage, offers an enterprise approach to webcasting that attempts to sell a full rich media database and indexing system on top of the webcasting solution.

We believe that Mediasite, originally developed with Carnegie Mellon with additional development made possible by grants from the Department of Justice, may have produced technology which is more integrated to the source of the media, is able to generate rich media indexes faster and is ultimately more economical than the pure enterprise applications that Convera and Autonomy offer. This may create a competitive edge over companies working to replicate Mediasite's presentation recorders and additional applications in areas like Homeland Security.

**Management**

We believe SOFO's management team is more than capable of executing the current plan to increase sales of Mediasite presentation recorders and commercialize its indexing, captioning and search technologies. Our opinion is based on the length of time they have worked together, which is important to functioning cohesively as a unit, and the successful sale of lower-margin business units while advancing more lucrative opportunities. In addition to Mr. Buinevicius, SOFO's Chairman of the Board and CEO, the company has six other directors, four of which have served over five years on the board.

Rimas P. Buinevicius has been SOFO's Chairman of the Board since October 1997 and CEO since January 1997. Mr. Buinevicius joined Sonic in 1994 as General Manager and Director of Marketing. Prior to joining SOFO, Mr. Buinevicius worked in biomedical and industrial control research and development. Mr. Buinevicius earned an M.B.A. degree from the University of Chicago, a Master's degree in Electrical Engineering from the University of Wisconsin, Madison, and a Bachelor's degree in Electrical Engineering from the Illinois Institute of Technology, Chicago. Mr. Buinevicius is also a recipient of Ernst and Young's Entrepreneur of the Year award.

Rimas P. Buinevicius		
	Salary	Bonus
2004	\$192,308	
2003	\$136,538	\$250,000
2002	\$31,854	
2,354,514 Shares, 7.5% outstanding		

Monty R. Schmidt is the founder of SOFO and has been the company's Chief Technology Officer since July 2003 to present, and a Director since February 1994. From March 1994 to July 2003 he served as President. Prior to joining SOFO, Mr. Schmidt served in software and hardware engineering capacities for companies in the medical and food service equipment industries. Mr. Schmidt has a B.S. degree in Electrical Engineering from the University of Wisconsin, Madison.

Monty R. Schmidt		
	Salary	Bonus
2004	\$168,269	
2003	\$144,615	\$250,000
2002	\$118,462	
3,292,938 Shares, 10.9% outstanding		

Kenneth A. Minor has been SOFO’s CFO since June 1997. He also has served as Secretary since February 2001, and Assistant Secretary from December 1997. From September 1993 to April 1997, Mr. Minor was employed as Vice President and Treasurer for Fruehauf Trailer Corporation, where he was responsible for financial, treasury and investor relations functions. Prior to 1993, Mr. Minor served in various senior accounting and financial positions for public and private corporations as well as Deloitte Haskins and Sells. Mr. Minor is a CPA and has a B.B.A. degree in accounting from Western Michigan University.

Kenneth A Minor		
	Salary	Bonus
2004	\$144,230	
2003	\$128,462	\$100,000
2002	\$103,973	
279,671 Shares, <1% outstanding		

Currently, approximately 22.4% of SOFO’s common stock is held by insiders and about 25% by institutions. There are approximately 30 million shares outstanding. As of the end of fiscal 2004, SOFO had outstanding options and warrants to acquire 6,341,599 shares of common stock, 852,517 of which are subject to future vesting. This includes 4,125,953 options granted under their 1995 Employee Stock Option Plan, 1999 Non-Qualified Stock Option Plan and a Non-Employee Director Stock Option Plan. Of these warrants, 3,273,436 are immediately exercisable.

**Financial Discussion**

SOFO initiated sales of its Mediasite presentation recorders in 3Q02, approximately one year before the sale of its Media Services and Desktop Software businesses. Prior to the sale of these businesses, SOFO had 246 full-time employees as of the end of fiscal 2002. This was subsequently reduced to 32 and 47 full-time employees, at the end of fiscal 2003 and 2004, respectfully. As of the end of 1Q05, the company had employees in sales and marketing, general and administrative, and research and development of 27, 8, and 12, respectively. Upon completion of the sale of the two business units, the company had about \$13 million in cash on its balance sheet, with no debt. As of the end of 1Q05 the company reported \$6.4 million in cash.

An upward trend in sales of the company’s recorders commenced in 1Q03 and has since increased at a quarterly CAGR of over 25%. The company reported revenues from sales of its recorders of \$1.2 and \$3.4 million in fiscal 2003 and 2004 respectively. Other income includes sales of maintenance and service contracts as well as revenues from grants related to the company’s Publisher technology. Management noted on its recent conference call good progress in renewing expiring contracts.

Despite expected choppiness in operations early in fiscal 2003, gross margins quickly stabilized within a range of 54% to 64% in fiscal 2004. Operating expenses have increased slightly, with the increase primarily confined to selling and marketing expense, increasing to \$1.2 million in 1Q05, up from \$748,000 in 1Q04, due to salaries and commissions paid on increasing sales. Over the last two years the company has been able to achieve growth while keeping G&A and R&D at about \$700,000 and \$400,000 per quarter, respectively. The company used cash of about \$2 million per quarter in fiscal 2003 to sustain operations. This has been reduced to about \$1.4 million by the end of 1Q05.

The company reported a net loss of \$0.27 and \$0.18 per share in fiscal 2003 and 2004, respectively, which did not include taxes. As of the end of the 2004 fiscal year, SOFO had net operating loss carry forwards of approximately \$64 million for U.S. Federal and State tax purposes. Net operating loss carry forwards expire in varying amounts between 2013 and 2024.

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## Risks and Mitigations

We believe SOFO may be past the risk of its products not being accepted by the market. We draw this conclusion based on the number of multiple sales to existing customers accelerating and exceeding management's expectations. In the near term, the primary risk to both ongoing operations and valuation is achieving breakeven and avoiding further dilution. In the mid-term, we see a period where the company may be vulnerable to acquisition. This would happen if valuations suffer, possibly due to missing investor perceptions of growth or due to the introduction of significant competition. In the long run, should SOFO maintain gross margins at the current level, we may see product imitators and pricing pressure. In the long run, well beyond the investment horizon, we expect the industry to mature, sales growth to moderate and margins to contract.

**Risk:** SOFO has only been in the Rich Media business since October 2001, and marketing its Mediasite production recorders since June 2002, for a relatively short duration in a developing market.

**Mitigation:** In a short period of time, the company has demonstrated that it can execute a growth strategy, while maintaining operating expenses, focusing on the most attractive opportunities and investing in developing products.

**Risk:** SOFO has not yet attained profitability, which presents a risk to ongoing operations or impacting valuation if the company should complete a secondary increasing dilution.

**Mitigation:** The company appears to have adequate liquidity to cover the period leading to profitability. In addition, we believe the company has the ability for positive revenue surprises that may result in achieving profitability ahead of our forecast in 1Q06.

**Risk:** The more successful SOFO is in the emerging market for rich media, the more competitors are likely to emerge. These include turnkey media application; streaming media platform developers; and digital media applications service providers reverse engineering the company's products. Additional competition could place ongoing operations at risk by taking market share and increasing pricing pressure. This could present significant problems should a major competitor take a keen interest in SOFO's niche.

**Mitigation:** The company has utilized a combination of copyright, trade secret, trademark and contractual protection to establish and protect intellectual property where possible. We believe the company has a distinct advantage by being first to market and having a good opportunity to secure a position in the market as evidenced by higher than expected multiple sales to existing customers. In addition, we believe the potential for the company to integrate its Mediasite and Publisher products may present a significant barrier to entry. Lastly, we believe SOFO's rich media recorders may compete on their own.

**Risk:** SOFO's business could be impacted by the departure of Chairman and CEO Rimas P. Buinevicius or Chief Technology Officer Monty R. Schmidt.

**Mitigation:** Messrs. Buinevicius and Schmidt have long-term employment agreements with SOFO.

**Risk:** Tandberg and Polycom, two prominent manufacturers, may displace SOFO with competitive offerings, leaving them to find a new distribution source.

**Mitigation:** SOFO has an advantage in the way they bridge content over an IP network, publish the content, perform content management and ultimately add further value by indexing, captioning and providing search of that content. SOFO is not only complementary to videoconferencing but all forms of communication including web-based conferencing and collaboration.

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- Risk:** Much of SOFO's technology is based on a license from Carnegie Mellon, which the company has a non-exclusive, which may be utilized by potential competitors.
- Mitigation:** SOFO has been developing its own technology as related to the Mediasite recorders and the indexing, captioning and search of the content. No royalties are owed to any third party institutions as related to the capture technology and associated content management. Certain algorithms in use may be licensed from other parties or may be modified versions of open source technology such as Carnegie Mellon's Sphinx speech recognition technology. The company is confident that there are multiple sources for both licensed and open source software that might be incorporated in the products in the future and therefore, does not pose a significant risk to rolling out future product offerings. Likewise, this allows the company to deploy what it determines is the best of breed technology at any given time.

### **Reasons for Consideration for Investment**

1. High rate of sales growth of a well-conceived product in a developing market.
2. Potentially large commercial markets, education and government markets.
3. Significant level of repeat and multiple units sales to existing customers.
4. High gross margins with demonstrated operating expense control.
5. Rapidly approaching breakeven with significant cash reserves.
6. Management team has demonstrated performance and cohesiveness.
7. Publisher technology may provide future barriers to entry.
8. No analyst coverage, reasonable level of insider and institutional ownership.

### **Our Model**

#### ***Management Guidance:***

On the company's most recent conference call, SOFO management offered guidance for revenues of \$1.9 million in 2Q05 and a net loss of \$0.04 per share. They believe they can achieve revenues of \$10 million and approach breakeven late in the late in fiscal 2005. Management expects gross margins to improve with increased post-contract support and software license fees, consulting and Publisher revenues. They anticipate gross margins will average the mid 60% level in fiscal 2005. They also expect a similar headcount, but expect sales and marketing expense to increase with increase in sales.

#### ***Our Assumptions:***

We do not take exception to any specific item of management's guidance. We have forecast revenues growing at about 20% to 30% per quarter, and reaching the company's revenue guidance for fiscal 2005. Though this is a very rapid rate of growth, we sense that, given the high levels of repeat and multiple unit sales, it may prove to be conservative. We also believe SOFO may experience some small expansion of gross margins during fiscal 2005 and beyond. We also anticipate that the company will keep good control of operating expenses. We are a little concerned that increases in commissions for sales growth may erode the operating margin, which may push out our forecast for the company breaking even in 1Q06. Excluding income taxes, given the significant net operating loss tax carry forwards, we estimated that SOFO will have a net loss of \$0.14 per share in fiscal 2005, and net income of \$0.06 and \$0.33 per share in fiscal 2006 and 2007, respectively.

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**Conclusion and Valuation**

We are initiating coverage of SOFO with a **Buy** rating and price target of **\$3** per share, or 4x our estimate of sales per share of \$0.75 for fiscal 2006. This is 5.8x current book value of \$0.52 per share. We are also assigning SOFO a **High** risk rating as the company is in the early stages of product introduction and not yet profitable. Because SOFO is introducing a new product in a niche, there are no easy comparables available. Most mature providers of A/V equipment may be in mature markets and experiencing lower rates of growth and lower margins. SOFO may be best compared to its own performance and its particular position in its growth cycle. We see the stock currently trading at high multiples to trailing sales as a clear indicator that investors are anticipating high rates of revenue growth and profitability in the near term.

We believe that our price target is reasonable given the rapid acceptance, especially as seen through multiple unit purchases from current customers, and high gross margins in the early stages of product introduction. While we anticipate multiples will moderate as growth slows, we don't see this occurring in the near term, and believe the stock has good potential to appreciate should revenues increase, margins remain solid, and the company's performance is noticed by investors. Though profitability is important for investor interest, we anticipate that as the company's products move beyond academia and government into corporate boardrooms, the numbers of interested investors may increase by word of mouth.

**SLB Equity Research LLC**  
March 15, 2005

**Sonic Foundry, Inc.**

September FYE

	1Q04A Dec.-03	2Q04A Mar.-04	3Q04A Jun.-04	4Q04A Sept.-04	1Q05A Dec.-05	2Q05E Mar.-05	3Q05E Jun.-05	4Q05E Sept.-05	2003A	2004A	2005E	2006E
Income Statement												
Revenues												
Mediasite revenues	\$603	\$691	\$959	\$1,190	\$1,339	\$1,700	\$2,450	\$3,300	\$1,172	\$3,443	\$8,789	\$21,800
Customer support fees	67	90	110	158	189	220	250	280	84	425	939	1,420
Other	229	160	85	71	63	60	60	60	8	545	243	240
Total revenues	899	941	1,154	1,419	1,591	1,980	2,760	3,640	1,264	4,413	9,971	23,460
Cost of goods sold	324	431	443	561	536	658	911	1,192	888	1,759	3,297	7,525
Gross profit	575	510	711	858	1,055	1,322	1,849	2,448	376	2,654	6,674	15,935
Operating expenses												
Selling and marketing expenses	748	798	1,176	1,104	1,231	1,400	1,550	1,650	2,975	3,826	5,831	8,400
General and administrative expenses	681	644	738	763	815	825	835	845	3,189	2,826	3,320	3,480
Product development expenses	368	393	420	428	455	460	460	465	1,742	1,609	1,840	1,880
Total operating expense	1,797	1,835	2,334	2,295	2,501	2,685	2,845	2,960	7,906	8,261	10,991	13,760
Operating income	(1,222)	(1,325)	(1,623)	(1,437)	(1,446)	(1,363)	(996)	(512)	(7,530)	(5,607)	(4,317)	2,175
Other income (expense)	34	22	25	18	46	25	24	23	(19)	99	118	94
Interest expense	0	0	0	0	0	0	0	0	0	0	0	0
Income (loss) before income taxes	(1,188)	(1,303)	(1,598)	(1,419)	(1,400)	(1,338)	(972)	(489)	(7,549)	(5,508)	(4,199)	2,269
Provision for income taxes	0	0	0	0	0	0	0	0	0	0	0	0
Net income (continuing operations)	(1,188)	(1,303)	(1,598)	(1,419)	(1,400)	(1,338)	(972)	(489)	(7,549)	(5,508)	(4,199)	2,269
Earnings per share (continuing operations)	\$ (0.04)	\$ (0.04)	\$ (0.05)	\$ (0.05)	\$ (0.05)	\$ (0.04)	\$ (0.03)	\$ (0.02)	\$ (0.27)	\$ (0.19)	\$ (0.14)	\$ 0.07
Diluted shares	29,192	29,387	29,572	29,665	29,966	30,200	30,400	30,600	28,375	29,457	30,292	31,100
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	36.0%	45.8%	38.4%	39.5%	33.7%	33.3%	33.0%	32.8%	70.3%	39.9%	33.1%	32.1%
Gross profit	64.0%	54.2%	61.6%	60.5%	66.3%	66.8%	67.0%	67.3%	29.7%	60.1%	66.9%	67.9%
Selling and marketing expenses	83.2%	84.8%	101.9%	77.8%	77.4%	70.7%	56.2%	45.3%	235.4%	86.7%	58.5%	35.8%
General and administrative expenses	75.8%	68.4%	64.0%	53.8%	51.2%	41.7%	30.3%	23.2%	252.3%	64.0%	33.3%	14.8%
Product development expenses	40.9%	41.8%	36.4%	30.2%	28.6%	23.2%	16.7%	12.8%	137.8%	36.5%	18.5%	8.0%
Total operating expense	199.9%	195.0%	202.3%	161.7%	157.2%	135.6%	103.1%	81.3%	625.5%	187.2%	110.2%	58.7%
Operating income	-135.9%	-140.8%	-140.6%	-101.3%	-90.9%	-68.9%	-36.1%	-14.1%	-595.7%	-127.1%	-43.3%	9.3%
Other income (expense)	3.8%	2.3%	2.2%	1.3%	2.9%	1.3%	0.9%	0.6%	-1.5%	2.2%	1.2%	0.4%
Net income (continuing operations)	-132.1%	-138.5%	-138.5%	-100.0%	-88.0%	-67.6%	-35.2%	-13.4%	-597.2%	-124.8%	-42.1%	9.7%
Sales/share (ttm)	\$ 0.07	\$ 0.09	\$ 0.12	\$ 0.15	\$ 0.17	\$ 0.21	\$ 0.26	\$ 0.33	NA	\$ 0.04	\$ 0.15	\$ 0.75

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March 15, 2005

**Sonic Foundry, Inc.**

September FYE

## BALANCE SHEET

ASSETS	2001	2002	2003	2004	2Q04	3Q04	4Q04	1Q05
Cash and equivalents - (000's)	\$7,809	\$3,704	\$12,623	\$7,583	\$11,043	\$9,095	\$7,583	\$6,365
Accounts receivable	4,065	484	508	1,345	602	1,062	1,345	1,303
Accounts receivable, other	26	43	139	18	2	26	18	15
Inventory	0	48	111	371	68	240	371	391
Other current assets	2,203	294	214	281	419	443	281	211
Assets of discontinued operations	0	4,087	0	0				
<b>Total current assets</b>	<b>14,103</b>	<b>8,660</b>	<b>13,595</b>	<b>9,598</b>	<b>12,134</b>	<b>10,866</b>	<b>9,598</b>	<b>8,285</b>
Net property, plant, and equipment	11,804	574	588	745	643	783	745	691
Goodwill & intangibles	44,805	8,949	8,618	8,288	8,453	8,371	8,288	8,206
Deferred long-term asset charges	514	653	0	0	0	0	0	0
Other assets	457	0	0	0	0	0	0	0
Long-term assets of discontinued operations	0	8,807	0	0	0	0	0	0
<b>Total assets</b>	<b>\$71,683</b>	<b>\$27,643</b>	<b>\$22,801</b>	<b>\$18,631</b>	<b>\$21,230</b>	<b>\$20,020</b>	<b>\$18,631</b>	<b>\$17,182</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>								
Accounts payable	\$2,316	\$1,531	\$1,065	\$879	\$696	\$885	\$879	\$797
Accrued liabilities	2,064	950	1,263	686	676	763	686	363
Unearned revenues	83	0	194	473	354	415	473	467
Current portion of capital lease obligation	5,219	217	48	0	28	0	0	0
Convertible debt	0	3,482	0	0	0	0	0	0
Liabilities of discontinued operations	0	2,976	0	0	0	0	0	0
<b>Current liabilities</b>	<b>9,682</b>	<b>9,156</b>	<b>2,570</b>	<b>2,038</b>	<b>1,754</b>	<b>2,063</b>	<b>2,038</b>	<b>1,627</b>
Long-term debt	742	230	0	0	0	0	0	0
Deferred long-term liability charges	28	38	0	27	30	29	27	26
Other long term liabilities	0	235	0	0	0	0	0	0
Shareholders' equity	61,231	17,984	20,231	16,566	19,446	17,928	16,566	15,529
<b>Total liabilities and shareholders' equity</b>	<b>\$71,683</b>	<b>\$27,643</b>	<b>\$22,801</b>	<b>\$18,631</b>	<b>\$21,230</b>	<b>\$20,020</b>	<b>\$18,631</b>	<b>\$17,182</b>
Cash per share	\$0.35	\$0.14	\$0.44	\$0.26	\$0.38	\$0.31	\$0.26	\$0.21
Quick ratio	1.23	0.46	5.11	4.38	6.64	4.92	4.38	4.71
Current ratio	1.46	0.95	5.29	4.71	6.92	5.27	4.71	5.09
Debt to capitalization ratio	1.26%	1.49%	0.00%	0.16%	0.15%	0.16%	0.16%	0.17%
Book per share	\$2.76	\$0.67	\$0.70	\$0.56	\$0.66	\$0.61	\$0.56	\$0.52

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This report has been written in accordance with current SEC regulations and the Standards of Practice developed by the Chartered Financial Analyst Institute (CFAI). Our research has been conducted by employing analytical practices generally accepted as standard within the analytical industry. In this instance, a comparison of financial strength, a bottom-up earnings projection based on a recovery in the U.S. economy, and relative multiples, were employed. The target price was calculated on comparative EPS, sales and book value multiples, and our knowledge of small-cap markets when enjoying both a sector and a cyclical rebound. Our conclusions are, by the very nature of forecasting, speculative, but are also reasonable, supportable and consistent.

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<b>Sell</b>	The stock has reached the target price objective and/or conditions have changed sufficiently to alter the outlook for the stock.

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