

MARCH 20, 2007



**BEACON  
ROCK  
RESEARCH**

**Sonic Foundry, Inc.**  
NasdaqNM: SOFO

**Mike Niehuser**  
503-307-3188

[mniehuser@beaconrockresearch.com](mailto:mniehuser@beaconrockresearch.com)

[www.beaconrockresearch.com](http://www.beaconrockresearch.com)

5956 N.W. 213th Place, Portland, Oregon 97229

Price	\$3.85	Shares (mils)	32.3
P/E Ratio (ttm)	NA	Market Cap (mils)	\$133.8
P/S Ratio (ttm)	8.61 X	52 Week Range	\$5.15 - \$1.25
Sales/share (ttm)	\$0.44	Ave. Daily Vol.	458,105
Price/Book	5.92 X	Short Interest	331,805
Book Value	\$0.64	Gross Margin	77.7%
Cash/share	\$0.37	Oper. Margin	-41.7%
Quick Ratio	2.54	Insider Ownership	30.0%
Debt to cap ratio	0.00 %	Inst'l Ownership	17.2%

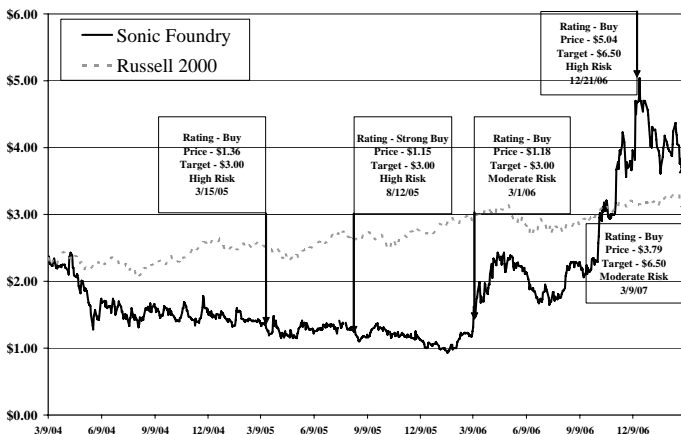
Disclosures 1,2,3,4

Price Target	<b>\$6.50</b>
Rating	<b>Buy</b>
Risk	<b>Moderate</b>

Sonic Foundry, Inc.'s (Nasdaq: SOFO) Mediasite recorders are proving to be the "Rolls Royce" of the information superhighway and the leading vehicle for transporting serious rich media (video, audio, graphics) content on the Internet. The recent announcement of its advanced search technology completes the company's product offering securing its position in one-to-many long distance learning.

- Revenues of \$3.5 million in 1Q07, up 86% over 1Q06.
- Pipeline approaches \$50 million, up 67% over last year.
- Guidance for profitability on GAAP basis for fiscal 2007.

We reiterate our Buy rating and our price target of **\$6.50** per share, or 10x our estimate of sales per share of \$0.65 per share for the next four quarters.



Earnings Per Share					
	Q1: Dec	Q2: Mar	Q3: Jun	Q4: Sep	Annual*
2007E	\$ (0.04)	\$ 0.00	\$ 0.02	\$ 0.03	\$ 0.01
2006E	\$ (0.05)	\$ (0.03)	\$ (0.02)	\$ (0.01)	\$ (0.11)
2005A	\$ (0.05)	\$ (0.03)	\$ (0.03)	\$ (0.02)	\$ (0.13)
2004A	\$ (0.04)	\$ (0.04)	\$ (0.05)	\$ (0.05)	\$ (0.18)

\* numbers may not add up due to rounding

Corporate Officer  
Contact Person  
Corporate Address  
Website

Rimas P. Buinevicius, CEO  
Kenneth A. Minor, CFO  
222 West Washington Ave., Madison, WI 53703  
[www.sonicfoundry.com](http://www.sonicfoundry.com)

(608) 443-1600  
(608) 443-1600

This Information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.

### *Price Correction in Seasonally Weak Quarter Reduces Risk Assessment*

We retain our **Buy** recommendation for Sonic Foundry, Inc. (Nasdaq: SOFO) and the 12-month price target of **\$6.50** per share. In our previous report we increased our risk assessment to High as the price of Sonic Foundry's shares were hitting record highs and the company was heading into its seasonally weakest quarter. In addition, we anticipated, with the stock's rapid rise, that there would be profit-taking by long-term investors combined with short-term momentum traders. As the company is now moving away from its seasonally softest quarter into its three strongest quarters and potentially breaking-even on a GAAP basis in fiscal 2007, we suspect the company's shares may be finding a new level with good fundamental support. We are sufficiently confident of these factors, in an environment increasingly taking note of video on the Internet, to upgrade our risk assessment to **Moderate** from High.

The recent price corrections, during a seasonally weak quarter, have created an entry point or opportunity to add to a position with a 12-month investment horizon. Even though the current stock price is above our previous long-term price target of \$3.00 per share and well off the recent all-time high of \$5.15 per share (enjoying the notoriety of being one of the highest performing stocks in 2006), Sonic Foundry may still be viewed as both a solid company and investment.

In the wake of the \$1.6 billion 2006 acquisition of YouTube Inc. by Google Inc. (Nasdaq: GOOG), the video on the Internet genie is out of the bottle. The increased demand for video, with supply and universality of increasing bandwidth, has created a balance of supply and demand, where information driven organizations may now understand the value proposition of Sonic Foundry providing a means of producing, transmitting, viewing, archiving, and searching serious video (rich media). Sonic Foundry is the only company to offer a solution capable of effectively and economically meeting all these needs. For this reason, we believe we are well justified in utilizing higher valuation multiples in justifying our current price target.

Sonic Foundry continues to demonstrate solid financial performance. While not yet profitable on a GAAP basis, the company continues to increase revenues and expand margins. Much of the growth has come from increasing deal size or additional sales to existing customers. The company continues to demonstrate to shareholders a return on product development or R&D with intra-quarter, quarterly, and annual improvements to their value proposition. Most significant, in our opinion, is the release of their remarkable advanced search capabilities readily available on its Mediasite.com website. We were a little surprised by the size of the loss in the quarter, but it can be attributed to increasing marketing efforts. With significant sales to existing customers, the increased focus on marketing makes good sense to leverage an expanding product offering. We see the increased opportunity for higher revenues as gross margin expands to be a good investment.

In summary, we believe Sonic Foundry has moved into position to exceed guidance for fiscal 2007. The company has the leading full rich media product offering from production to archival storage and search. The marketing organization and alliances are in place. The bandwidth is now available for rich media and demand for solutions for information-based markets of higher education, government, and corporate segments appear to be on the increase for the foreseeable future.



Source: Sonic Foundry

*Fiscal 1Q07 Financial Results*

Total revenues increased to \$3.5 million in 1Q07, up 84% over \$1.9 million in 1Q06, but short of our forecast of \$3.6 million for the quarter. The first quarter is seasonally the company's weakest. SOFO reported revenues from sales of Mediasite presentation recorders of \$2.6 million in 1Q07, up from \$1.3 million in 1Q06. Service revenue increased to \$878,000 in 1Q07, up from \$415,000 in 1Q06. The company noted an increase in this recurring source of income as total server license and support, hosting, training, and maintenance billings increased to \$3.4 million in the quarter, up from \$2.0 million in 1Q06. Unearned revenue was \$1.9 million at the end of 1Q07 compared to \$1.4 at the end of 1Q06. Server License fees increased to 19% of billings, or \$649,000, compared to 11%, or \$228,000 in 1Q06, representing an annual quarter-over-quarter increase of 185%. The only decline was in other income of only \$9,000 for 1Q07, down from \$111,000 in 1Q06.

Gross profit was \$2.7 million in 1Q07, up from \$1.3 million in 1Q06, also below our forecast of \$2.9 million. As management anticipated, gross margin continued to expand to 78% in 1Q07, up from 70% in 1Q06, meeting our forecast. The year-over-year increase in gross margins is due to higher levels of customer support and license fees. This is also in line with management guidance toward gross margins in excess of 80% due to higher levels of servicing and licensing fees.

Total operating expenses were \$4.1 million in 1Q07 as forecast, compared to \$2.9 million in 1Q06, and up from \$3.5 million in the prior quarter. The company reported selling and marketing expense of \$2.5 million in 1Q07, up from \$1.7 million in 1Q06, well ahead of our estimate of \$1.8 million. Other expenses for general and administrative and product development expenses were slightly above our estimate but were generally in line with our forecast. In our opinion, the company continues to demonstrate good management of overhead during periods of rapid growth and product development.

SOFO reported a net loss of \$1.4 million in 1Q07, or a loss of \$0.04 per share, compared to a loss of \$0.05 per share in 1Q06. Excluding non-cash charges of \$358,000 the company had an operating loss of about \$1.1 million. Cash balances at the end of 1Q07 were \$12.1 million. Management previously reported that they have a net operating loss carry forward of approximately \$72 million, which we estimate could reduce future taxes about \$27 million.

SOFO remains debt free. The company filed a \$42.6 million shelf in November of 2006. In December the company issued 3 million shares of common stock with net proceeds of about \$10.6 million. Management reports the capital will be used to invest in the rapidly developing professional services group and hosted service offerings, and further research and development efforts, including developing opportunities from its recently announced advanced search technologies.

*Management Guidance*

Management offered guidance for total GAAP revenues of approximately \$20 million for fiscal 2007. They anticipate continued expansion of gross margins to over 80% toward the end of fiscal 2007. They expect to end the year fully profitable on a GAAP basis. Considering the company incurred a loss of \$0.04 per share in its first quarter, this would suggest that they are expecting a significant increase in profitability later in the year.

Management recently reported a pipeline of approximately \$50 million compared to about \$30 million the same time last year. While accepting the definition of a pipeline to include prospects beyond serious tire kicking to negotiations, this is a good indicator that the company is on track for meeting or exceeding guidance for fiscal 2007. This is also supported by significant sales to existing customers, which includes expanding services as well as renewing licenses. In the next several years, with increased renewals of hosting and software services, management sees the potential for gross margins in the mid 80% range. They also believe that with high levels of renewals to existing customers, marketing expenses as a percentage of revenues may moderate.

### Our Model

We believe management's guidance for fiscal 2007 is readily achievable. On its previous conference call management noted the distance learning market is approximately \$15 billion. In addition, only 3% of higher education is associated with distance learning. Considering the increasing mobility and flexibility of learning of all types, the company appears to be ideally suited for expanding revenues. Long distance education is in demand by both a technology driven college age population and more mature professionals. In addition, we have stated our belief that the advanced search capabilities may eventually prove to be an historic achievement in personalizing self-directed life-long learning. In addition, the benefit to educational, corporate, and government clients may be difficult to quantify.

Our model forecasts \$21.7 million in revenues for fiscal 2007 compared to \$12.6 million in fiscal 2006. We forecast gross margins to increase to 79.7% for fiscal 2007 compared to 74.4% in fiscal 2006. We have forecast an increase in operating expenses to \$17.2 million for fiscal 2007 up from \$12.9 million in fiscal 2006. We are now estimating earnings on a GAAP basis of \$0.01 per share in fiscal 2007 compared to a loss of \$0.11 per share in fiscal 2006.

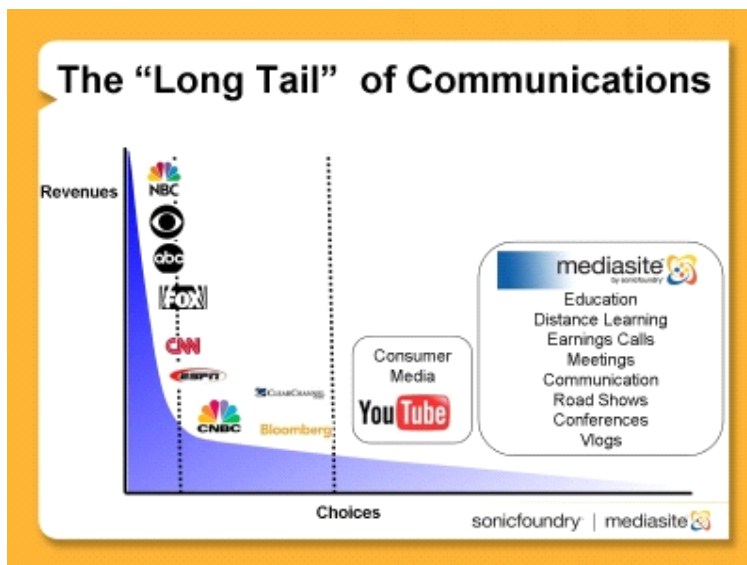
We would anticipate some deviance between our modeling and the eventual financial performance. Sonic Foundry is well situated in a growing market. It would appear to us that with increasing revenues and expanding margins, profitability is a matter of "when not if." We now believe profitability is within management's control. We are pleased to see the increased investment in marketing and ongoing investment in R&D. We believe that revenues should come with the industry maturing and investors will reward market share over near term profitability.

### Valuation and Conclusion

We recently increased our 12-month price target to \$6.50 per share from \$3.00 per share. We justified this based on the YouTube acquisition and the company reaching profitability on an operating basis. In our opinion, the apparent increase in interest for video over the Internet and improving financial performance warranted a valuation of 7x to 14x sales relative to the historic trading range of 4x to 7x sales. Applying a sales multiple of 10x our sales estimate of \$0.65 per share for the next four quarters, we arrived at a target price of \$6.50 per share.

### Risks

It would appear, with the recent profit-taking, that much of the anticipated volatility is out of the stock. With the softest quarter behind the company and the increased pipeline it would appear that the company has good potential to meet or exceed guidance for fiscal 2007. In addition, it would appear that with increasing awareness of availability of video over the Internet that the company is well situated for increased investor awareness as well as attracting additional clients. In addition, the company appears to be adding key marketing individuals to its management roster and, having completed a recent equity offering, now has increased operating and financial flexibility. We believe we are well supported to upgrade our risk assessment to Moderate from High.



Source: Sonic Foundry

# Beacon Rock Research, LLC

December 21, 2006

## Sonic Foundry, Inc.

September FYVE

(#'s in 000's)

	1Q06A	2Q06A	3Q06A	4Q06A	1Q07A	2Q07E	3Q07E	4Q07E	2005A	2006A	2007E	2008E
	Dec.-05	Mar.-06	Jun.-06	Sept.-06	Dec.-06	Mar.-07	Jun.-07	Sept.-07				
Income Statement												
Revenues												
Mediasite revenues	\$1,346	\$2,288	\$2,967	\$3,301	\$2,586	\$4,200	\$5,100	\$5,400	\$6,928	\$9,902	\$17,286	\$20,400
Customer support fees	415	652	663	776	878	1,000	1,150	1,350	975	2,506	4,378	7,425
Other	111	13	17	15	9	20	20	20	439	156	69	80
<b>Total revenues</b>	<b>1,872</b>	<b>2,953</b>	<b>3,647</b>	<b>4,092</b>	<b>3,473</b>	<b>5,220</b>	<b>6,270</b>	<b>6,770</b>	<b>8,342</b>	<b>12,564</b>	<b>21,733</b>	<b>27,905</b>
Cost of goods sold	560	861	812	982	773	1,083	1,238	1,320	2,754	3,215	4,415	5,545
<b>Gross profit</b>	<b>1,312</b>	<b>2,092</b>	<b>2,835</b>	<b>3,110</b>	<b>2,700</b>	<b>4,137</b>	<b>5,032</b>	<b>5,450</b>	<b>5,588</b>	<b>9,349</b>	<b>17,318</b>	<b>22,360</b>
Operating expenses												
Selling and marketing expenses	1,718	1,750	2,101	2,061	2,504	2,600	2,900	2,850	5,277	7,630	10,854	12,500
General and administrative expenses	696	766	744	835	970	970	980	990	2,864	3,041	3,910	4,060
Product development expenses	534	544	593	567	675	600	600	600	1,803	2,238	2,475	2,440
Total operating expense	2,948	3,060	3,438	3,463	4,149	4,170	4,480	4,440	9,944	12,909	17,239	19,000
<b>Operating income</b>	<b>(1,636)</b>	<b>(968)</b>	<b>(603)</b>	<b>(353)</b>	<b>(1,449)</b>	<b>(33)</b>	<b>552</b>	<b>1,010</b>	<b>(4,356)</b>	<b>(3,560)</b>	<b>79</b>	<b>3,360</b>
Other income (expense)	24	21	20	12	20	20	25	30	187	77	95	170
Interest expense	0	0	0	0	0	0	0	0	0	0	0	0
Income (loss) before income taxes	(1,612)	(947)	(583)	(341)	(1,429)	(13)	577	1,040	(4,169)	(3,483)	174	3,530
Provision for income taxes	0	0	0	0	0	0	0	0	0	0	0	0
<b>Net income</b>	<b>(1,612)</b>	<b>(947)</b>	<b>(583)</b>	<b>(341)</b>	<b>(1,429)</b>	<b>(13)</b>	<b>577</b>	<b>1,040</b>	<b>(4,169)</b>	<b>(3,483)</b>	<b>174</b>	<b>3,530</b>
<b>Earnings per share</b>	<b>\$ (0.05)</b>	<b>\$ (0.03)</b>	<b>\$ (0.02)</b>	<b>\$ (0.01)</b>	<b>\$ (0.04)</b>	<b>\$ (0.00)</b>	<b>\$ 0.02</b>	<b>\$ 0.03</b>	<b>\$ (0.14)</b>	<b>\$ (0.11)</b>	<b>\$ 0.01</b>	<b>\$ 0.10</b>
Diluted shares	31,275	31,694	31,995	32,300	32,363	34,100	34,800	35,100	30,363	32,015	32,088	35,700
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	29.9%	29.2%	22.3%	24.0%	22.3%	20.8%	19.8%	19.5%	33.0%	25.6%	20.3%	19.9%
Gross profit	70.1%	70.8%	77.7%	76.0%	77.7%	79.3%	80.3%	80.5%	67.0%	74.4%	79.7%	80.1%
Selling and marketing expenses	91.8%	59.3%	57.6%	50.4%	72.1%	49.8%	46.3%	42.1%	63.3%	60.7%	49.9%	44.8%
General and administrative expenses	37.2%	25.9%	20.4%	20.4%	27.9%	18.6%	15.6%	14.6%	34.3%	24.2%	18.0%	14.5%
Product development expenses	28.5%	18.4%	16.3%	13.9%	19.4%	11.5%	9.6%	8.9%	21.6%	17.8%	11.4%	8.7%
Total operating expense	157.5%	103.6%	94.3%	84.6%	119.5%	79.9%	71.5%	65.6%	119.2%	102.7%	79.3%	68.1%
Operating income	-87.4%	-32.8%	-16.5%	-8.6%	-41.7%	-0.6%	8.8%	14.9%	-52.2%	-28.3%	0.4%	12.0%
Other income (expense)	1.3%	0.7%	0.5%	0.3%	0.6%	0.4%	0.4%	0.4%	2.2%	0.6%	0.4%	0.6%
Net income (continuing operations)	-86.1%	-32.1%	-16.0%	-8.3%	-41.1%	-0.3%	9.2%	15.4%	-50.0%	-27.7%	0.8%	12.7%
<b>Sales/share (tm)</b>	<b>\$ 0.28</b>	<b>\$ 0.31</b>	<b>\$ 0.35</b>	<b>\$ 0.39</b>	<b>\$ 0.44</b>	<b>\$ 0.50</b>	<b>\$ 0.57</b>	<b>\$ 0.63</b>	<b>\$ 0.27</b>	<b>\$ 0.39</b>	<b>\$ 0.63</b>	<b>\$ 0.78</b>

This information is obtained for sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.

**Sonic Foundry, Inc.**  
**September FYE**  
**(#'s in 000's)**  
**BALANCE SHEET**

ASSETS	2003	2004	2005	2006	2Q06	3Q06	4Q06	1Q07
Cash and equivalents - (000's)	\$12,623	\$7,583	\$4,271	\$2,751	\$2,727	\$2,315	\$2,751	\$12,054
Accounts receivable	508	1,345	2,232	3,442	2,505	3,338	3,442	3,396
Accounts receivable, other	139	18	0	0	0	0	0	0
Inventory	111	371	414	398	466	241	398	297
Other current assets	214	281	363	399	354	413	399	423
Assets of discontinued operations	0	0	0	0	0	0	0	0
<b>Total current assets</b>	<b>13,595</b>	<b>9,598</b>	<b>7,280</b>	<b>6,990</b>	<b>6,052</b>	<b>6,307</b>	<b>6,990</b>	<b>16,170</b>
Net property, plant, and equipment	588	745	1,007	2,294	1,292	1,372	2,294	2,301
Goodwill & intangibles	8,618	8,288	7,958	7,628	7,793	7,711	7,628	7,575
Deferred long-term asset charges	0	0	0	0	0	0	0	0
Other assets	0	0	0	0	0	0	0	0
Long-term assets of discontinued operations	0	0	0	0	0	0	0	0
<b>Total assets</b>	<b>\$22,801</b>	<b>\$18,631</b>	<b>\$16,245</b>	<b>\$16,912</b>	<b>\$15,137</b>	<b>\$15,390</b>	<b>\$16,912</b>	<b>\$26,046</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>								
Accounts payable	\$1,065	\$879	\$1,323	\$1,521	\$1,187	\$1,227	\$1,521	\$1,908
Accrued liabilities	1,263	686	780	1,225	673	753	1,225	868
Unearned revenues	194	473	957	2,005	1,421	1,569	2,005	1,931
Current portion of capital lease obligation	48	0	15	41	50	40	41	41
Convertible debt	0	0	0	0	0	0	0	0
Liabilities of discontinued operations	0	0	0	0	0	0	0	0
<b>Current liabilities</b>	<b>2,570</b>	<b>2,038</b>	<b>3,075</b>	<b>4,792</b>	<b>3,331</b>	<b>3,589</b>	<b>4,792</b>	<b>4,748</b>
Long-term debt	0	0	0	0	0	0	0	0
Deferred long-term liability charges	0	27	49	519	44	106	519	486
Other long term liabilities	0	0	0	0	0	0	0	0
Shareholders' equity	20,231	16,566	13,121	11,601	11,762	11,695	11,601	20,812
<b>Total liabilities and shareholders' equity</b>	<b>\$22,801</b>	<b>\$18,631</b>	<b>\$16,245</b>	<b>\$16,912</b>	<b>\$15,137</b>	<b>\$15,390</b>	<b>\$16,912</b>	<b>\$26,046</b>
Cash per share	\$0.44	\$0.26	\$0.14	\$0.09	\$0.09	\$0.07	\$0.09	\$0.37
Quick ratio	5.11	4.38	2.11	1.29	1.57	1.58	1.29	3.25
Current ratio	5.29	4.71	2.37	1.46	1.82	1.76	1.46	3.41
Debt to capitalization ratio	0.00%	0.16%	0.37%	4.47%	0.37%	0.91%	4.47%	2.34%
Book per share	\$0.70	\$0.56	\$0.43	\$0.36	\$0.37	\$0.37	\$0.36	\$0.64

This Information is obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. Copying, faxing, replicating, or quoting from this report without permission is in direct violation of copyright laws. Beacon Rock employees and affiliates may have positions and effect transactions in the securities or options of the issuers reported herein. Please refer to the company index in the back of this issue for additional disclosures.

**DISCLOSURES:**

Information, opinions, or recommendations contained in Beacon Rock Research's research reports or research notes are submitted solely for advisory and information purposes. Beacon Rock Research, LLC provides information and analysis on selected companies, with a focus on small-cap and micro-cap companies.

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.

Key to disclosures:

1. The research analyst has a long position in the securities of the Subject Company.
2. The Subject Company has provided a Mediasite™ recording unit plus additional software and server availability valued at \$25,000 to SLB Equity Research, LLC., one of its affiliates, for securing research coverage and providing other awareness building services. SLB Equity Research, LLC may provide additional awareness building services on an ala carte basis.
3. The research analyst principally responsible for preparing this research report received compensation based upon various factors, including SLB Equity Research, LLC total revenue.
4. This report was prepared exclusively for the benefit of institutional investors and may or may not receive compensation directly or in soft dollar arrangements.

The analyst, Mike Niehuser, hereby certifies that the research conclusions and recommendation contained herein accurately reflects his personal views about the industry, company and shares and also hereby certifies that no part of his research compensation was or will be directly or indirectly related to the earnings estimates, target price or recommendation about the security.

The research provided herein should not be considered a complete analysis of every material fact regarding the companies, industries or securities named above. The opinions expressed herein reflect the analysis and judgment of the author on the date of publication and are subject to change without notice. Facts have been obtained from sources considered reliable but should not be construed as complete and are not guaranteed to be accurate. Beacon Rock Research, LLC; its members; employees and their families may have positions in the securities covered within the research material above and may make purchases or sales while this report is in circulation. Additional information on the subject companies is available upon request.

**EQUITY RECOMMENDATION SYSTEM:**

- Buy** Immediate purchase is recommended. The security expected to outperform the market over the next 12 to 18 months.
- Hold** Holding the stock is recommended because the share price's appreciation potential is less than or equal to the market.
- Sell** The stock has reached the target price objective and/or conditions have changed sufficiently to alter the outlook for the stock.

**EQUITY RISK SYSTEM:**

- High** The security is more volatile than the market and/or the company is more leveraged than its peer group.
- Moderate** The security has about the same volatility as the market and/or the company carries a level of leverage in line with its peer group.
- Low** The security is less volatile than the market and/or the company is less leveraged than its peer group.

**DISTRIBUTION OF RECOMMENDATIONS:**

At this time, there are an insufficient number of companies under coverage to generate usable distribution information or draw any conclusions regarding bias about the research methodology. Prospective companies are screened and evaluated by sales personal and research analysts with the investment thesis and overall research recommendation developed before the commission is established.