RENAISSANCE RESEARCH GROUP
Special Situations Research

Principal Investments & Private Client Research

U.S. (Microcap) – NASDAQ March 6, 2003

Strong Buy

The SCO Group, Inc.

NASDAQ: SCOX

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Stock Price (3/5/03): $2.26
Shares Outstanding: 11.244 million
Fiscal Year End: October 31st

Earnings Per Share:	**2002A**	**2003E**	**2004E**	**2005E**
Q1 (Jan.):	($0.77)	($0.06) A*	U/R	U/R
Q2 (April):	($0.47)	($0.05)	U/R	U/R
Q3 (July):	($0.35)	$0.05	U/R	U/R
Q4 (Oct.):	($0.26)	$0.09	U/R	U/R
Full-Year EPS	($1.93)	$0.04	$0.71	$1.30
P/E Multiple:	NMF	NMF	3.2x	1.7x

* SCO generated positive EBITDA (earnings before interest, taxes, depreciation, and amortization) of $361,000 for 1Q 2003 or $0.03 per common share. Quarterly figures do not sum to annual due to weighted average share calculations that reflect a 4.3 million share repurchase during the 3Q FYE 2002. 2003E & 2004E use 7% & 15% tax rate, respectively.

Investment Thesis – Reasons for Recommendation:

- We find SCO's valuation compelling with a Price-to-Sales ratio of ~0.4:1, despite SCO's current cash-flow-positive status and our forecast of consistent and growing GAAP profitability beginning in the upcoming July quarter. Our near term price target for SCO is $7, which represents a 25% discount to our estimate of SCO's "fair value," the NPV of SCOsource "arrearages" ($3.18/Shr.) + 10.0X estimated recurring Free Cash Flow ($0.72/Shr.) for the next four quarters *(see "Our Fair Value Model for SCO," Page 4)*, and a reasonable 1.3X recurring revenues for FYE 2003 ($61.3MM).
- We estimate SCO's current PEG ratio (P/E to Earnings Growth rate) to be 0.22:1, based upon our conservative estimate for forward 12 months core earnings (*2Q`03 – 1Q`04*) and our forecasted five-year revenue and earnings growth rates of 18% and 30%, respectively. We expect much higher earnings growth over the next 18 – 24 months, and feel there is upside to our estimates. *See more next page.*

Company Description:

The SCO Group (NASDAQ: SCOX) provides software solutions for small- to medium-sized businesses (SMBs) and replicated branch offices. SCO solutions include UNIX and Linux platforms; management, messaging, and e-business tools; and services that include technical support, education, consulting, and solution provider support programs.

Based in Lindon, Utah, SCO has a worldwide presence with offices in 13 countries and representation in 82 countries. This infrastructure enables SCO to provide local support and dependable solutions to businesses around the world. In addition, SCO has a channel of more than 16,000 resellers, a developer network of nearly 4,000, thousands of direct account customers and an installed base of more that two million systems. SCO solutions are divided into three broad areas: operating systems, extended platforms and services. For more information on SCO products and services, visit http://www.sco.com.

Please refer to important disclosures at the end of this report.

Investment Thesis – Reasons for Recommendation *(continued)*:

- On the February 26, 2003 SCO (quarterly earnings) conference call, management announced their expectations for 2Q (ending April 30th) revenue in the range of $23 million to $25 million, with anticipated revenue from current operating platforms of $13 million to $15 million *(consistent with the estimates set forth in our February 24, 2003 report)* plus $10 million from the SCOsource licensing initiative. We believe management's forecasted $10 million of SCOsource revenue in 2Q represents near-term settlement of possible license violations in arrears *(related to heretofore unlicensed use of the SCOsource shared libraries)* from one or more large vendors of Linux solutions, but we are unable to glean more specifics at this time. SCO's 2Q estimate of $10 million nearly equals – in a single quarter – our prior estimate of the net present value ($15.1 million or $1.26/share) of ten years worth of SCOsource gross margin dollars related to prior license violations. SCO management also stated they lacked the visibility to estimate SCOsource license revenues in future quarters, but that the vast majority of interactions with customers and other software vendors with respect to the SCOsource initiative were positive. **Our view is that lumpy, and possibly large, bookings of SCOsource license fees will continue for several quarters while these negotiated settlements of prior license violations in arrears work their way through the pipeline. SCO's resulting balance sheet should soon look a lot prettier, though we doubt the market will value such lumpy SCOsource fees as part of a consistent and predictable earnings stream – until all or most SCOsource arrearages are cleared and these license fees become part of normalized product revenues**. *(Until such point as SCOsource license fees reflect current product revenues, not arrearages, we will continue to reflect such arrearages settlements for prior SCOsource license violations as extraordinary items in our SCO earnings model).*
- Our current thinking is that by 3Q or 4Q, SCO will have booked many of the "arrearages," which we count as one-time windfalls, and move at least a portion of SCOsource into the recurring "Product Revenue" category. But for the time being – and until we gain more clarity – we will model only $1 million of SCOsource (recurring) product revenue into the 3Q, increasing by 5% per quarter sequentially through FYE 2004. We, and the company, believe this is conservative.
- **We currently estimate the net present value of SCOsource "Extraordinary Items" (arrearages settlements related to prior license violations)** *(assuming 8% discount rate, $10MM 2Q SCOsource windfall + $10.0MM of arrearages, on average, for each of the next 3 years)*, **to be $35.8 million or $3.18 per share, exclusive of the company's current cash generating status and its earnings power based on current and new products**.
- SCO's current balance sheet shows reasonable liquidity but negative working capital. *(2/27/03 Research Note: This will change in the 2nd / April quarter with estimated $10 million from SCOsource).* This combined with the current lack of equity research coverage on the company, we believe, explains the stock's orphan status and low valuation. We view this extremely low valuation as unwarranted though, given factors cited in this report plus the commitment by the company's principal shareholder, Canopy Group, to lend funds or guarantee any loans necessary to fund operations through the 2003 fiscal year (this was noted in SCO's recent 10-K dated January 29, 2003). *(February 24, 2003)*
- **Sales Growth + 78% Gross Margins + High Operating leverage = Geometric Earnings Expansion Relative to Sales.** New products are driving increased revenues at SCO. We believe the recent upturn in revenue growth, combined with sustainable company gross margins in the neighborhood of 78%, presents an attractive earnings model capable of generating a geometric expansion of earnings relative to revenue growth.
- **Deep Intrinsic Value of SCO's UNIX Intellectual Property.** On January 22, 2003, SCO announced the formation of a new business unit, SCO*source*, to manage the licensing of SCO's UNIX intellectual property. SCO owns and now licenses the unbundled source code to "UNIX System V" operating system technology, which originated in Bell Labs in the 1960s and has been evolved and enhanced since its introduction. SCO has retained David Boies of the law firm *Boies, Schiller and Flexner* (of *U.S. versus Microsoft* fame) to develop SCO's licensing strategy for its "UNIX shared libraries," now available for sale unbundled from the company's UNIX and Linux product offerings. SCO believes intellectual property violations may exist, and the law firm is helping the company develop solutions to resolve those violations. SCO effectively owns the root of the UNIX tree that has branched – through license agreements with SCO and its predecessors – into various flavors of UNIX, including IBM's UNIX *("AIX")*, Hewlett-Packard's UNIX, Sun Microsystems's UNIX, Silicon Graphics' UNIX and Linux; and Linux is derived from UNIX.

SCO's "UNIX shared libraries" represent the shared source code at the root of these various UNIX / Linux operating systems. We believe a large and growing number of business enterprise customers desire to marry their existing UNIX applications and environments to Linux products, and because of the legal need to license the UNIX shared libraries from SCO, it will drive many customers to SCO's products (that include the shared libraries) in preference to the products of other Linux vendors. A wealth of additional information related to SCO*source* is available through its corporate web site, www.sco.com.

- **Our twelve-month stock price target is $18**. We believe SCO can close approximately one fourth of its valuation gap with Red Hat in the next twelve months and achieve a P/E multiple of 25X our FYE October 2004 earnings estimate of $0.71, equating to a stock price of $18.
- We estimate tax rates of 7% and 15% for the FYE October 2003 and FYE 2004, respectively. *(As of 2/26/03: the company has approximately $80 million in available loss carryforwards with which to partially shelter future earnings).*

Bigger Picture:

Caldera International purchased substantially all of the assets and operations of the server and professional services group of Tarantella, Inc., formerly known as The Santa Cruz Operation, Inc., in May 2001, which supplied UNIX solutions to an installed base of business customers worldwide. The company subsequently changed its name to The SCO Group in late 2002.

SCO has evolved, since its founding in 1979 as a UNIX system porting and consulting company, into a recognized software solutions leader in the retail space, building upon the source code developed by and later acquired (via Novell) from AT&T's UNIX System Laboratories. SCO has a heritage spanning more than 20 years and platforms currently powering six of the top ten worldwide retailers. The former Caldera has married its Linux product lines to SCO's UNIX operating systems and now markets combined offerings under the unified SCO brand. SCO can now deliver its legacy UNIX customers a migration path to robust, new Linux-based business software applications and server products.

"UNIX/C programming was the original computer operating system and language (circa 1972), and it is still used throughout the world. Bell Labs researchers Dennis Ritchie (b. 1941) and Kenneth Thompson (b. 1943) created a system based on simple, discrete commands that worked on multiple machines and supported many users; one person could tryout Spellcheck, while another created a document. C programming paved the way for thousands of applications. **Today UNIX is still used to run most Internet servers and large business systems."** *(Forbes – December 23, 2002)*

Additional Comments:

We believe The SCO Group is building an important franchise in enterprise-level UNIX and Linux-based operating systems, applications and platforms for business. Red Hat may now be playing catch-up in the enterprise space, since four Linux sellers – SCO Group, SuSe, Turbolinux, and Conectiva – formed their UnitedLinux consortium in 2002 to counter Red Hat's dominance. In light of Microsoft's near lock on the desktop, hardware vendors appreciate the opportunity to source from more than one vendor the more robust enterprise-level software applications, operating systems and platforms upon which their critical business systems depend. Learning from IBM's mistake with Microsoft in the 1980s *(when IBM turned over control of the software operating system for PCs to MSFT)*, we believe hardware vendors and business customers will avoid reliance upon one major vendor of Linux enterprise solutions, thereby creating the possibility of a duopoly in Linux systems from the two dominant vendors in the Linux space, Red Hat and The SCO Group.

Regarding Red Hat – Valuation Gap, a Pricing Dichotomy:

We think a pricing dichotomy exists between the only two dominant – and publicly traded – pure Linux solutions providers:

	SCOX	**RHAT**
Market value 2/21/2003	**$15.6 million**	**$980.5 million**
Share Price	$1.30	$5.50
Number of Shares	11.962 million	178.268 million

Revenue	$64.2 million FYE October `02	$78.9 million FYE February `02
Price/Sales	**0.24X**	**12.4X**
Est. Addressable Market	Over $10 billion	Over $10 billion
P/E	NM (Cash Flow Positive)	NM (Cash Flow Positive)
Cash & Equivalents on Hand	$6.6 million	$80.3 million (* incl. debt inv. securities)

Red Hat Vulnerabilities, a Probable Income Stream to SCO:

BusinessWeek's special report (dated March 3, 2003) entitled *"The Linux Uprising"* presents the opinion that investors are still skeptical about the prospects of Raleigh-based Red Hat, a provider of Linux software, to turn the growing popularity of Linux into a firmly profitable business model for the long haul. Red Hat introduced its latest attempt at a sustainable business model last year, a subscription-based "advanced server" designed for large corporations. "Red Hat's high valuation makes it vulnerable to any hiccups in its new business model, as well as to setbacks in the broader market," the article said. "For long-term (share) buyers, Red Hat remains a risky bet while it's still fighting to prove itself."

We believe SCO is the top of the food chain in a Red Hat / SCO Group universe. We note that Red Hat is still in large part a services business and should be valued accordingly – it books approximately half its revenues from its Linux systems integration services business, not from the sale of software, which carries higher profit margins. The converse is true at SCO, where software product sales and subscriptions represent approximately 80% of revenues as of the most recent quarter. Arguably SCO Group deserves a higher valuation, relative to profits derived from proprietary, high margined software sales, than Red Hat.

Importantly too, IBM and Red Hat have been partnering on systems integration projects at large corporations that involve integrating Linux systems with legacy UNIX software installations. Whether these legacy UNIX systems are IBM, Hewlett-Packard, Sun, Silicon Graphics or SCO variants, all such Linux / UNIX integration projects require the UNIX shared libraries to port UNIX applications to Linux. Heretofore, many systems integrators have made unlicensed copies of these shared libraries from other non-SCO sources, an illegal practice the *SCOsource* initiative (unbundling the source code for sale) was designed to address.

In our conversations with SCO post the 1Q earnings release (2/26/03), management referred to discussions with Red Hat and IBM concerning SCO*source*, which we believe will turn into a licensor / licensee relationship – **with SCO selling SCO*source* licenses into Red Hat / IBM systems integration projects.** *(See more on SCOsource in other sections of this report).*

Our Fair Value Model for SCO:

Our current thinking relative to SCO's fair value is summarized below:

	SCO Fair Value	Per Share Amount for SCO
NPV of SCOsource Arrearages	$35.771 million	**$3.18/Share**
10x next 4Qs Est. Core EBITDA	$72.450 million	**$6.44/Share**
Our estimate of "Fair Value for SCO	$108.221 million	**$9.62/Share**

New Product Developments, Product Line:

Below is a brief summary of SCO's products and services. SCO's products are available by one-time license fee payment, subscription, or as a monthly (SCObiz) service offering. A wealth of additional information on SCO's products and services is available through its corporate web site, www.sco.com.

- **SCOsource:** (*SCOsource is SCO's most recently announced product consisting of unbundled source code and software libraries related to its UNIX intellectual property*). Please refer to our bulleted summary of the SCO*source* business unit and its activities entitled *"Deep Intrinsic Value of SCO's UNIX Intellectual Property"* under the **"Investment Thesis"** section above.
- **Server Solutions:** Server software resides on corporate or network "servers," which are large, industrial strength computers that "serve" data and specific-function software applications to client computers that

connect to or reside on the network. This configuration, referred to as client / server computing, has evolved rapidly and has become standardized in most business environments. It allows many "thin clients" (i.e. computers – laptop, desktop or otherwise – with less computing power) to share the resources of larger and more powerful network computer servers. These network servers may reside inside the corporation or reside as nodes on our national communications network, a subset of the Internet. As Forbes noted in a December 23rd 2002 article, "… Today UNIX is still used to run most Internet servers and large business systems."

- **UNIX Server Solutions:** (*SCO's UNIX server solutions include UnixWare 7.1.3, OpenServer, OpenUnix 8, Clustering*). SCO's UNIX offerings support and operate seamlessly with SCO Linux products. SCO's UNIX products evolved from mainframe computing solutions designed at Bell Labs during the 1960s. They were originally designed to run on Intel-based computing architectures (including AMD), which have become ubiquitous in business and network computing environments.
- **Linux Server Solutions:** (*SCO's Linux server solutions include SCO Linux Server 4.0, OpenLinux 64, OpenLinux Server*). According to a new study by Goldman Sachs, Linux will emerge as the dominant operating system in corporate data centers. According to the January 2003 study, IT buyers will use Linux to take advantage of lower-cost, higher-performance Intel-based servers and to avoid "premium-priced proprietary systems." Forrester Research director Josh Walker corroborates this, believing Linux is on a path to dominate the data center: "The cost pressures that IT departments are under makes Linux a very compelling purchase." (*NewsFactor, January 2003). (Renaissance Research Note: Intel-based servers refer to those offered by IBM and others, as opposed to Sun Microsystems' servers, among others, that are based upon proprietary and frequently more expensive non-Intel chip architectures).* Linux is a free UNIX-type operating system originally created by Linus Torvalds while he was a student at University of Helsinki in Finland and improved with the assistance of developers around the world. Developed under the GNU General Public License, the source code for Linux is freely available to everyone. (*For more information on Linux, go to www.linux.org*).

- **Desktop Solutions:** (*SCO's desktop solutions include OpenLinux 64, OpenLinux Workstation, Merge*). SCO's desktop solutions include: an enterprise-class Intel *"Itanium"* family processor-based Linux operating system that includes both PC workstation and server operating configurations *(see above)*, development tools and utilities for software developers, and interoperability solutions allowing customers to run Windows ME, Windows 95, Windows 98 and DOS operating systems and certain applications on SCO's UNIX platforms.
- **Business Solutions:** (*SCO's business solutions include SCOoffice Mail Server, SCO Authentication, SCO Manager*). SCO's business solutions include: an email and collaboration solution, a secure network password management solution and a web-based systems management solution for IT administrators. These software solutions reside on and are "served" by SCO's server software to computers on corporate / business networks.
- **Internet Solutions**: (*SCO offers e-business solutions through VARs to small- and mid-size business through its Applications Service Provider (ASP) SCObiz, which includes the assets of recently acquired Vista.com*). SCO delivers web site creation, web-based commerce, content management and marketing services to small businesses, through VARs *(Value Added Resellers)*, as service offerings over the Internet for a monthly fee (~$100/month). These ASP services do not require the purchase of software, just the ability of a customer's desktop or laptop to connect to the Internet.
- **Services:** (*SCO offers Support, Education, Professional Services, SCO Upgrade Services, and the SCO Update Service*). Approximately 20% of SCO's revenues currently come from these services.

Customers, New Customer Wins:

- New customer wins during 1Q 2003 were: Pearl Vision and France Telecom for SCO Linux; and Citigroup, McDonalds and U.S. Navy for SCO OpenServer. *(February 26, 2003)*
- SCO's retail customers include: 6 of the top 10 global retailers (Kroger, Sears, Metro AG, Carrefour, Intermarche and Kmart), and 7 of the top 10 U.S. retailers (Kroger, Sears, Kmart, Target, JC Penney, Safeway and Costco).

Other Items, Important Developments:

- Scott McNealy, CEO of Sun Microsystems, responded to questions from *BusinessWeek* Correspondent Jim Kerstetter regarding Sun's proprietary UNIX software versus the growing popularity of Linux operating systems in a *BusinessWeek* email interview dated 2/18/03. When asked if Linux has a more significant impact on UNIX companies or Microsoft, McNealy says, "Linux impacts everyone. As I said, IBM and HP are so impacted they're apparently abandoning their enterprise-class UNIX in favor of Linux, marooning customers in the process. Abandoning that investment just seems shortsighted. We're actively redoubling our support of Solaris *(Sun's UNIX variant)* on Sparc *(Sun's own computer chips)* as well as Intel and AMD." *(Renaissance Research Note: We believe SCO Group is best positioned to migrate legacy UNIX customers to Linux and will begin to gain market share in Linux applications due in part to its SCOsource initiative).* McNealy adds, "It was just a few years ago that everyone said (Microsoft Windows) NT would be the only OS *(operating system)* left anywhere. So my answer based on that is: Clearly Microsoft has been impacted. … Linux is good news for UNIX. A vote for Linux is a vote for UNIX." *(Renaissance Research Note: SCO owns UNIX source code and is in a position to benefit from other vendors' UNIX / Linux conversions).*

- Recent surveys from research firm International Data Corp. (IDC) size the market for enterprise software for large corporations at $42 billion and enduring a slow decline. But they see the small- to medium-size businesses (SMBs) market sized at $47 billion and growing approximately 16% per year. We note that SCO Group's product offerings, besides its solutions for replicated (retail) branch offices, target the SMB market. *(February 26, 2003)*
- On July 23, 2002, Caldera (now *The SCO Group*) announced it had repurchased 4,304,000 million shares of its common stock for $4,029,000 cash during the 3Q FYE 2002 from Tarantella, Inc. (NASDAQ: TTLA) and MTI Technology Corporation (NASDAQ: MTIC). SCO management believes the average $0.94 purchase price was attractive, and – since these two large shareholders needed cash – it removed a market overhang on SCO's stock.

Historical Earnings, Comments, Estimates & Revisions:

- For 1Q (ended January 31st) of fiscal year 2003, The SCO Group reported a net loss of ($724,000), or ($0.06) per share, on revenue of $13.5 million. The loss was smaller than our estimated loss of ($0.08) per share, and SCO's EBITDA for the quarter beat our estimates by a penny. For the first time since the company's founding, SCO generated positive EBITDA of $361,000, or $0.03 per share. This was accomplished on revenues in line with our expectations and previous company guidance but down sequentially from 4Q FYE 2002's revenues of $15.5 million. We believe general weakness in IT spending, minor 1Q seasonality and customers' and VARs' need to digest several new, concurrent product launches led to the sequential revenue decline. SCO management delivered excellent expense control and met their prior commitment to achieve positive cash flow during this quarter. Management also announced their expectations for 2Q (ending April 30th) revenue in the range of $23 million to $25 million, with anticipated revenue from current operating platforms of $13 million to $15 million *(consistent with the estimates set forth in our February 24, 2003 report)* plus $10 million from the SCOsource licensing initiative. We believe management's forecasted $10MM of SCOsource license revenue in 2Q represents near-term settlement of possible license violations *(related to unlicensed use of the SCOsource shared libraries)* from one or more large vendors of Linux solutions. *(February 26, 2003)*
- We find SCO's valuation compelling with a Price-to-Sales ratio < 0.25:1, despite SCO's current cash-flow-positive status and our forecast of consistent and growing GAAP profitability beginning in the upcoming July quarter. Our near term price target for SCO is $6, which we believe represents fair value for SCO at 1.2X revenues ($61.3MM) and 3.0X EBITDA ($0.44/Shr.) for the FYE October 2003. *(February 24, 2003)*
- We estimate SCO's current PEG ratio (P/E to Earnings Growth rate) to be 0.3:1, based upon our conservative estimate for forward 12 months earnings (*2Q`03 – 2Q`04*) and our forecasted five-year revenue and earnings growth rates of 18% and 30%, respectively. We expect much higher earnings growth over the next 18 – 24 months, and feel there is upside to our estimates. *(February 24, 2003)*
- On December 18, 2002, Caldera International doing business as The SCO Group reported fourth quarter revenue of $15.5 million, which was in line with expectations and previous company guidance and up from revenue of $15.4 million the prior quarter (3Q). SCO had a net loss for 4Q 2002 of ($2.7 million), or ($0.26) per common share. Excluding non-cash expenses of $1.5 million and a restructuring charge of $1.1 million, the net loss for 4Q `02 would have been ($62,000) or ($0.01) per common share. The company has made significant cost reductions during FYE 2002, reducing employees from 664 at the time of the Tarantella acquisition to 340 as of October 31, 2002. The company believes its reduced overhead will allow it to accumulate cash and operate profitable for FYE 2003. Company management believes additional reductions in operating expenses can be made if necessary, if actual quarterly revenues are less than forecasted for the periods ahead.

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Other Companies Mentioned:

Conectiva, S.A. (Privately held)
Hewlett-Packard Co. (NYSE: HPQ – $15.56)
IBM (NYSE: IBM – $77.73)
Intel Corp. (NASDAQ: INTC – $16.98)
Microsoft Corp. (NASDAQ: MSFT – $23.44)
MTI Technology Corporation (NASDAQ: MTIC – $0.74)
Red Hat, Inc. (NASDAQ: RHAT – $5.85)
Sun Microsystems, Inc. (NASDAQ: SUNW – $3.33)
SuSe Linux AG (Privately held)
Tarantella, Inc. (NASDAQ: TTLA – $0.15)
Turbolinux, Inc. (Privately held)

BACKGROUND:

Total Shares Issued and Outstanding (1/31/03): 12,167,000. (Total Fully-Diluted Shares: 17,648,000)
Institutional Holdings: ~45,000 shares (<1%)
Insider Holdings: 7.115 million (59.5%)
Underwriting Information: 1.425 million shares @ $14 per share in March 2000; Robertson Stephens & Co.
1:4 reverse split in April 2002 (Adjusted IPO price $56/shr.).
Additional Financing: N/A.