

RENAISSANCE RESEARCH GROUP

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Research Notes

The SCO Group, Inc.

NASDAQ: SCOX

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“Handicapping the SCO – vs. – IBM Lawsuit”

Background:

- Please refer to our full report (8 pages) on The SCO Group dated March 6, 2003, which provides comprehensive information on the company, our earnings estimates for SCO and our analysis of its products, business prospects and competitive position within the industry.
- On March 7, 2003, SCO initiated a lawsuit against IBM in the State Court of Utah, alleging misappropriation of trade secrets, tortious interference, unfair competition and breach of contract. SCO is seeking damages in an amount to be proven at trial, but no less than \$1 billion. Specifically, SCO alleges that IBM misappropriated trade secrets from SCO’s version of UNIX – which IBM had access to under its license of “UNIX System V” source code for use in developing “AIX” as well as the terminated (around May 2001) “Monterey Project” with SCO – and contributed them to the code base of open-source Linux, in a concentrated effort to destroy the economic value of UNIX, particularly undermining SCO’s UNIX-on-Intel business, in an effort to benefit IBM’s new Linux services business.
- SCO also demanded that IBM cease the alleged anti-competitive practices based on specific requirements sent in a notification letter (dated March 6, 2003) to IBM. If these requirements are not met, per the original UNIX license agreement IBM entered into with SCO’s predecessor (AT&T’s Unix Systems Laboratories) in February 1985, SCO will have the specific authority (per the contract) to revoke IBM’s AIX / UNIX license 100 days following receipt of SCO’s letter.

Research Notes:

- We have reviewed the lawsuit filings and initial exhibits (available on SCO’s website at <http://www.sco.com>) along with much commentary in the industry press on the lawsuit and its projected fallout. Our key takeaways are: 1) the case is well founded, 2) the core case is a matter of contract law governing illegal misappropriation, disclosure and misuse of trade secrets in prohibition of the contract, 3) the 100-day fuse on SCO’s contractual cure to revoke IBM’s and its customers’ AIX / UNIX licenses appears valid and has many of SCO’s and IBM’s common customers beating on IBM for resolution of the possible software license violations, and 4) SCO refers customer inquiries related to resolving any unpaid licenses back to IBM, hence 5) resolution of IBM’s customers concerns has become a core business issue for IBM more than an intellectual property dispute, with meaningful impact upon its reputation and relationship with its customers.
- We believe SCO’s claims against IBM are well founded and that SCO has additional credible claims it can make against other vendors of Linux products. **Please refer to our base report on SCO dated March 6, 2003 for a discussion of the deep intrinsic value of SCO’s intellectual property ownership.**
- At the end of SCO’s 100-day fuse on SCO’s contractual cure, on June 13, 2003, SCO has the specific authority per the license agreement to revoke IBM’s AIX / UNIX licenses and require IBM to return or destroy all copies of its software products subject to the license. We believe the aforementioned contractual cure would be upheld by the court and mandated upon IBM, and would then wreak havoc on IBM’s large corporate customers bringing serious injury to IBM’s business reputation and customer relationships, unless the matter is settled prior to trial. **We believe the business risk to IBM is too high. Therefore, we believe IBM will settle the case prior to trial.**

- IBM has requested and SCO has accepted change of venue for the lawsuit from the State Court of Utah to Federal District Court in the State of Utah. We do not believe the move will meaningfully affect the merits of SCO's case against IBM, and it may open the door for SCO to add claims of copyright infringement to the suit. IBM has requested an additional 30 days from the court to respond to the suit – SCO acceded to the request. We handicap the odds of IBM settling SCO's claims prior to the 100-day deadline for contractual cure at 30% – though until IBM responds to SCO's lawsuit, we are unable to estimate the path to resolution with much clarity.
- We discussed with SCO legal costs related to the IBM lawsuit, and management tells us that they should book "normal software-type" margins on any judgments or settlements gained through the services of David Boies of *Boies, Schiller and Flexner* ("BSF"). Hence, we estimate legal costs related to the IBM suit to be 25% of any settlements or paid judgments received by SCO, with manageable cash outlays in the event the lawsuit goes to trial and SCO loses on its claims. Currently BSF is engaged only on the IBM matter, though SCO has the option of adding other intellectual property disputes to their agreement.
- On a related subject, we estimate the costs associated with SCO's projected \$10 million of SCOSource revenues for 2Q 2003 (related to settlements of SCOSource license violations "in arrears") to be 30%, which costs may decline over time. The estimated \$3 million of 2Q 2003 SCOSource costs includes initial legal and consulting expenses related to initiation of the SCOSource effort. Until we receive further guidance from SCO management, we will estimate all future costs-of-sales for SCOSource revenues after the upcoming second quarter to be 30%, equating to 70% gross margins on the SCOSource line of business.
- We understand that David Boies, the lead attorney for SCO on the IBM suit, agreed to take on the case after a referral from a business relationship of SCO's CEO Darl McBride. And *Boies, Schiller and Flexner* is working for less than its standard hourly fee structure. We believe this testifies to the validity of the case in the eyes of one of the world's foremost intellectual property attorneys.
- One possible outcome of the IBM lawsuit is the death of Linux, in which case, we believe, SCO owns the bulk of the intellectual property – the "root of the UNIX tree" – for the world's dominant, hardened enterprise operating system. Certainly software markets would be in disarray, but given the practical alternative to unplugging the lights, we believe a worst-case scenario of the world abandoning Linux and flocking back to UNIX would not be so bad for SCO. SCO once held the dominant UNIX market share, and we believe SCO's current management team is capable of delivering that again if it needs to do so.

SCO – vs. – IBM Settlement Matrix

Lawsuit Settlement Amount	BSF Legal Fees	Net Settlement to SCO	Net to SCO Per Fully-Diluted Share
\$200,000,000	\$50,000,000	\$150,000,000	\$8.50 / share
\$350,000,000	\$87,500,000	\$262,500,000	\$14.87 / share
\$500,000,000	\$125,000,000	\$375,000,000	\$21.25 / share
\$750,000,000	\$187,500,000	\$562,500,000	\$31.87 / share
\$1,000,000,000	\$250,000,000	\$750,000,000	\$42.50 / share

* Using 17,648,000 Fully-Diluted Shares Outstanding

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

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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.

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