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New Rec: InfoSpace (INSP: $45.25) February 3, 2005

Position: Sell **Target: $30** **Timing: 2 (1=aggressive; 5=cautious)**

$MM	Q1 05e	Q2 05e	Q3 05e	Q4 05e	Q1 06e	F2005e	F2006e
Revenue	86.8	91.8	96.3	100.9	104.6	375.8	437.4
EPS*	0.37	0.39	0.41	0.44	0.45	1.62	1.89
Y/Y Grow	118%	44.4%	14.5%	-9.3%	20.5%	24.5%	16.8%
PE	n/a	n/a	n/a	n/a	n/a	27.9	23.9
PSR	n/a	n/a	n/a	n/a	n/a	4.6	3.9
Consen.	0.36	0.41	0.47	0.59	0.53	1.83	2.40

*Tax rate = 6%. INSP had $1.1 BB US Federal Tax NOLs at 12/31/03

Shares Out: 38M **Market Cap: $1.7B** **FYE: Dec**

Summary: InfoSpace's two divisions are "mobile", which provides news, weather, and sports updates, and entertainment such as ringtones, graphics, and games to

cellphone users, and "search and directory", (S&D) which provides those functions to internet users directly and through pages it designs for third-party websites.

"Street" expectations are for "mobile" revenue to grow from $92M in 2004 to $182M in 2005 and to $250M in 2006, and S&D to grow from $157M in 2004 to $203M in 2005 and to $239M in 2006. We think these expectations for growth are unrealistic for a number of reasons, which we discuss below. We expect <u>reported</u> "mobile" revenue to reach $177M in 2005 and $223M in 2006, and S&D to reach $199M in 2005 to $215M in 2006.

It is important to note both search distribution and mobile revenue are reported "gross", but INSP actually shares revenue with distribution partners and INSP pays both content license holders and its telco partners royalties on mobile revenues. Through 2003, revenue sharing expense was recorded in selling and marketing expense, while royalty expense was recorded in cost of goods sold. As of 2004 these expenses are on the "content and distribution" line. Some of these embedded costs are growing dramatically, and, as a result, "net" revenues, i.e. net of such expenses, should likewise miss consensus expectations.

A. Mobile, which contributed 37% of 3Q04 sales, has been the fastest growing part of the business, growing with 2004's huge upswing in ringtones (and, to a lesser degree, with an upswing in graphics) for cellphones. As the ringtone market matures in 2005, it will shift to MP3-type files of the actual song/sound versus basic and polyphonic files, which dominated 2004. This shift seems inevitable as cellphones ship with more memory and embedded MP3 players. MP3s require little actual "production" by INSP, and much less testing on each phone model. They require only deciding what section of the song/sound to use and a simple cut-and-paste. Since INSP adds less value to MP3-type content, the record labels and other copyright holders demand a higher royalty rate on them.

Even though MP3 tones carry higher ASPs than mono and polyphonic tones, INSP keeps less of the gross. The result is that INSP's Mobile operating margin fell from 32.6% in 2Q04 to 24.9% in 4Q04. INSP admitted it was due to lower margins on MP3 tones. The incremental Mobile operating margin was 12-13% in both Sep04 & Dec04, which we think provides a much better measure of INSP's value-add in a world of MP3 ringtones. This is a major decline, since many in the industry claim that MP3s were still a small part of the ringtone business in 3Q04.

Bulls claim that MP3's higher ASP will offset much of the margin % impact. We disagree. The table below shows our estimate of the unit contribution, which might also be called "Net ASP", for the various tones. Details follow later.

	Monophonic Tones	Polyphonic Tones	MP3-type Tones
Net ASP	$0.83	$0.95	$0.40 - $0.60

Bulls also claim INSP can make it up in volume. We agree that volumes will increase; however, we think INSP could lose more market share than bulls expect over the next 12 – 18 months. As a result, sales should fall short.

Bulls see the increasing penetration of cellphones capable of downloading and playing ringtones as a key growth driver of volume. They cite statistics that indicate that over 10% of US cellular subs have bought a ringtone. We think the bullish recital of the narrow penetration of ringtones today ignores the much higher penetration of the real market: 12-25 year olds.

A serious threat to INSP's Mobile market share is the recent entry of Jamba into the US market. Jamba probably has the #1 worldwide market share in ringtones, and dominates Europe. Verisign (VRSN) acquired it in mid-'04, and is financing an expensive push into the US. Jamba changes the nature of competition in the market, eliminating a barrier that the current ringtone providers like to discuss: the limited number of vendors any telco is likely to allow (though we think that in the long-term, many of those relationships will be cancelled anyway).

Jamba sells direct-to-the-consumer, whereas nearly all ringtones in the US are now sold semi-anonymously via telco-designed screens on the cellphone itself. Jamba advertises in youth-oriented media like MTV and popular magazines. In Dec04, it began ads on MTV(2) in the US, but so far it is selling random junk, so it does not yet seem to have licenses for much decent content in the US. The ad prompts the consumer to use SMS to send a "short-code" identifying the tone or image to Jamba's "phone" number. That results in a purchase, which Jamba sends in a file in a return SMS.

Jamba needs a much simpler relationship with the telco than does INSP. All Jamba requires is that the telco bill the consumer and pass a share of the proceeds on to Jamba. The major benefit to the telco is the incremental demand driven by Jamba's huge marketing budget. INSP doesn't create demand. It simply fulfills whatever is out there. For this reason, we think Jamba will get the telco relationships it needs in the US.

VRSN is willing to invest a lot to gain market share in the US for Jamba. The Jamba ads we've seen on MTV so far are quite expensive, and Jamba is running them before it even has high-impact content to sell. We do not think the current US marketing campaign is profitable. Rather, VRSN is investing to promote the brand and to get teens used to the idea of buying the Jamba way.

B. INSP's search has grown mainly through "distribution". In this business INSP designs a web-page for a third party site and provides the search function. We think INSP could once again be disintermediated. The issue is the increasing strategic importance that Yahoo (YHOO), Google (GOOG), Microsoft (MSFT) and Amazon (AMZN) placed on search. Search should increasingly become a main battleground and INSP could be a civilian casualty.

All of the above competitors have released search "toolbar" in the last few months. All intend to integrate web-search with desktop-search. These two changes could alter the way most people search, shifting to use of a toolbar for its simplicity, for the benefits of also searching the contents of their own PC, and for the benefits of "personalization" features, which may become popular. As people use their toolbar to do an integrated search, they will not use the home–pages of their ISP, be it cable or DSL or other, or any other web page to perform searches. Thus, INSP's distributed traffic will decline, even if it retains all of its partners.

Another threat is the likelihood that MSFT will find other ways to devalue search to damage GOOG's money-machine. Google accounts for a significant portion of INSP's search revenue. Note: Google is both a competitor and a partner. MSFT has used this strategy repeatedly, most famously with Netscape.

In addition, INSP's distributed search business seems to have lost a marquee customer now that Verizon (VZ) signed Yahoo to provide the portal for its DSL subs. Any slowing growth as INSP's partners would slow its growth. Cable, incl. Cablevision, and DSL, incl. VZ, ISPs are significant customers for INSP. Cable and DSL modem subs grew about 30% and 50%, respectively in 2004.

INSP reports lightly taxed EPS, due to over $1B of tax-loss carry-forwards. It would take INSP decades to use it all, so we will use the reported EPS. We think INSP could have trouble making estimates in 3Q05, due to slightly light sales, and well-above consensus royalty expenses. In 4Q05, sales could miss current estimates by 10%, with expenses continuing to exceed current estimates.

Another risk to INSP is customer concentration. At the end of 2003, 10 customers accounted for 68% of revenue, up from the top 10 accounting for 56% in 2002. With the recent run-up in the stock price, insiders have been selling.

Our EPS estimates of $1.62 on revenue of $376M in FY05 and $1.89 (up 16% Y/Y) on revenue of $437M in FY06 contrast with "street" expectations of $1.84 EPS on $384M revenues for FY05 and $2.44 EPS on $489M revenues for FY06. Because of INSP's revenue recognition policy, which we discuss in more

detail below, using sales to value INSP is not meaningful. We value INSP at 16x FY06 $1.89 EPS or $30.

Background:

An array of acquisitions from 1998 to 2002 gave INSP a core technology to aggregate content such as white pages, yellow pages, maps, news and weather, on its own web servers, and then to present relevant views of it to on-line PCs or cellphones. From the start, it mainly distributed anonymously behind the brand name of its dot-com or wireless carrier affiliates. Additional acquisitions brought the metacrawler.com and dogpile.com meta-search engines, e-commerce payment services, and multi-protocol wireless services such as 2-way SMS, downloading via SMS, HTML, or all the leading WAP gateways. Revenue grew to $215M in 2000 before the bubble burst. Due mainly to acquisition charges, cumulative losses grew to $1BB by 2001.

The bursting of the dot-com bubble brought annual sales down to $136M, and forced INSP's founder into one of the more complicated insider-trading cases of the period. Cumulative reported losses ballooned to nearly $1.5BB. In 2003, INSP began to focus more on search under its own InfoSpace.com brand name, also began distributing search through cable and DSL ISPs. In Nov-03 INSP made the very timely acquisition of the Moviso business from Vivendi for $25M. By the end of 2003, INSP reached profitability after many years of losses.

In 2004, INSP focused on its Mobile and S&D businesses by selling the e-commerce payments business for $82M, and acquiring Switchboard (on-line directories) for $109M and three small mobile gaming firms for $47M. Also, INSP announced a settlement with its ex-CEO Jain.

The $25M Moviso acquisition generated huge returns. We estimate it provided roughly $50M in sales and $15M in profits in 2004. However, in 2H04, its margins began to fall dramatically.

The company's revenue recognition accounting appears to be an aggressive interpretation of EITF 99-19. The accounting is explained in the 2003 10K as follows:

> For distribution partner arrangements, whereby the Company shares a portion of the revenues earned through a distribution partner's Web site, revenue is recorded on a gross basis in accordance with EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*. The Company recognizes the cost of revenue share payments to the distribution partners as a sales and marketing expense. Typically, revenue share expenses are based on a contracted rate per paid search or as a percent of gross revenue earned by the Company.

Subscriber usage fee revenue is generated based on the end users usage of the Company's messaging or browsing services.

The Company's revenue from media downloads is generated when end users purchase wireless applications, such as ringtones or graphics, via their cellular phone. Revenue is recognized in the period in which the content is delivered.

The Company enters into royalty agreements to secure the content for its messaging services and media downloads. The Company records royalty expense as a cost of revenue in the period in which the content is delivered. Certain agreements are based on a flat fee for a contracted period of time and these content expenses are recorded ratably over the contract period.

As noted above, beginning in 1Q04, royalty expense is in the "content and distribution" line, not in cost of goods. The company's use of EITF 99-19, while it may be acceptable, appears to be at least on the aggressive side. The way we read EITF 99-19, we think the company should be reporting net revenue. EITF 99-19 gives three main indicators of when net revenue reporting is appropriate: 1. INSP is not the primary obligor in the transaction with the customer and does not appear to have the risk and reward as principal in the transaction. 2. The amount INSP earns is fixed: it is a flat fee or a flat percentage of the transaction. 3. We do not think that any credit risk resulting from the transactions is borne by INSP. If this is also correct, it also would indicate that INSP is an agent and should record net revenues. According to the 10K, INSP has just 10 customers that account for 68% of revenue in 2003. Apparently, Deloitte and Touché, INSP's auditors, do not share our opinion.

Discussion:

1. The hyper-growth ringtone business should move to MP3-type tones, slashing the profits of intermediaries such as INSP.

Mobile contributed 41% of 4Q04 sales, and contributed 55% of the Y/Y sales growth. It has been the fastest growing part of the business due to 2004's huge upswing in ringtones (and to a lesser degree, graphics) for cellphones. INSP benefited by its very timely (Nov03) acquisition of the Moviso ringtone and graphics business from Vivendi. Prior to 4Q03, INSP's mobile business (news, weather, sports, etc.) was not growing, and INSP has indicated it sees little to no growth there. We estimate downloads of ringtones and other phone personalization content now accounts for 65% of Mobile sales.

To gauge the rapid ascent of ringtones, we can use Vodafone's reported statistics on % of revenue from "data". This table shows how the Y/Y growth in data revenue as a % of total services revenue growth, accelerated in late-03, just as

INSP acquired the US ringtone business. Note this does not include "messaging", which has actually peaked as a % of revs in many European countries.

Y/Y as a %	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03	3Q03	4Q03	1Q04	2Q04	3Q04
UK	33%	22%	11%	-9%	-17%	0%	20%	50%	90%	100%	108%
Germany	67%	100%	133%	100%	60%	50%	71%	88%	113%	122%	92%

Source: Vodaphone

The problem that INSP faces is that in 2005, the ringtone market should shift to MP3-type files of the actual song/sound versus mono and polyphonic files, which dominated 2004. This shift seems inevitable as cellphones ship with more memory and embedded MP3 players. INSP now calls MP3-type tones: "label" tones. Mono and polyphonic tones are synthesized files, which must be actually played and produced by humans. The process is neither difficult nor expensive. In fact, a competitor to INSP told us that it has just a few low-end studio musicians on contract, and the total cost, including the production steps is $100 / tone. Still, it is a process outside the core competency of either the labels or the telcos.

MP3 tones eliminate most of those steps. MP3 tones require only deciding what section of the song/sound to use and a simple cut-and-paste. The margin pressure takes a few forms:

a. Record labels, and to a lesser degree the telcos, understand that INSP simply doesn't provide much content value in MP3 ringtones, so they can demand bigger pieces of the pie. Industry sources indicate that labels may receive 35%-50% of the pie for MP3-type tones of their copyrighted material versus half that for polyphonic tones and even less for monos.

b. Intermediaries such as INSP will have to work harder to create value-added content. INSP's big step in this direction in 4Q04 was to sponsor a concert and then produce ringtones of the "live" music. This is a good, but expensive step. Contrast the cost of that promotion to paying an unknown musician $100 to tap on a synthesizer for a few minutes.

Even though MP3-type tones carry higher ASPs than mono and polyphonic tones, INSP keeps less. Bulls claim that MP3's higher ASP will offset much of the margin % impact. We disagree. The table below shows our estimate of the unit contribution, which might also be called "net ASP", for the various tones.

	Monophonic Tones	Polyphonic Tones	MP3-type Tones
Gross ASP	$ 1.50	$ 2.00	$ 2.50
Telco Take	$ 0.51	$ 0.70	$0.90 +/-
Copyright Royalties	$0.16	$ 0.35	$0.95 - $1.20
Net ASP	$0.83	$0.95	$0.40 - $0.60
Pre-Gross Margin	55 %	48 %	20 %

The shift from mono to poly has hurt reported margins, but it also raised profits as the net ASP rose from $0.83 to $0.95. On the other hand, the shift to MP3-types (from poly) lower both margin % and profit dollars.

INSP has already admitted margin pressure from this shift. As shown in this table, INSP's incremental Mobile operating margin in 2H04 was 12%-13% versus previous margins of 25%-33%. We think a 13% margin provides a much better measure of INSP's value-add in a world of MP3 ringtones; therefore, we expect this margin pressure to continue. This is a major decline, since many in the industry claim that MP3s were a small part of the ringtone business in 3Q04.

	Mar04	Jun04	Sep04	Dec04	FY04	FY05e
Mobile Revs (MM)	14.8	20.0	25.1	32.5	92	172
Mobile Expenses	11.0	13.5	17.9	24.4	66	134
Mobile Op Income	3.8	6.5	7.2	8.1	26	38
Mobile Op Margin	25.5%	32.6%	28.5%	24.9%	27.6%	21.9%
Mobile Incremental Op Margin	35 %	53 %	12 %	13 %	31 %	15 %

INSP's recently acquired mobile games will boost Mobile's gross margin later in 2005, but given the low absolute sales rate, we think it's unlikely that it will produce above average operating margins. We will discuss that in more detail later. As shown above, we model a 15% incremental operating margin for 2005, which lowers the overall Mobile margin down to just 21.9%. And we model a 13% incremental Mobile margin in 2006, due to the continuing shift to MP3 and intensifying competition. Conversely, consensus expectations assume the Mobile margin remains between 24-25%.

The margin drop in recent quarters is significant, since most in the industry claimed that MP3s were still a small part of the ringtone business for the last two quarter. Operating margin for Dec-04 declined to 24.9%, compared to 28.5% a quarter ago. We think consensus is being very optimistic to think the pressure has stopped at 25% operating margin, when the driver of the margin pressure is in its infancy.

One counterpoint to the MP3 trend is INSP's claim that MP3-type tones accounted for the same % of its Mobile revenues in 4Q04 as in 3Q04. We would explain this by pointing to the popularity of Christmas tones and graphics during Q4. Jingle Bells, etc. sold mainly in the cheaper mono & poly-tones. This actually makes the Mobile margin drop in Q4 even more worrisome, as much of the Christmas content would have high margins, with an unusually high portion of it being in the public domain, with no copyright holder to take a cut.

Another aspect of the rising royalties is that, were INSP to report Net Revenues, i.e. net of royalties and commitments to distribution partners, its growth would look less impressive. This table subtracts INSP's reported "Content & Distribution Costs" from total revenues to get Net Revenues. Note that distribution partner commitments for the S&D business are also included in "C&D Costs". In FY04 and FY05, growth of Net Revs is 2/3rds or less of reported revenue growth.

	FY04	Mar05e	Jun05e	Sep05e	Dec05e	FY05e	FY06e
Revs (MM)	249	86	91	96	100	373	438
C&D costs	93	37	40	43	45	165	198
Net Revs	157	49	51	53	55	208	240
Y/Y Revs	89%	80%	67%	43%	26%	50%	17%
Y/Y Net Revs	50%	58%	42%	24%	17%	33%	15%

3. The recent entry of Jamba (www.jamster.com) into the US market presents INSP with a well-financed competitor aiming to buy market share, and a competitor whose unique (for the US) business model should be increasingly attractive to both telcos and record labels.

Jamba may have #1 worldwide market share in ringtones. Its sales in 4Q04 were $94M, nearly all of which comes from Europe. None of it came from the US. Verisign (VRSN) acquired Jamba in mid-04, and is financing an expensive push into the US. Jamba changes the nature of competition in the market, eliminating a barrier that the current ringtone providers like to discuss: the limited number of vendors any telco is likely to allow (though, as discussed above, we think that in the long-term, most of those relationships could be canceled anyway).

Jamba sells direct-to-the-consumer, whereas, nearly all ringtones in the US are now sold semi-anonymously via telco-designed screens on the cellphone itself. Jamba advertises in youth-oriented media like MTV and magazines. In Dec04, it began ads on MTV(2) in the US. In Jan05, its ads began to blanket multiple youth-oriented cable TV channels. So far, Jamba is selling relatively unappealing content, so it does not yet seem to have licenses for good content in the US. (A Jamba employee told us that Jamba does have licenses, but that the ads being run now are for test marketing.) The ad prompts the consumer to use SMS to send a "short-code" identifying the product (tone, image, etc.) to Jamba's "phone" number. This is known as "Premium SMS" or PSMS. That results in a purchase, which Jamba sends in a file in a return PSMS.

There are actually three main channels for selling ringtones: on the cellphone via the telco's screens, PSMS, and at websites like Jamster.com using a PC. Depending on the website, the tone may be sent to the cellphone or downloaded on the PC and then transferred to the cellphone. The US market

reportedly is now 90% via the telco's screens. In Europe, Jamba sells about 50% via PSMS, 30% via the telco's screens, and 20% via a PC.

Jamba needs a much simpler relationship with the telco than does INSP. To sell via PSMS, all Jamba requires is that the telcos bill the consumers and pass a share of the proceeds on to Jamba. In order, to sell via the telco's screens, Jamba would need the standard relationship.

Jamba provides a major benefit to both the label and telco. It drives incremental demand with its huge marketing budget. INSP doesn't create demand. It simply fulfills whatever is out there. For this reason, we think Jamba will get the content and relationships it needs in the US.

Jamba quickly signed deals with Cingular, AWE, and T-Mobile. It has yet to sign Sprint or Verizon (VZ). It has a technical hurdle to leap with VZ, since VZ's BREW-based network disables Jamba's standard PSMS transaction.

Jamba presents another new challenge for the existing vendors in the US. Jamba sells only as a subscription service, whereas INSP sells a la carte, though INSP does offer a bundle of 8 tones for $10. Jamba's US price is likely to be roughly $2/week for 2 tones. So, as Jamba signs up subs, the subs would seem unlikely to ever buy from INSP and others, assuming Jamba has the content the subscribers want.

The major limit on Jamba's potential is probably whether people can be motivated to buy a tone or image while they are watching TV, reading a magazine, or listening to a CD. (In Europe, short-codes are even being given prominent positioned in the packaging of CDs.) Some claim this is simply an impulse purchase. Will teens get up from TV to get their phone to buy it or just wait until they are out on the street somewhere? Do teens talk on their cell & watch TV at the same time? Probably.

The Jamba ads we've seen on cable TV so far are quite expensive, and Jamba is running them before it even has high-impact content to sell. The current US marketing campaign is surely not profitable. Rather, VRSN is investing to promote the Jamba name and to get teens used to the idea of buying the Jamba way. VRSN recently disclosed that it expects to spend $10M/quarter on Jamba's US marketing, in order to gain #1 US market share by late 2005.

4. The shift to MP3s could cause the record labels and telcos to work together more closely, and to eventually disintermediate INSP.

The simple cut-and-paste “production” process of MP3-type tones will make it much easier for the labels and telcos to work together and to disintermediate the third parties, like INSP. Hiring a musician to “cover” the song is enough of a process to have enabled the intermediaries to insert themselves between the record labels and the telcos. Other value-add services, which telcos/record labels could potentially perform, that ringtone intermediaries currently provide:

a) Licensing, which can be complex due to artists and publishers having different rights under different scenarios.
b) Digital Rights Management, meaning those who deserve to get paid, do get paid.
c) Testing content on a wide range of phones, which certainly needs to be done, but it surely is something at which the telcos are competent.
d) Promotion/Demand Generation. INSP has done little here. As we shall discuss later, this is an area that will become very important, and expensive, with Jamba’s entry into the US market.
e) Custom content creation has grown in importance quickly. INSP’s sponsorship of a live concert could be categorized here, as are the large number of tones spoken by artists famous for singing. The graphics download business rests heavily on custom content.

A catalyst to make telcos and labels work together is the recently introduced ring<u>back</u> tone, which is a tone that a consumer can choose to have played for a caller while the caller waits for the cellphone user to answer. Ringbacks sit on the telcos network, rather than on the user’s cellphone, and are becoming available as MP3 tones become more common. INSP is not in the ringback business, and as ringbacks teach the dinosaurs to dance together, INSP could see itself squeezed out of the ringtone business.

5. We think significant purchases of ringtones and graphics rests on a narrow demographic, which is more highly penetrated than general statistics imply.

Bulls see the increasing penetration of cellphones capable of downloading and playing ringtones as a key growth driver. They cite statistics saying that only 1/3rd of the 180M (e.g. 60M) cellphones in the US are now "download-capable" and that this was 1/6th in late 2003. This seems to imply that the market can triple as the other 2/3rds of the cellphones are replaced with new models.

The problem with this is that the ringtone market relies on narrow demographics. Probably 80% of ringtones are sold to people under the age of 25, the same people who hold a disproportionate share of those "download-capable" cellphones. We do not know the exact demographics of either ringtone buyers or

"download-capable" cellphone holders, but we think that more than 1/3rd of the target population already has the required technology.

Bulls further claim that only 20% of the users of those 60M phones have been customers. We do not know how deeply ringtones will penetrate the overall population, but we think that at least half of today's population is unlikely to buy more than a couple of ringtones in their lifetimes.

Maybe in 20 years, when today's teens pass the age of 30, penetration will rise well above 50%, but cellphone technology changes so quickly that we think today's population is the issue. In summary, we think the bullish recital of the narrow penetration of ringtones today ignores the much higher penetration of the real market: 12-25 year olds.

6. As Cingular's ringtone provider, INSP is a temporary beneficiary, as AT&T Wireless subs switch to Cingular-provided phones.

Cingular acquired AWE in Oct. 04, and began moving AWE's TDMA subs over to Cingular GSM phones. Cingular reported that almost 8% of its 49.1M sub base switched phones during Q4. That means 3.9M new potential customers with download-capable phones, many of which can play MP3-type tones.

On the other hand, Cingular switched its "storefront" platform from INSP to Motricity in late 4Q04, allowing additional ringtone, graphics, and game vendors to compete with INSP content. Cingular is also one of Jamba's main US partners to date. This is why we say "temporary" beneficiary. In a few quarters, INSP could have a much smaller share of a nicely bigger pie at Cingular.

7. INSP's wireless gaming acquisitions bring it into an already competitive market that could pay off in the long-run, but should not show significant profits for the next year or two.

In 2H04, INSP acquired three tiny producers of cellphone games to further broaden the mobile business. While INSP's existing telco relationships are likely to make the acquisitions a success, it is likely to be a slow ramp. The market is already full of entrenched competitors and content development takes much longer than in the ringtone business.

We think it unlikely sales from these games will generate much profit in 2005. Due to the need to stay ahead of all the new entrants, Jamdat's (JMDT) operating margin fell from 21% in 1Q04 to 9.5% in 3Q04 even as its sales grew 36% to $9.5M/Q. INSP's mobile games business will leverage much of the SG&A

expenses from INSP's other Mobile businesses. However, INSP forecasts roughly $15M in 2005 mobile gaming sales. JMDT's R&D budget will exceed that.

8. Search is about to become a battleground among the super-powers and INSP could be a civilian casualty.

Internet search was probably the most glamorous stock topic in 2004, thanks to extraordinary growth and the GOOG IPO. Despite the market growth, INSP's own search sales have been flat for the last year, and are smaller than 18 months ago. In mid-04, its sales fell even as its ASP has risen almost 40%.

INSP's "distributed" search business, on the other hand, has grown nicely. In this, it designs a web page for a third party site and provides the search function. In truth, INSP again acts simply as an intermediary, since it provides what it calls "meta-search", which is PhD-wannabe-speak for passing the search request on to search engines, mainly GOOG's and YHOO's, and forwarding a subset of their results. We think INSP could once again get disintermediated.

The issue is the increasing strategic importance firms like GOOG, Microsoft (MSFT), Amazon (AMZN), etc. placed on search. Search seems about to become a battleground and INSP could be a civilian casualty. The search wars present many threats for a marginal player like INSP.

The first threat is search "toolbars". Since Sep 04, all of the above have released search toolbars. AMZN and MSFT did it with their initial entrance into the search business.

The second threat is the integration of web-search with desktop-search. These first two threats make it likely that end-users will not use home pages of their ISP, be it cable or DSL or other, to perform their searches. Users will be trained to use their toolbar to do an integrated search.

The third threat is the likelihood that MSFT will find other ways to devalue search to damage GOOG's money-machine.

The fourth threat is that search "personalization" may become popular. INSP's "meta-search" makes it ill-equipped to compete in this arena.

9. Verizon signed Yahoo to co-brand a portal that will compete with the INSP-driven portal that VZ currently offers. This exacerbates a likely subscriber slowdown for INSP's cable and DSL distribution partners.

Aside from the MSFT/GOOG/YHOO threat, the distributed search business is likely to see slowing growth as its partners' growth slows. Cable companies, including CVC, and DSL, including VZ, are significant customers for INSP.

INSP claims GOOG, YHOO, etc. are no threat to this business. YHOO, for one, however, seems to want some of the business for itself.

On January 18, VZ announced: "Beginning this summer, customers will have the choice of Yahoo! in addition to the portal service Verizon offers today, and Verizon's existing base of subscribers will have the option to switch to the Verizon Yahoo! service." VZ will not force its current 3.6M DSL subs to switch to the Yahoo portal, but "Yahoo will be presented to the customer first". It is likely that the vast majority of new VZ DSL subs will not become INSP users, and that the installed base will switch to the Yahoo portal over time. The Yahoo portal will offer will offer premium services such as greater e-mail storage, video and radio as well as access to a co-branded home page.

10. Financial assumptions.

a) Mobile: We assume strong sales growth for the mobile personalization downloads in the US through 2006: 110% growth in 2005 is helped by a 18% rise in ASPs due to MP3s. 53% growth in 2006 sees only a 7% ASP rise. We assume INSP's market share will be unchanged from 2004 to 2005, though it will be lower in 2H05 than in 1H05. In 2006, we think INSP could lose about 1/3rd of its downloads share, leaving it with little growth other than games.

Due to a Mobile operating margin that could fall from 28% in 2004 to 22% in 2005 to 20% in 2006, INSP's mobile profits would grow only 51% in 2004 to $39M and then 17% in 2006 to $45M.

b) Distributed Search: Growth here could fall from 104% in 4Q04 to a still respectable 34% in 2005 and 13% in 2006. Even if INSP doesn't lose any more distribution partners, its partners are likely to see their volumes slow as people use search toolbars. We are not bearish on search ASP. We model it to rise 7% in 2005 and 1% in 2006, though it would be down slightly from 4Q04's lofty level.

c) Owned-search: Given recent results and our view that the rapid changes in the search will hurt INSP's volumes, we model no growth here.

d) Directory: We model little growth here.

e) Margins: The rise in "C&D Costs" could lower INSP's gross margin from 57% in 2004 to 51% in both 2005 and 2006. Expense controls could enable

overall operating margin to remain above 22%. Note that 22% is higher than any previous quarter for INSP other than Sep04 and Dec04.

11. Valuation and Risks

The primary risk to our thesis in ringtones would be if Jamba does not gain market share and if technology changes in the ringtone and search markets do not change the current business dynamics in the US market, i.e the status quo.

In ringtones, that would mean that record labels and telcos continue to allow third parties to generate very nice margins as intermediaries in the business and INSP retains healthy share of the market.

Another risk is that people over the age of 30 buy significant numbers of ringtones, graphics, etc. for their cellphones, enlarging the market beyond our model. A wildcard risk would be that Jamba's direct-to-consumer marketing in the US creates demand for ringtones for which Jamba has no exclusive supply, and that people buy those products via the telcos' inventory, including INSP's, rather than from Jamba.

In S&D, the primary risk is the status quo. INSP's search distribution partners continue to use INSP's service, and the subscribers of those partners continue to use the search function provided by the partner, rather than using a search toolbar, or some MSFT-enabled search function. Also, unexpectedly strong overall demand could raise ASPs and support volumes even as INSP trails overall market growth.

In valuing INSP shares looking at sales is of little value, as we have discussed. Our EPS estimates are $1.62 in 2005 rising to $1.89 in 2006, an increase of 16%. At 16 times 2006 EPS of $1.89 we set our target price at $30.00.

12. Financial projections.

Inc. Statement ($MM)	Q3 04	Q4 04	Q1 05e	Q2 05e	Q3 05e	Q4 05e	Q1 06e	Q2 06e
Mobile	25.1	32.5	39.7	43.7	45.9	47.8	51.5	54.6
Search & Directory	42.0	47.2	47.1	48.2	50.4	53.1	53.0	52.8
Total Revenue	67.2	79.7	86.8	91.8	96.3	100.9	104.6	107.4
Content & Distrib Costs	24.5	32.7	38.3	41.4	43.5	45.5	47.5	48.6
Systems & Network Costs	3.5	3.7	3.8	3.9	4.0	4.1	4.2	4.3
Depreciation	1.7	1.7	1.8	1.9	2.0	2.1	2.2	2.3
Research & Development	6.4	6.7	7.0	7.4	7.7	8.1	8.5	9.0
Sales and Marketing	6.2	6.7	7.1	7.4	7.8	8.2	8.6	9.0
General and Administrative	9.6	8.3	9.6	9.9	10.2	10.5	10.8	11.1
Operating Income	15.2	19.9	19.2	19.9	21.0	22.4	22.7	23.0
Intangible Amortization	3.1	3.1	5.3	5.3	5.3	5.3	5.3	5.3
Other Inc., net	1.0	1.7	1.2	1.3	1.4	1.5	1.6	1.7
Pretax Income	13.1	18.5	15.1	15.9	17.1	18.6	19.0	19.4
Income Tax	0.0	0.0	0.9	1.0	1.0	1.1	1.1	1.2
Net Income	13.1	18.5	14.2	14.9	16.1	17.4	17.8	18.3
Diluted Shares	36.4	37.9	38.2	38.6	39.0	39.4	39.8	40.2
Diluted EPS	0.36	0.49	0.37	0.39	0.41	0.44	0.45	0.45

Y/Y Change	Q3 04	Q4 04	Q1 05e	Q2 05e	Q3 05e	Q4 05e	Q1 06e	Q2 06e
Mobile	342.1%	249.5%	168.0%	118.3%	82.8%	47.1%	29.9%	25.1%
Search & Directory	76.6%	66.8%	41.7%	40.0%	19.9%	12.5%	12.5%	9.6%
Total Revenue	115.0%	104.4%	80.5%	68.6%	43.3%	26.6%	20.5%	17.0%
Content & Distrib Costs	231.6%	188.9%	126.5%	122.5%	77.4%	39.4%	24.2%	17.4%
Systems & Network Costs	57.7%	41.9%	17.7%	2.1%	14.0%	10.8%	10.6%	10.3%
Depreciation	-27.9%	-12.8%	2.4%	11.5%	21.7%	22.9%	21.7%	20.6%
Research & Development	71.7%	59.3%	58.2%	32.2%	20.3%	21.6%	21.6%	21.6%
Sales and Marketing	55.3%	40.2%	29.4%	45.5%	25.5%	21.6%	21.6%	21.6%
General and Administrative	29.9%	5.9%	0.7%	9.5%	6.1%	26.0%	12.6%	12.6%
Operating Income	265.6%	217.8%	184.3%	87.9%	38.0%	12.4%	17.9%	15.7%
Intangible Amortization	93.8%	55.5%	212.4%	165.5%	71.3%	70.7%	0.0%	0.0%
Other Inc., net	29.9%	157.6%	20.0%	17.1%	40.0%	-11.8%	33.3%	30.8%
Pretax Income	293.7%	275.7%	149.4%	63.8%	30.3%	0.4%	25.4%	22.2%
Income Tax	n/a	n/a	n/a	n/a	n/a	n/a	25.4%	22.2%
Net Income	293.7%	275.7%	134.4%	53.9%	22.5%	-5.6%	25.4%	22.2%
Diluted Shares	9.3%	9.1%	7.5%	6.6%	7.0%	4.1%	4.1%	4.1%
Diluted EPS	260.1%	244.5%	118.0%	44.4%	14.5%	-9.3%	20.5%	17.4%

% of Revenue	Q3 04	Q4 04	Q1 05e	Q2 05e	Q3 05e	Q4 05e	Q1 06e	Q2 06e
Mobile	37.4%	40.8%	45.7%	47.5%	47.7%	47.4%	49.3%	50.9%
Search & Directory	62.5%	59.2%	54.3%	52.5%	52.3%	52.6%	50.7%	49.1%
Total Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Content & Distrib Costs	36.5%	41.0%	44.1%	45.1%	45.2%	45.1%	45.5%	45.3%
Systems & Network Costs	5.2%	4.6%	4.4%	4.2%	4.1%	4.1%	4.0%	4.0%
Depreciation	2.5%	2.2%	2.1%	2.1%	2.1%	2.1%	2.1%	2.2%
Research & Development	9.6%	8.4%	8.1%	8.0%	8.0%	8.1%	8.2%	8.3%
Sales and Marketing	9.2%	8.4%	8.1%	8.1%	8.1%	8.1%	8.2%	8.4%
General and Administrative	14.3%	10.4%	11.0%	10.7%	10.5%	10.4%	10.3%	10.3%
Operating Income	22.7%	25.0%	22.2%	21.7%	21.8%	22.2%	21.7%	21.5%
Intangible Amortization	4.6%	3.9%	6.1%	5.8%	5.5%	5.3%	5.1%	4.9%
Other Inc., net	1.5%	2.1%	1.4%	1.4%	1.5%	1.5%	1.5%	1.6%
Pretax Income	19.5%	23.2%	17.4%	17.3%	17.8%	18.4%	18.2%	18.1%
Income Tax	0.0%	0.0%	1.0%	1.0%	1.1%	1.1%	1.1%	1.1%
Net Income	19.5%	23.2%	16.4%	16.3%	16.7%	17.3%	17.1%	17.0%

Inc. Statement ($MM)	FY04	FY05e	FY06e
Mobile	92.4	177.0	222.6
Search & Directory	156.9	198.7	214.8
Total Revenue	249.3	375.8	437.4
Content & Distrib Costs	92.7	168.7	196.3
Systems & Network Costs	14.2	15.8	17.4
Depreciation	7.0	8.0	9.6
Research & Development	23.2	30.3	36.8
Sales and Marketing	23.5	30.5	37.0
General and Administrative	36.4	40.0	45.1
Operating Income	52.5	82.5	95.3
Intangible Amortization	9.9	21.2	21.2
Other Inc., net	4.8	5.4	7.0
Pretax Income	47.4	66.7	81.1
Income Tax	0.0	4.0	4.9
Net Income	47.4	62.7	76.2
Diluted Shares	36.5	38.8	40.4
Diluted EPS	1.30	1.62	1.89

Y/Y Change	FY04	FY05e	FY06e
Mobile	230.6%	91.6%	25.8%
Search & Directory	67.1%	26.7%	8.1%
Total Revenue	88.6%	50.7%	16.4%
Content & Distrib Costs	336.1%	82.0%	16.3%
Systems & Network Costs	129.5%	10.8%	10.2%
Depreciation	64.2%	14.5%	20.1%
Research & Development	130.1%	30.8%	21.6%
Sales and Marketing	134.7%	29.6%	21.6%
General and Administrative	112.8%	10.1%	12.6%
Operating Income	343.1%	57.3%	15.5%
Intangible Amortization	145.7%	114.3%	0.0%
Other Inc., net	153.7%	12.3%	29.6%
Pretax Income	407.5%	40.8%	21.6%
Income Tax	n/a	n/a	22.5%
Net Income	407.5%	32.3%	21.6%
Diluted Shares	28.1%	6.3%	4.1%
Diluted EPS	370.3%	24.5%	16.8%

% of Revenue	FY04	FY05e	FY06e
Mobile	37.1%	47.1%	50.9%
Search & Directory	62.9%	52.9%	49.1%
Total Revenue	100.0%	100.0%	100.0%
Content & Distrib Costs	37.2%	44.9%	44.9%
Systems & Network Costs	5.7%	4.2%	4.0%
Depreciation	2.8%	2.1%	2.2%
Research & Development	9.3%	8.1%	8.4%
Sales and Marketing	9.4%	8.1%	8.5%
General and Administrative	14.6%	10.7%	10.3%
Operating Income	21.0%	22.0%	21.8%
Intangible Amortization	4.0%	5.7%	4.9%
Other Inc., net	1.9%	1.4%	1.6%
Pretax Income	19.0%	17.7%	18.5%
Income Tax	0.0%	1.1%	1.1%
Net Income	19.0%	16.7%	17.4%