THE EYESHADE REPORT September 30, 2003

Company: **XYBERNAUT CORPORATION**	Address and Phone: 12701 Fair Lakes Circle Fairfax, VA 22033 (703) 631-6925
Ticker: XYBR	Shares Out (basic): 158.9 M
Exchange: NasdaqSC	Float: 155.3
Market Cap: $ 261 M	Short Interest: 2 M
P/S: 26.8	Closing Price: (9/30/03): $ 1.64
P/E: NE	52 Week Range: $ 0.19 - $ 2.66

Description of Business: *Xybernaut Corporation (the "Company" or "XYBR") is engaged in the research, development, manufacture, marketing and sale of mobile, wearable computing and communication systems as well as software and service solutions designed to enhance productivity and improve product management, asset management, and the accuracy, timeliness and utilization of captured data.*

Summary

- Shares outstanding more than doubled in the past year.
- Material number of potentially dilutive shares outstanding.
- Possible need to issue additional shares (and/or reduce warrant prices) to raise cash.
- Reported revenue growth would have been a decline absent new product sales.
- Increase in gross margin attributable to new product and one-time factors.
- Material decline in R&D expenses.
- Inventory write-down.
- Material increase in customer concentration and decline in disclosure regarding the identity of the customer.
- Related party transaction.

Financial Statement Review

Shares outstanding more than doubled in the past year – As of June 30, 2003, the Company reported an **accumulated deficit of $140 million**. However, the Company is **showing improvement** in a number of areas (though we have reservations, expressed herein, about some of those improvements). For examples, sales improved (though off a low base) to $2.8 million in the quarter ended June 30, 2003 (Q2 03) from $2 million in the year ago quarter. Gross profit margins improved to 34.8% in Q2 03 from 21.7% in the year ago quarter (after removing a provision for inventory in Q2 02). The Company is also making progress in controlling its costs as selling, general and administrative expenses declined to $3.1 million in Q2 03 from $5.3 million in the year ago quarter. Its net loss fell to $3.3 million in Q2 03 from $6.7 million in the year ago quarter.

Additionally, since September 10, 2003, XYBR has announced three orders from customers totaling $2.38 million.[1] While not a large amount, it is material to a company that reported only $10 million in revenue for the fiscal year ended December 31, 2002.

Cash increased to $5.3 million at June 30, 2003 from $2.8 million at June 30, 2002. (The Company also announced yesterday that it has completed a private placement of common stock with institutional investors for approximately $7 million. The financings, which were accomplished at what the Company described as a modest discount to market, brought its cash position to $13 million).[2] The Company had no long-term debt as of June 30, 2003 (short-term notes payable totaled $3.1 million). Deferred revenue also increased to $253 thousand at June 30, 2003 from $64.6 thousand at June 30, 2002.

Loss per share declined even more dramatically than net loss to a loss per share of $0.02 in Q2 03 from $0.10 in the year ago quarter. However, that was aided by **an increase in average shares outstanding in Q2 03 to 136.6 million from 66.2 million in Q2 02**. Much of the increase in additional shares involved selling stock (and the exercise of warrants) at prices materially below current levels.[3]

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1 . XYBR, press releases dated September 10, 15 & 24, 2003.

2 . XYBR, press release dated 9/29/03.

3 . For example, on March 26, 2003, the Company borrowed $1,750,000 from a lender pursuant to a one-year promissory note that bore interest at 3.5% per annum. In connection with this borrowing, the Company issued to the lender warrants to purchase 1,750,000 shares of common stock at an exercise price of $1.25 per share and warrants to purchase 2,000,000 shares of common stock at an exercise price of $0.43 per share.

During March 2002, the Company received gross proceeds of $9,000,000 through a private placement of 5,625,000 shares of its common stock to certain investors. In connection with this private placement, the Company issued to the investors callable warrants to purchase 1,406,250 shares of common stock at an exercise price of $3.00 per share. In connection with this placement, the Company paid $270,000 in cash to financial advisors.

During June 2002, the Company received gross proceeds of $4,000,000 through a private placement of 6,666,666 shares of its common stock to certain investors. In connection with this private placement, the Company issued to the investors callable warrants to purchase 1,666,666 shares of common stock at an exercise price of $1.50 per share. In connection with this placement, the Company issued 740,740 shares of its common stock to financial and business development advisors.

While the jump in total shares outstanding aids reported loss per share (EPS) results when the Company is reporting a loss, **the situation will be reversed** when and if the Company begins to report net income. **Total shares outstanding stood at <u>158.9 million</u> at August 8, 2003 from <u>75.1 million</u> at August 9, 2002**.[4]

<u>Material number of potentially dilutive shares outstanding</u> – In addition to the increase in basic shares outstanding, there is also a material number of potentially dilutive shares outstanding. At June 30, 2003, the Company had **warrants outstanding to purchase 11,785,840 shares** of its common stock at prices that range from $0.45 to $5.00 per share, with a weighted average of $1.94 per share.[5]

As of December 31, 2002, there were **options to purchase 7,156,367 shares** of the Company's stock with a weighted average price per share of $3.13. The Company granted options to purchase 1.7 million shares of its stock in 2002 at a weighted average price of $0.88.[6]

During February 2003, the Company received gross proceeds of $2,000,000 through a private placement of 6,666,667 shares of its common stock to an investor. In connection with this private placement, the Company issued to the investor callable warrants to purchase 3,333,333 shares of common stock at an exercise price of $1.25 per share.

During May 2003, the Company received gross proceeds of $3,000,000 through a private placement of 9,375,000 shares of its common stock to certain investors. The shares were sold at $0.32 per share, representing an approximate 20% discount to the closing price of the shares for the ten trading days immediately prior to the date of the agreement. In connection with this private placement, the Company issued to the investors three-year callable warrants to purchase 3,281,250 shares of common stock. These warrants have an exercise price of $0.45 if exercised in the first year, $0.90 if exercised in the second year and $1.35 if exercised in the third and final year. (Continued on next page).

During June 2003, the Company received gross proceeds of $2,000,000 through a private placement of 5,405,405 shares of its common stock to an investor. The shares were sold at $0.37 per share, representing an approximate 10% discount to the closing price of the shares for the ten trading days immediately prior to the date of the agreement. In connection with this private placement, the Company issued to the investor three-year callable warrants to purchase 4,054,054 shares of common stock. These warrants have an exercise price of $0.75 if exercised in the first year, $1.50 if exercised in the second year and $2.25 if exercised in the third and final year.

In addition to the stock sales discussed above, the Company received cash through the exercise of warrants to purchase shares of its common stock. For example, the Company received gross proceeds of $1,000,000 and $3,354,167 through the issuance of 3,333,333 and 11,875,001 shares of its common stock during the three and six months ended June 30, 2003, respectively, and $772,180 through the issuance of 1,544,361 shares of its common stock during both the three and six months ended June 30, 2002, exclusive of the exercises made in connection with the note repayment discussed above. Concurrently with their exercise, the exercise price of such warrants was reduced from a weighted average of $1.25 per share to $0.28 per share during the six months ended June 30, 2003 and $3.16 per share to $0.50 per share during the six months ended June 30, 2002. XYBR, 10-Q (6/30/03), p. 10-11.

4 . XYBR, 10-Q's (6/30/03 and 6/30/02), cover page.
5 . XYBR, 10-Q (6/30/03), p. 11.
6 . XYBR, 10-K (12/31/02), p. F-20.

<u>Possible need to issue additional shares (and/or reduce warrant prices) to raise cash</u> – The Company has improved its cash burn rate from the year ago period. For the six months through June 30, 2003, the Company's cash burn (defined as cash used in operations plus acquisitions of property, equipment, patents and trademarks plus capitalization of tooling costs) declined to $8.1 million from $13.9 million for the six months ended June 30, 2002. As of September 29, 2003, the Company stated that its cash position was $13 million.[7] Thus, its financial picture is improving.

However, in its latest 10-Q, the Company warned that *"…[w]hile management expects to fund a portion of [its operating] activities through gross profits resulting from revenues, the Company* ***will be required to obtain most of such amounts through outside financings****. Potential sources of additional financing include* ***private equity offerings, warrant exercises, strategic investments and various forms of debt financing****. In certain instances, concurrently with the exercise of certain these warrants,* ***the exercise prices were reduced****. Such reduction has resulted in the issuance of substantially more shares of common stock than would have occurred had the exercise price of the warrants not been reduced. The Company* ***may reduce the exercise price of additional warrants in the future****."*[8]

As an example of XYBR's decision to reduce warrant prices to raise cash, the Company also stated: "[*s]ubsequent to June 30, 2003, the Company received gross proceeds of approximately $3,000,000 through the issuance of 7,335,304 shares of its common stock upon the exercise of outstanding warrants. Concurrently with their exercise,* ***the exercise price of 4,054,054 of such warrants was reduced from $0.75 per share to $0.40 per share****."*[9]

<u>Reported revenue growth would have been a decline absent new product sales</u> – For the quarter ended June 30, 2003 (Q2 03), the Company's revenue increased 38% from the year ago quarter. The revenue increase occurred mainly in XYBR's hardware revenue, though consulting, licensing and other revenue ("Consulting Rev.") also increased.

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7 . XYBR, press release dated 9/29/03.

8 . XYBR, 10-Q (6/30/03), p. 21 (emphasis supplied).

9 . XYBR, 10-Q (6/30/03), p. 12 (emphasis supplied). In addition, the Company received through the exercise of warrants gross proceeds of $1,000,000 and $3,354,167 for the issuance of 3,333,333 and 11,875,001 shares of its common stock during the three and six months ended June 30, 2003, respectively, and $772,180 for the issuance of 1,544,361 shares of its common stock during both the three and six months ended June 30, 2002. Concurrently with their exercise, the exercise price of such warrants was reduced from a weighted average of $1.25 per share to $0.28 per share during the six months ended June 30, 2003 and $3.16 per share to $0.50 per share during the six months ended June 30, 2002. XYBR, 10-Q (6/30/03), p. 10-11.

Revenue As Reported

$	Q2 02	Q2 03	% change
Hardware Rev.	1,158,423	1,775,792	53%
Consulting Rev.	855,040	1,012,789	18%
Total Revenue	2,013,463	2,788,581	38%

However, revenue in Q2 03 was enhanced by a new product line entitled Atigo[10] that the Company introduced in Q3 02 (September 2002) and that accounted for $1.2 million in sales in the United States in Q2 03. (There was also some small amount of revenue attributable to Atigo sales in Europe in Q2 03, but we were unable to ascertain the exact amount). Consulting revenue was also slightly enhanced by the new Atigo line.[11] Without the U.S. revenue from the Atigo product line, the Company's total revenue would have **declined by 22%** in Q2 03 from the year ago quarter.

Revenue Without New Atigo Product Line Sales in the U.S.

$	Q2 02	Q2 03	% change
Hardware Rev.	1,158,423	600,116	(48%)
Consulting Rev.	855,040	980,289	15%
Total Revenue	2,013,463	1,580,405	(22%)

In addition, the Company stated that the increase in its gross margin for consulting revenue in Q2 03 was the result of price increases for consulting services that were put in effect in Q3 02.[12] However, we were unable to find the exact amount of the increased consulting fees that were attributable to the higher rates.

Increase in gross margin attributable to new product and one-time factors – As previously mentioned, the Company's **overall gross profit margin** increased to **34.8%** in the quarter ended June 30, 2003 (Q2 03) from **21.7%** in the year ago quarter. Gross margins from **hardware sales** (which constituted 64% of total sales) increased to **32.7%** in Q2 03 from **12.5%** in Q2 02. Gross margins from **consulting, licensing and other revenue** increased to **38.4%** in Q2 03 from **34.1%** in Q2 02.

However, the Company stated "[*t*]*he more favorable gross margin* [in hardware sales] *in 2003 can be attributed to sales of the Atigo product line, which* ***was introduced in the third quarter of 2002****, since margins are typically highest following a product's commercial launch. Also contributing to the favorable gross margin in 2003 compared to 2002 is a $138,276* ***warranty cost*** *in 2002 compared to $26,961 in 2003…. Gross*

10 . Up until the introduction of the Atigo product line, the Mobile Assistant® ("MA®") series was the Company's primary line of wearable computer hardware products, the current versions of which are the MA V and MA TC. Introduced in 2002, the Atigo™ product line is a family of mobile wireless web panels that can be used either as stand-alone handheld personal computers ("PCs") or as displays for an MA system, a laptop or a conventional PC. XYBR, 10-Q (6/30/03), p. 13.

11 . XYBR, 10-Q (6/30/03), p. 14.

12 . XYBR, 10-Q (6/30/03), p. 14.

margins on consulting contracts in 2003 were more favorable compared to margins in 2002 due to increased billing rates for consulting labor that became effective beginning in the third quarter of 2002."[13]

Material decline in R&D expenses – For the quarter ended June 30, 2003, the Company's research and development ("R&D") expense **declined to $858,193 from $1,619,372** in the year ago quarter. For the six months ended June 30, 2003, R&D expenses declined to $2,000,328 from $3,524,138 in the year ago period.

While we applaud the Company's efforts to reduce many of its other expenses, our concern when a company reduces its R&D expenses is that it may be sacrificing a future competitive position for the sake of a short-term improvement in its operating results. Our concern is exacerbated when a company has to write-down some of its inventory, possibly indicating past research efforts were not sufficiently predictive of market demand (see next section).

The Company's high price-to-sales ratio (26.8) may indicate the market is placing a high value on its technology. However, we are concerned the market may be over-valuing XYBR's technology in light of its recent write-off a fairly large percentage of its inventory and the material reduction in its R&D expenses.

Inventory write-down - For the three months ended March 31, 2003, a charge of $1,749,354 was recorded to reflect management's estimate of losses to be incurred on the systems in inventory and on the total remaining production run of the MA® V[14] product line.[15] In addition, the Company had purchase obligations for additional inventory manufactured by IBM totaling $40 million, subject to a cancellation fee of $4 million. However, in March 2003, the Company entered into an agreement with IBM under which the Company was released of its obligation to pay the penalty and its purchase obligation was reduced to $4.9 million. The final pricing provided to the Company represented a discount from the original contractual prices.[16]

While some of the $1,749,354 charge included orders for inventory that had not been received as of March 31, 2003,[17] we note that at March 31, 2003, the Company reported inventory of only $2.5 million. Hence, the $1.7 million write-off represents a fairly substantial portion of the Company's total inventory as of that date. As of

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13 . XYBR, 10-Q (6/30/03), p. 14.

14 . The Mobile Assistant® ("MA®") series is the Company's primary line of wearable computer hardware products, the current versions of which are the MA V and MA TC. Introduced in 2002, the Atigo™ product line is a family of mobile wireless web panels that can be used either as stand-alone handheld personal computers ("PCs") or as displays for an MA system, a laptop or a conventional PC. Since their commercial introductions, the Company has recognized revenue of approximately $23,000,000 on sales of approximately 5,800 MA and Atigo systems. XYBR, 10-Q (6/30/03), p. 13.

15 . XYBR, 10-Q (6/30/03), p. 7.

16 . XYBR, 10-Q (6/30/03), p. 12.

17 . XYBR, 10-Q (6/30/03), p. 7.

June 30, 2003, net of the effect of write-offs and reserves, the Company's inventory totaled $3.8 million, but still consisted mainly of the MA® V product line ($2,701,570 in MA® V systems, $906,056 in MA® TC systems, $145,474 in Atigo systems and $37,848 in *poma*® systems).[18]

Material increase in customer concentration and decline in disclosure regarding the identity of the customer - The following table summarizes the number of customers that individually comprise greater than 10% of total revenue or total accounts receivable and their aggregate percentage of the Company's total revenue or total accounts receivable for fiscal years ended December 31, 2002, 2001 and 2000. IBM (NYSE: IBM) was the Company's 16% customer for fiscal year 2002.[19]

	As of and for the year ended December 31,		
	2002	**2001**	**2000**
Revenue:			
Number of Customers	1	2	1
Percent of Total Revenue	16%	30%	11%
Accounts Receivable:			
Number of Customers	2	3	3
Percent of Total Accounts Receivable	64%	56%	64%

For the **three and six months ended June 30, 2003**, there was **a material increase** in customer concentration as only **one (1) customer accounted for 45%** of sales in Q2 03 versus **three (3) customers accounting for 40%** of sales in Q2 02.[20]

	As of and for the Three Months Ended June 30,		As of and for the Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
Revenue:				
Number of Customers	1	3	1	2
Percent of Total Revenue	45%	40%	31%	22%
Accounts Receivable:				
Number of Customers	2	3	2	3
Percent of Total Accounts Receivable	65%	69%	65%	69%

We did not locate the identity of the 45% customer in Q2 03 in either the Company's 10-Q or earnings conference call. However, it apparently was not IBM as

18 . XYBR, 10-Q (6/30/03), p. 7.

19 . The Company stated that "[f]*or the years ended December 31, 2002, 2001 and 2000, revenue from the following customers comprised greater than 10% of total revenue: IBM; the State of Tennessee Department of Transportation ("Tennessee DOT") and Europart KG; and Cambridge Technologies Partners (MA), Inc., respectively. As of December 31, 2002, 2001 and 2000, the following customers' accounts receivable balances comprised greater than 10% of total accounts receivable: IBM and Tennessee DOT; IBM, Tennessee DOT and Europart KG; and Federal Express, Tennessee DOT and Europart KG, respectively*." XYBR, 10-K (12/31/02), p. F-22.

20 . XYBR, 10-Q (6/30/03), p. 11.

IBM accounted for only one percent (1%) of revenue in Q2 03 ($30,453 out of a total of $2.8 million).[21] Usual the Company states who its more than 10% customers are in its 10-K's and 10-Q's. (For example, in its Q1 03 10-Q, the Company stated that 2 customers, Europart KG and SCRA, accounted for 25% of total Q1 03 revenue).[22] Not revealing the 45% customer in its Q2 03 10-Q is a change (and a decline) in the Company's usual disclosures. One of our concerns with the failure to disclose the identity of the large customer in Q2 03 is whether the Company has not revealed this information because the purchaser was only making a one-time purchase that will not repeat in future quarters. While we do not know, we caution investors regarding this issue as we opine there is often a reason for a decline in a company's disclosures.

Related party transaction – The Company purchases some of its inventory from IBM and IBM provides financing for those purchases.[23]

As previously mentioned, in fiscal year 2002, IBM accounted for 16% of the Company's total revenue, though it appears IBM's contribution to revenue declined to only 1% for the quarter ended June 30, 2003.[24]

21 . XYBR, 10-Q (6/30/03), p. 12.
22 . XYBR, 10-Q (3/31/03), p. 11.
23 . XYBR, 10-Q (6/30/03), p. 12.
24 . XYBR, 10-Q (6/30/03), p. 12.

<u>**1-Year Stock Chart**</u>

Chart courtesy of StockCharts.com (http://stockcharts.com).

<u>**12 Month Short Interest Data***</u>

Settlement Date	Short Interest	Avg Daily Share Volume	Days to Cover
Sep. 15, 2003	1,976,645	8,687,918	1.00
Aug. 15, 2003	1,552,397	4,276,941	1.00
Jul. 15, 2003	1,589,259	4,582,776	1.00
Jun. 13, 2003	1,559,404	6,122,981	1.00
May 15, 2003	1,677,447	2,351,079	1.00
Apr. 15, 2003	1,815,839	1,148,438	1.58
Mar. 14, 2003	1,839,853	687,891	2.67
Feb. 14, 2003	2,092,501	913,140	2.29
Jan. 15, 2003	2,106,183	1,831,502	1.15
Dec. 13, 2002	2,070,603	2,892,745	1.00
Nov. 15, 2002	2,007,601	6,118,223	1.00
Oct. 15, 2002	2,001,604	988,199	2.03

* Source: NASDAQ® website: www.nasdaq.com. Neither The Eyeshade Report nor Forensic Advisors, Inc. is associated with or sponsored by Nasdaq.

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