

# ***THE EYESHADE REPORT***

**January 14, 2004**

<u>Company:</u> <b>XYBERNAUT CORPORATION</b>		<u>Address and Phone:</u> 12701 Fair Lakes Circle Fairfax, VA 22033 (703) 631-6925
Ticker: XYBR		Shares Out (basic): 167.9 M
Exchange: NasdaqSC		Float: 163.9
Market Cap: \$ 307 M	EV:* \$294 M	Short Interest: 11.7 M
P/S: 31.1	EV/S: 29.8	Closing Price: (1/14/04): \$ 1.83
P/E: NE		52 Week Range: \$ 0.28 - \$ 2.66

\* Enterprise value – market capitalization plus long-term debt minus cash and equivalents.

*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.*

**UPDATE** – This is an update of our prior report on XYBR dated September 30, 2003.

## **Summary**

- Sequential decline in revenue in Q3 03.
- Company issued press release last week announcing record revenues in Q4 03, but provided no details as to amount.
- Prior headline in press release (in July 2003) announcing record sequential revenue increase was untrue.
- Material inventory write-off and majority of remaining inventory consists of the written-off product line.
- Sequential increase in S,G&A expenses and continued decline in R&D expenses.
- Shares outstanding more than tripled in the last two years.
- Material decline in revenue per share.
- Continued private placements of stock below market prices.
- Increase in customer concentration and decline in disclosure regarding the identity of its customers.

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## Financial Statement Review

**Sequential decline in revenue in Q3 03** – For the quarter ended September 30, 2003 (Q3 03), the Company reported a year-over-year revenue increase of 6%. However, revenue declined sequentially as detailed in the following table.

\$ - M's	Q3 03	Q2 03	Q1 03	Q4 02	Q3 02	Q2 02	Q1 02	Q4 01
Rev.	2.70	2.79	1.79	2.60	2.54	2.01	2.81	3.21

\$ - M's	Q3 01	Q2 01	Q1 01	Q4 00	Q3 00	Q2 00	Q1 00	Q4 99
Rev.	2.32	2.02	2.27	2.45	2.02	2.93	1.50	1.24

**Company issued press release last week announcing record revenues in Q4 03, but provided no details as to amount** – XYBR issues a press release on January 8, 2004, headlined “*Xybernaut® Expects Record Revenues.*” The stock jumped 11% on the news to close at \$1.97 on the day (it traded as high as \$2.10 intraday) on 17.9 million shares traded (more than three times average volume). However, the Company provided no details regarding the amount of the revenue increase. (The stock also jumped 13% two (2) days earlier - on January 6, 2004 - on almost 14 million shares traded, though we found no news to account for it. We have not been able to ascertain if any of the trading that occurred on January 6, 2004 involved material inside information).

As the table in the previous section shows, the Company’s highest quarterly revenue to date was **\$3.21 million in Q4 01**. While we do not know how much revenue XYBR will report in Q4 03, we opine that exceeding that previous high would **not** necessarily represent a material increase in revenue on a dollar basis for a company with a \$300 million market cap.

During 2003, the Company issued a number of press releases announcing contract awards. However, despite the relatively large number of press releases (8) we located describing the specific amount of contract awards, the total dollar amount of those contracts was relatively small at \$7.9 million (after deducting the \$700,000 that was recognized in Q1 03 – see the following table).<sup>1</sup> Further, it is unlikely that entire amount will be recognized in Q4 03. And, even if it were, we would be concerned about the Company’s pipeline of revenue going forward.

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<sup>1</sup> . XYBR, press release dated January 14, 2003.

### 2003 Press Releases Announcing Contract Awards

Press Release Date	Customer	Amount	Recognition Period
Nov. 18, 2003	Unknown	\$2 M	Q4 03 and FY 04
Nov. 5, 2003	Leading cable network co.	\$1 M	Unknown
Sept. 24, 2003	Fortune 50 pharma	"initial..." \$250 K	Begin in Q3 03
Sept. 15, 2003	DOD	\$510 K	Unknown
Sept. 10, 2003	DOD	\$1.62 M	Unknown
Sept. 2, 2003	State govt.	Add-on contracts > \$1 M	Unknown
April 25, 2003	Mitsubishi Heavy Ind.	Not disclosed	Unknown
Jan. 14, 2003	Fortune 250 Transport Co.	\$2.25 M	\$700 K – Q1 03; Rest – FY 03 to Q1 04
<b>TOTAL</b> (less the \$700 K recognized in Q1 03)		<b>\$7.93 M</b>	

The Company also announced on December 31, 2003 that new service contracts awarded during 2003 exceeded \$5 million. While the press release is not sufficiently detailed, it appears that some - if not all - of those contracts **were announced in prior press releases** and are listed in the previous table.<sup>2</sup> Further, not all the \$5 million revenue will be recognized in 2003 as XYBR stated that only a portion of the revenue will be recognized in 2003, with the remaining amount to be recognized in 2004.<sup>3</sup>

**Prior headline in press release (in July 2003) announcing record sequential revenue increase was untrue** - XYBR previously issued a similar, vague press release on **July 9, 2003**, which contained the headline: "*Xybernavt® Expects Record Quarterly Revenue Increase.*" XYBR's stock jumped **25%** that day to close at \$0.71 on 33 million shares traded.

That **headline** was untrue. The June 2003 quarter's sequential revenue increase was **\$1 million** or **56%**. XYBR's highest sequential revenue increase was a **\$1.43 million**, a **95%** increase, in the June 2000 quarter (see the revenue tables in the first section of this report). However, XYBR **qualified** the language in its July 9, 2003 **headline** with an explanation in the **body** of that press release wherein it admitted: "...that it expects revenue for the second quarter ended June 30, 2003 to increase more than **50%** compared to revenue for the first quarter of 2003. This would be the highest quarterly percentage increase **since the Company's acquisition of Xybernavt Solutions Inc. in 2000.**"<sup>4</sup> Further, we note that the sequential revenue increase was short-lived as revenue declined sequentially in Q3 03 (though it probably will increase sequentially in Q4 03).

While the July 9, 2003 headline might be construed as deceptive, we have little doubt that XYBR's Q4 03 revenue will exceed all prior quarterly revenue. However, we

<sup>2</sup> . For example, the Department of Defense (DOD) contracts and the add-on contracts with state governments.

<sup>3</sup> . XYBR, press release dated December 31, 2003. No details were provided as to how much will be recognized in 2003 or 2004.

<sup>4</sup> . XYBR, press release dated July 9, 2003 (emphasis supplied). Xybernavt Solutions, Inc. was acquired in April 2000. XYBR, 10-Q (9/03), p. 6.

opine that the revenue increase would need to be extremely material to offset our other concerns regarding the Company.

**Material inventory write-off and majority of remaining inventory consists of the written-off product line** – During the nine months ended September 30, 2003, charges of \$3,174,354 were 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** product line.<sup>5</sup> As of September 30, 2003, XYBR only reported inventory of \$2.7 million. However, the majority of that remaining inventory, \$2.2 million, consisted of **MA V** systems.<sup>6</sup> Hence, while it wrote-off more than **50%** of its total inventory in 2003, **81%** of its remaining inventory consists of the product line which it wrote-off this year.<sup>7</sup>

**Sequential increase in S,G&A expenses and continued decline in R&D expenses** – The Company has made strides in lowering its selling, general and administrative (“**S,G&A**”) expenses as exhibited in the follow table. However, it efforts may be coming to an end as S,G&A expense **increased sequentially in both** the June and September 2003 (Q2 03 and Q3 03) quarters.

Additionally, its research and development (“**R&D**”) expenses continued their decline in Q3 03, both sequentially and year-over-year. When R&D expenses decline, one of our concerns is whether the company is sacrificing a future, competitive position derived from its technology for the sake of a current, short-term improvement in bottom line results. The Company’s high price-to-sales ratio (31.1) may indicate the market is placing a high value on its technology. However, we are concerned as to whether the market is 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.

**Revenue and S,G&A and R&D Expenses**

\$ - M's	Q3 03	Q2 03	Q1 03	Q4 02	Q3 02	Q2 02	Q1 02	Q4 01
<b>Rev.</b>	2.70	2.79	1.79	2.60	2.54	2.01	2.81	3.21
<b>S,G&amp;A</b>	3.10	3.08	3.04	3.35	5.12	5.33	6.84	7.29
<b>R&amp;D</b>	0.71	0.86	1.14	1.23	1.60	1.62	1.91	2.83

\$ - M's	Q3 01	Q2 01	Q1 01	Q4 00	Q3 00	Q2 00	Q1 00	Q4 99
<b>Rev.</b>	2.32	2.02	2.27	2.45	2.02	2.93	1.50	1.24
<b>S,G&amp;A</b>	6.48	5.54	4.75	4.73	4.02	4.26	4.17	3.37
<b>R&amp;D</b>	2.44	2.44	1.84	2.47	1.25	1.62	0.59	0.28

<sup>5</sup> . At September 30, 2003, these inventory charges were allocated as an inventory reserve totaling \$2,662,658, an accrued liability totaling \$497,016 and to demonstration units totaling \$14,680. At December 31, 2002, no such balances were recorded. XYBR, 10-Q (9/03), p. 7.

<sup>6</sup> . XYBR, 10-Q (9/03), p. 7.

<sup>7</sup> . At September 30, 2003, inventory on its balance sheet was valued at **\$2.7 million**, net of reserves of **\$2.7 million**. We advise investors to monitor the level of these inventory reserves for signs of a possible reversal of prior reserved inventory into income in future quarters. As XYBR’s CFO said during the Q3 03 conference call regarding the inventory reserve: *“This reserve was booked largely against the MA V product line. While we still anticipate selling much of the remaining MA V product at above cost, we felt that it was proper and conservative to book this charge in the current period.”*

**Shares outstanding more than tripled in the last two years** – Through November 10, 2003, the Company continued its pattern over the last two years of materially increasing its shares outstanding as outlined in the following table.<sup>8</sup>

**Shares Outstanding (in millions)**

	11/8/01	3/21/02	5/13/02	8/9/02	11/13/02	3/26/03	5/9/03	8/8/03	11/10/03
<b>Shares</b>	52.8	65.9	65.9	75.1	112.9	128.8	129	158.9	167.9

**Material decline in revenue per share** - Trailing twelve-month revenue per share has declined materially – from **\$0.17** at September 2001 to **\$0.06** at September 2003.<sup>9</sup>

**Continued private placements of stock below market prices** – At various times during 2003, XYBR has raised cash through the private placement of stock at below market prices. Those private placements also involved the issuance of warrants on terms that have proven to be quite attractive.

**2003 Private Placements through September 2003<sup>10</sup>**

Month issued	\$ raised	Shares issued	Price per share	Discount to Market	Warrants
Sept. 2003	2,000,000	1,600,000	\$1.25	18% <sup>11</sup>	800,000 @ \$1.25*
Sept. 2003	5,000,000	6,849,315	\$0.73	20% <sup>12</sup>	3,424,658 @ \$0.91*
June 2003	2,000,000	5,405,405	\$0.37	23% - 43% <sup>13</sup>	4,054,054 @ \$0.75*
May 2003	3,000,000	9,375,000	\$0.32	18% - 38% <sup>14</sup>	3,281,250 @ \$0.45*
Feb. 2003	2,000,000	6,666,667	\$0.30	21% - 35% <sup>15</sup>	3,333,333 @ \$1.25

\* If exercised in the first year.

<sup>8</sup> . In addition, at September 30, 2003, the Company had warrants outstanding to purchase 8,367,397 shares of its common stock at prices that range from \$0.50 to \$5.00 per share, with a weighted average of \$2.25 per share. XYBR, 10-Q (9/03), p. 11. This is down from the level at June 30, 2003, when 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. XYBR, 10-Q (6/30/03), p. 11.

<sup>9</sup> . Trailing twelve-month revenue was \$9.88 million at September 2003 versus \$9.06 million at September 2001.

<sup>10</sup> . Information from XYBR, 10-Q (9/03), p. 19 and historical closing prices.

<sup>11</sup> . XYBR, 10-Q (9/03), p. 19.

<sup>12</sup> . XYBR, 10-Q (9/03), p. 19.

<sup>13</sup> . Based on the lowest June 2003 closing price of \$0.48 and the highest closing price of \$0.65. We did not locate the amount of the discount in XYBR's quarterly filings.

<sup>14</sup> . Based on the lowest May 2003 closing price of \$0.39 and the highest closing price of \$0.52. We did not locate the amount of the discount in XYBR's quarterly filings.

<sup>15</sup> . Based on the lowest February 2003 closing price of \$0.38 and the highest closing price of \$0.46. We did not locate the amount of the discount in XYBR's quarterly filings.

In addition, it appears the Company may have **materially reduced the exercise price** of a number of its warrants in connection with their exercise.<sup>16</sup>

**Increase in customer concentration and decline in disclosure regarding the identity of its material customers** - For the three and nine months ended September 30, 2003, there was a material increase in customer concentration as only two (2) customer accounted for 43% of sales in the September 2003 quarter versus only one customer representing 19% of sales in the year ago period.<sup>17</sup> (This is a slight improvement over the quarter ended June 2003 when only one customer accounted for 45% of sales).<sup>18</sup>

	As of and for the Three Months Ended Sept. 30,		As of and for the Nine Months Ended Sept. 30,	
	2003	2002	2003	2002
Revenue:				
Number of Customers	2	1	2	1
Percent of Total Revenue	43%	19%	38%	10%
Accounts Receivable:				
Number of Customers	2	2	2	2
Percent of Total Accounts Receivable	48%	45%	48%	45%

As we noted in our last report, beginning with its June 2003 10-Q, XYBR ceased its prior habit of revealing the identity of its more than 10% customers. This decline in disclosure continued in the September 2003 quarter, as we found no information regarding the identities of its two customers that accounted for more than 10% of sales in Q3 03.

<sup>16</sup> . XYBR stated: "... Concurrently with their exercise, during the nine months ended September 30, 2003, the exercise price of 16,316,852 of the warrants was reduced from a weighted average of \$1.13 per share to \$0.31 per share. Concurrently with their exercise, during the nine months ended September 30, 2002, the exercise price of 6,034,837 of the warrants was reduced from a weighted average of \$1.48 per share to \$0.15 per share." XYBR, 10-Q (9/03), p. 19.

<sup>17</sup> . XYBR, 10-Q (9/03), p. 12.

<sup>18</sup> . XYBR, 10-Q (6/03), p. 11.

## 1-Year Stock Chart



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

## 12 Month Short Interest Data\*

<u>Settlement Date</u>	<u>Short Interest</u>	<u>Avg Daily Share Volume</u>	<u>Days to Cover</u>
Dec. 15, 2003	11,698,595	4,675,680	2.50
Nov. 14, 2003	10,909,643	5,569,804	1.96
Oct. 15, 2003	10,280,693	15,149,113	1.00
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

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