

Synchronica

June 2009

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Index: Aim

Sector: Technology

Key points

- Major collaboration with a Korean Original Device Manufacturer and a major mobile device distributor
- A low-cost messaging device and service for emerging markets
- Supporting fund raise significantly strengthens the balance sheet
- Upside for Synchronica likely to be significant from 2010 onwards

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Synchronica



Synchronica is a UK-based, AiM-listed company specialising in mobile email, with a focus on emerging markets. Blue chip customers and distributors include Nokia Siemens Networks, Sun Microsystems and major mobile operators.

NEW LOW COST EMAIL DEVICE

Synchronica has announced a major new strategic collaboration with a Korean Original Device Manufacturer and a major mobile device distributor, and an associated fund raising that should transform the company's prospects. The three partners are developing a low cost (sub \$100) messaging-oriented handset that will be optimized for and bundled with Synchronica's Mobile Gateway 4.0, a low-cost end-to-end mobile email solution but at a price point for emerging markets. Synchronica will receive revenues per handset sold, plus Mobile Gateway licence fees. The impact should be significantly positive on Synchronica's revenues, profitability and cashflows from 2010 onwards.

The three partners believe that there is a significant opportunity for delivering a low-cost push email solution to the mass market, particularly in emerging economies, where Smartphone products and services are simply too expensive. They are thus developing an entry-level e-mail centric device for emerging markets, which will cost no more than 25% of a typical Smartphone device. Synchronica has been selected to provide the email and synchronisation service that will power the device.

This strategic collaboration is very positive for Synchronica, as it will open up new distribution channels, provide a complementary hardware-based solution to its existing software-based solution, and generate new revenue sources from a share of handset sales. The Korean ODM and the major handset distributor (who will be named officially in coming months) are excellent partners for Synchronica, given respectively their handset design and manufacturing expertise and their high level relationships with mobile network operators.

As a condition of the deal, Synchronica has raised £4.723m gross of new equity to significantly strengthen its balance sheet. Whilst Synchronica will incur additional ongoing costs to support the collaboration (c\$1.5m per year initially), we estimate that the collaboration will be profitable for Synchronica from 2010; hence the additional funding will support Synchronica's growth from all sources. One of the collaboration parties will be granted options for 38.85m shares (approximately 6.7% of the new, enlarged share capital) at a price of 2.5p, subject to performance criteria.

We believe the market potential for such a device is significant, with global handset sales of over 1 billion a year (of which two-thirds are in emerging markets), and comparable Smartphone device sales of 31m a year based on 4Q2008/9. Sales of the new device(s) should be in the low millions at the very least.

Synchronica

SYNC

Date:	12.06.09
Share price p	3
52 week High/Low p	6.5/2.38
Issued share cap	388.52
Market cap £m	11.7
Year to December	Pre-tax £m
2007	- 2.55
2008	- 2.75
2009 E	- 1.41
2010 E	3.69
Year to December	EPS (p)
2007	-3.57
2008	-1.20
2009 E	-0.25
2010 E	0.66



ADVFN

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We are taking this opportunity to revise our existing forecasts for the significant appreciation of sterling in recent weeks, which will have a negative impact on Synchronica given that many of its revenues are in USD, whereas a reasonable proportion of its costs are in GBP. A change in the assumed £ / \$ rate from 1.48 to 1.70 reduces 2009 forecast EBITDA from £1.165m to £0.394m and 2010 from £6.4m to £4.9m, before the impact of the collaboration and fund raise.

We have then adjusted these new forecasts to reflect the collaboration, incorporating additional costs for 2009, enhancements to revenues, EBITDA, net income and cashflows from 2010, and the impact on EPS from the fund raise. Given the uncertainty over the sales potential of the new device, we have presented two scenarios that we believe err on the side of caution:

- In Scenario 1, sales of just 0.5m units in 2010 and 1m in 2011 would boost revenues and EBITDA by 20% and 8% in 2010 and 28% and 23% in 2011, compared with the revised base forecast.
- In Scenario 2, sales of 1m and 2m in 2010 and 2011 would boost revenue and EBITDA by 40% and 39% in 2010 and 56% and 65% in 2011.

We have adopted the first scenario for our new base forecasts for Synchronica, but will expect to revisit these as and when more information becomes available on the progress and potential of the collaboration.

Table 1: Synchronica Forecasts £'000s				
	2008A	2009E	2010E	2011E
Revenue	£3,708	£5,184	£12,333	£19,600
Revenue growth	62%	40%	138%	59%
EBITDA	-£2,261	£27	£5,280	£9,879
EBITDA margin	-61%	1%	43%	50%
EBIT	-£2,776	-£885	£3,977	£8,110
Profit (Loss) before Tax	-£2,752	-£1,170	£3,692	£7,837
Net Income	-£2,494	-£1,070	£3,792	£7,937
EPS	-1.2	-	0.20	1.39

ED estimates

UK-listed small and medium sized telcos trade on current year multiples of 4.8x EBITDA and 5.9x PE. Applying these to our revised forecasts support a share price of 3.9-5.1p for 2010, rising to 7.6-8.2p for 2011, suggesting considerable upside potential. Alternatively, at a price of 3p, Synchronica is trading on a forward PE of just 4.5x 2010 and 2.2x 2011.

A Low-Cost Messaging Handset for Emerging Markets

The collaboration is developing an entry level e-mail centric handset for emerging markets, with Synchronica's Mobile Gateway 4.0 providing the core push email and synchronisation of calendars and contacts. This new device will provide a tightly integrated hardware and software solution, but at a fraction of the price of comparable Smartphone products.

The first handset will be a feature-phone (not a smartphone), delivering a high level of functionality for a target retail price (unsubsidised) at a quarter of a comparable Smartphone. The main features of the handset include:

- GSM (Tri-band), with GPRS, the predominant and virtually universal data transport in GSM networks in emerging markets.
- Large screen to view emails and attachments.
- IMAP/SMTP and SyncML – industry standards ensuring that Mobile Gateway 4.0 can provide full push email and full synchronisation of calendar and contacts, in addition to document transcoding, downloading and viewing.

The collaboration is also developing a second, higher-spec model, with a slightly higher target retail price.

Synchronica has been heavily involved in the development of the handset specification, to ensure that the handset maximises usage of Mobile Gateway 4.0 functionality and provides a seamless user experience.

The partners have set themselves an ambitious timetable, with development and quality assurance complete by September 2009, and product launch and the first units shipped in 4Q2009. Our forecasts err on the side of caution by assuming that revenues do not come in until 1Q2010 at the earliest.

Synchronica's Role in the Collaboration

Synchronica is the obvious email software provider for the collaboration, given that:

- Synchronica's Mobile Gateway 4.0 is fully compliant with industry mobile email standards, and provides full push email and synchronisation capabilities.
- Mobile Gateway is a client-less application, which helps reduce the handset cost compared with competing email solutions that require a Java-based client to be downloaded to the handset.

Synchronica will be remunerated in two ways from sales of the new device:

- It will receive 3% of net handset sales revenues.
- In addition, it will receive Mobile Gateway licence and service fees, either through separate contracts or bundled into the device price.

Depending on the business model and order size, Synchronica can receive up to \$11 per unit sold. In addition, Synchronica can expect repeat revenues, as and when end users upgrade/replace their device with (hopefully) a new email device from the collaboration. Finally, carriers which introduce the device will also be able to offer Mobile Gateway services to legacy handsets, further driving Synchronica's revenue from standard license sales. The transformational impact on Synchronica's business thus comes from both a much deeper distribution platform and higher average revenue per new user.

Synchronica will be required to undertake some product development to Mobile Gateway 4.0, to add additional functionality for the new device. For example, the user will be guided through setting up their email details on the handset by a 'wizard' and Mobile Gateway will be optimized for the device to minimize data traffic. Synchronica will also need to hire additional staff to ensure that it delivers on its obligations to the collaboration, without compromising service to its existing clients. Extra staff will include a project manager, and engineering, sales and support staff. Total incremental costs are estimated by the company at \$1m per

year, plus \$1m of the collaboration's costs over the first two years, some of which can be capitalised.

In addition to enhancing its organisation capabilities to support the collaboration, Synchronica has been required to strengthen its balance sheet. Hence, the fund raising just completed. One of the collaboration partners will also be granted options over approximately 6.7% of Synchronica's enlarged share capital (pre new money) at the same price, which can only be exercised once various performance criteria have been met.

It is worth noting that only a relatively small proportion of the proceeds of the current fund raising will be required to support the collaboration, before the first revenues come in. Assuming that the collaboration meets its target of September for the first versions of the handset, and allowing for detailed testing by Synchronica and subsequent mobile operator trials, the first major revenues should come in early 2010. Thus, Synchronica may incur of the order of \$1-1.5m of additional costs up to this point, compared with the total net fund raising of \$6.5m. The fund raising thus should secure Synchronica's future overall, providing a funding cushion to enable a bigger marketing push and/or acquisitions to drive growth.

Potential impact on Synchronica

The rationale behind the new device is a shared view by the other collaboration partners and Synchronica, which we support, of a massive untapped market for push email services in emerging markets. Mobile Gateway 4.0 already addresses this potential, by providing a software-based push email solution that will work even on the most basic of handsets (for example using email to SMS conversion), as well as mid range feature phones and the most advanced smartphones. Synchronica is clearly gaining traction, with several new mobile operator contracts announced in recent weeks (most recently with a Dominican Republic operator, announced 27th April), as well as expansion orders from existing clients (for example with a Russian operator, announced 20th April), and agreements with major distribution partners (for example Nokia Siemens Networks, announced 17th February).

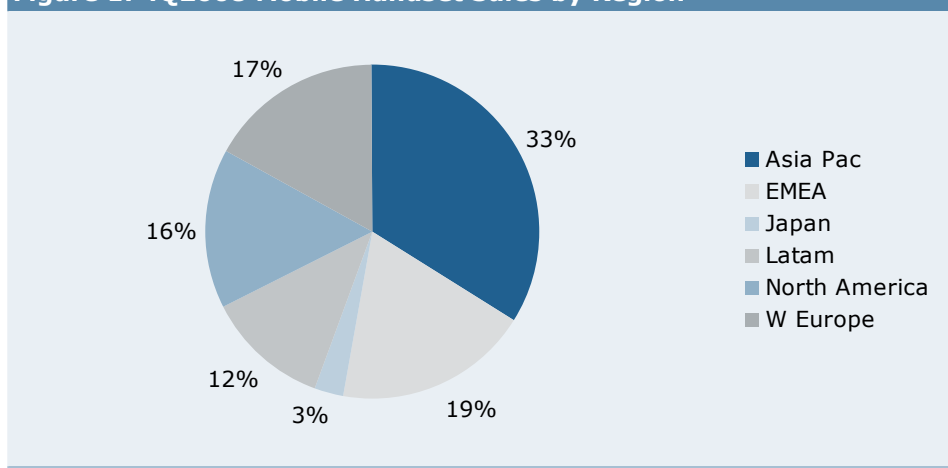
The new email-centric device represents a significant step forward for Synchronica, by enabling mobile network operators to sell a Smartphone-like product, but at an affordable price, suitable for emerging markets. Given that most mobile operator marketing centres on handsets, rather than generic mobile services, the device will be given far greater presence in operator marketing. Whilst the push email Smartphone leader RIM is gradually expanding its Blackberry service to include emerging markets, its target is still the highest value business customers able to afford \$400 for a handset and \$15-20 or more per month for the service. This strategy obviously works for RIM, but the fact that it has only 25m accounts (February 2009) out of 4 billion mobile subscribers globally shows that it has barely scratched the surface.

The target low (unsubsidised) retail price for the collaboration's handset is sufficiently inexpensive enough to provide a clearly alternative product to Smartphones. It will be able to provide most of the Smartphone email and synchronisation capabilities, including push email, synchronisation with personal calendar and contacts, and will also work in a business environment (Mobile Gateway 4.0 supports Microsoft Exchange). The main difference with other solutions is that, given that the handset it is not a smartphone, users will not be

able to download other applications. However, for cost conscious consumers and businesses, this relatively small lack of functionality will be a sacrifice worth making if it means they can actually afford a Smartphone-like device and service.

What then of the market potential? In 2008, 1.22bn handsets were sold worldwide, up 6% from 1.15bn in 2007 (Gartner). Smartphones accounted for 139m sales, up 13.9% on 2007, but still representing only 11% of all handset sales. Hence, basic phones and feature phones still account for most handset sales, which is no great surprise given that much of the growth in global mobile subscribers is coming from developing countries, in particular India, China and Brazil. As the following chart shows (based on 4Q2008 sales), Latin America, AsiaPac and EMEA accounted for almost two-thirds of global handset sales, with Western Europe, North America and Japan accounting for just over one-third, driven principally by replacement/upgrade sales.

Figure 1: 4Q2008 Mobile Handset Sales by Region



Gartner, ED analysis

The market in 2009 is proving tougher than in 2008, with Nokia estimating that global handset sales fell 14% in 1Q2009 against a year earlier, with a forecast of a 10% decline for the year as a whole. However, this still suggests c1.1 billion new handset sales globally. We understand that the handset distributor partner in the collaboration has received positive feedback from some its clients, and expects an initial order for 30,000 units from a large carrier in Latin America.

An alternative approach to sizing potential is to consider RIM/Blackberry sales. In fiscal year 2008/9 (to end February), RIM shipped 26m devices, with 7.8m in Q4. This was as many as RIM had shipped in all the years of its existence up to 2008/9! Q4 annualised represents just over 31m devices shipped annually.

Net net, given a still very substantial global handset market of perhaps 1.1bn units in 2009, and the current Blackberry performance of 31m devices shipping annually, the new email device(s) should easily achieve annual shipments in the low millions, and potentially in the tens of millions if it can become the Smartphone for emerging markets.

Financial forecasts and valuation

It is not an overstatement to say that the financial impact on Synchronica could be significantly positive from 2010 onwards, with each order for 100,000 units

delivering over \$1m in revenues to Synchronica, at a high gross margin. From a forecasting perspective, the main considerations are:

- The number of device sales per year, and the average unit cost.
- The average size of order, which impacts average licensing revenues and hosting costs.
- The extent to which these are incremental to existing assumed sales, or are a substitute.

We present a couple of scenarios showing the potential impact on Synchronica, using the following cautious assumptions:

- We assume an average handset cost of less than \$100, which is probably cautious, as the average will probably trend upwards as the collaboration adds higher-spec handsets to the range.
- All device sales substitute for existing assumed sales, generating incremental revenues per unit of approximately \$7.50 per unit rather than \$11.
- We assume additional operating costs of \$1.25m in 2009, \$2m in 2010 and \$2.5m in 2011, compared with Synchronica guidance of \$1m a year plus \$1m of the collaboration's costs over the first two years. 50% of costs are capitalised in 2009.
- We also assume hosting costs of \$1.66 per user over the three year period.
- In the lower scenario, we assume sales of 0.5m units in 2010 and 1m in 2011, whilst the higher scenario assumes 1m and 2m respectively. As we note above, sales could potentially be much higher than this. Note also that the collaboration expects to generate initial revenues in 4Q2009, compared with our 2010 assumption.

The revised base forecasts presented below reflect the impact of 1.7 £:\$ rate compared with our previous assumed 1.48 rate, assuming (probably a worst case scenario) that all revenues are denominated in USD and all costs are in £.

Table 2: Synchronica forecasts – Base and Scenarios (£000s)

Old Base (April 2009)	2008A	2009E	2010E	2011E			
Revenue	£3,708	£5,950	£11,810	£17,549			
EBITDA	-£2,261	£1,165	£6,426	£10,282			
Net income	-£2,494	£48	£4,928	£8,345			
EPS	- 1.20	0.01	1.29	2.19			
Revised Base (June 2009) – new £:\$ rate	2008A	2009E	2010E	2011E			
Revenue	£3,708	£5,184	£10,289	£15,289			
EBITDA	-£2,261	£394	£4,900	£8,015			
Net Income	-£2,494	-£720	£3,414	£6,107			
EPS	- 1.20	0.19	0.89	1.60			
Incorporating the collaboration					Change from base forecast		
Scenario 1	2008A	2009E	2010E	2011E	2009E	2010E	2011E
Unit sales (000)			500	1,000			
Revenue	£3,708	£5,184	£12,333	£19,600	0%	20%	28%
EBITDA	-£2,261	£27	£5,280	£9,879	-93%	8%	23%
Net Income	-£2,494	-£1,307	£3,792	£7,937		11%	30%
EPS	- 1.20	0.25	0.66	1.39		-26%	-13%
Scenario 2	2008A	2009E	2010E	2011E	2009E	2010E	2011E
Unit sales (000)			1,000	2,000			
Revenue	£3,708	£5,184	£14,377	£23,912	0%	40%	56%
EBITDA	-£2,261	£27	£6,836	£13,215	-93%	39%	65%
Net Income	-£2,494	-£1,307	£5,339	£11,237		56%	84%
EPS	- 1.20	0.25	0.94	1.97		5%	23%

ED estimates

Scenario 1 and 2 then show the impact of the collaboration and fund raise (based on £4.7m raised at 2.5 pence per share, and no additional interest income arising from the extra cash on the balance sheet). As the table shows, the incursion of additional operating costs in 2009 (assuming no revenues) hits EBITDA by approximately £0.37m, which is more than covered by the fund raise. From 2010 onwards, the impact is significantly positive on revenues and profitability. The impact on EPS is less marked due to the dilution from the fund raise, but is still significantly positive in Scenario 2.

We have adopted Scenario 1 as our new forecasts for Synchronica, post the fund raise, but will expect to be revising these as and when more details emerge of the progress of the collaboration in coming months.

Table 3: Synchronica Forecasts £'000s

	2008A	2009E	2010E	2011E
Total Revenue	£3,708	£5,184	£12,333	£19,600
Annual growth rate	62%	40%	138%	59%
Admin costs	-£5,969	-£5,157	-£7,053	-£9,721
Admin costs % of revenue	161%	99%	57%	50%
EBITDA	-£2,261	£27	£5,280	£9,879
EBITDA margin	-61%	1%	43%	50%
EBIT	-£2,776	-£885	£3,977	£8,110
Finance income	£457	£14	£15	£26
Finance costs	-£433	-£536	-£300	-£300
Profit (Loss) before Tax	-£2,752	-£1,407	£3,692	£7,837
Tax	£258	£100	£100	£100
Profit (Loss for the Year)	-£2,494	-£1,307	£3,792	£7,937
Reconciliation to reported				
EBIT (adjusted)	-£2,776	-£885	£3,977	£8,110
Profits on disposals				
Share based transactions	£117			
Other Exceptional items	-£4,046			
EBIT reported	-£6,705	-£885	£3,977	£8,110
PBT reported	-£6,681	-£1,407	£3,692	£7,837
Net profit reported	-£6,423	-£1,307	£3,792	£7,937
Earnings per share - reported				
Weighted shares in issue (m)	207.78	523.23	570.47	570.47
Earnings (loss) per share (pence)	-3.09	-0.25	0.66	1.39

ED estimates

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I certify that this report represents my own opinions
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