Decatur Jones
Equity Partners, LLC
Independent Equity Research

SCO Group, Inc.

(SCOX)

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Rating		Underperform
Current Price		$16.19
52 Week Range		$1.09 - $22.29
DCF Price		$4.82
Shares Outstanding		16,962,000
Market Cap ($000's)		$274,615
Cash and Equiv. ($000's)		$68,523
Long-term Debt ($000's)		$45,548*
Book Value / Share		$ 1.15
Enterprise Value ($000's)		$251,640
Year	Oct-03	Oct-04
Revenue ($000's)	$79,264	59,522
Rev Growth	23%	-25%
EPS (GAAP)	$0.36	($0.43)
EPS (consensus)	nm	nm
EPS Growth	nm	nm
EV/Rev (x)	3.17	4.23
P/E (x)	44	nm

*Includes effect of $50 million Series A Preferred private placement

End-user visibility worsens as Linux community raises defenses

We believe it is now unlikely that SCO will generate meaningful end-user SCOSource revenue in 2004.

Investment Considerations:

- ☐ Yesterday an industry consortium of Open Source-related companies (OSDL) announced an IP defense fund for end-users;
- ☐ In conjunction with its closing of the SuSE acquisition, Novell announced an indemnification program for its customers;
- ☐ We have cut our previous SCOSource revenue estimate of $7 million by 90%;
- ☐ Our new FY04 GAAP EPS estimate is a loss of ($.43) down from a $.20 profit;
- ☐ Our new target price is $5 down from $8;
- ☐ We maintain our Underperform rating.

Investment Summary

Our outlook for SCO has worsened given yesterday's news that an Open Source industry group has formed a fund that may be used to defend end-users from SCO claims. Contributors to the fund include technology giant Intel (INTC: not rated). Novell (NOVL: Market Perform) piled on late in the day by announcing an indemnification program for its customers. Coupled with Novell's previous filing of overlapping UNIX copyrights, we believe that end-users, already reticent to license from SCO, now have three justifiable reasons to wait to pay SCO even if SCO's claims are eventually proven valid.

PLEASE SEE PAGE 6 FOR ANALYST CERTIFICATION AND IMPORTANT DISCLOSURES

More blows to SCO's end-user licensing efforts
We believe yesterday's news that an industry consortium, Open Source Developments Labs (OSDL), had established a fund to defend end-users against infringement claims, represents the third strike in SCO's attempts to derive IP-related licensing revenue from end-users. The first couple items detailed in our prior reports include the ambiguity of SCO's claim over header files and Novell's copyrighting of duplicitous UNIX software code.

The "safe" action for the reasonable executive has switched from license to fight

Previous benefit of the doubt goes away
Furthermore, we previously had assumed that SCO would be able to generate $7 million in SCO Source licensing revenue this year. As stated in our prior report, *"The ability to win end-user settlements is based on our presumption that SCO will be very careful in choosing its initial targets. Suing the wrong end-user early on, one that is willing to fight, poses several problems for SCO. An end-user willing to fight could mean higher legal fees, management distraction, and further Linux community scrutiny of SCO's claims. More importantly however, the end-user does not even need to fight to victory to damage SCO's ability to collect licensing fees. In our opinion, the first end-user that successfully wins a stay of proceedings pending the outcome of the IBM (IBM: not rated) or Red Hat (RHAT: Outperform) cases effectively could shut SCO's efforts down as detailed in prior reports."*

Legal expenses remain even as SCOSource revenue shrinks
Now with the potential for legal costs to be borne by OSDL, whose defense fund contributors include heavyweight Intel, we now believe it may be difficult for SCO to win any settlement. Furthermore the "safe" action appears to have switched sides. Before, many organizations may have been willing to write a five-figure check to avoid legal risks and move on with business. We suspect anyone currently considering such an expenditure may now worry that they will be taken to task for wasting corporate funds. As a consequence, we have reduced our expectation for FY04 SCOSource revenue by 90%. Similarly our estimates for legal expenses have also increased in anticipation of more expensive initial end-user battles. Based on the pace of legal proceedings, it is highly unlikely SCO will be able to post a legal victory against an end-user this calendar year, even if it were to file an end-user lawsuit by mid-February as it discussed.

SCO now finds itself opposed by mainstream companies like Intel

More entities announce plans to oppose SCO
Later in the day, in what might be described as piling on, it was reported after the market close that Novell would indemnify its Linux customers. The indemnification program would apply to customers purchasing SuSE Enterprise Linux 8.0 after January 13, 2004. The timing of the indemnification corresponds to Novell's expected and announced completion of SuSE GmBH (In a separate announcement last night Novell announced that the acquisition of SuSE had closed.) Also this morning, in an interview reported on Groklaw, Daniel Egger, chairman of the Open Source Risk Management Group, announced plans for a

vendor-neutral indemnification program. The program would operate similar to insurance for companies supplying and using Open Source code and its agnostic approach is meant to eliminate the vendor lock-in, and potential fragmentation, inherent with vendor specific indemnification.

STOCK OUTLOOK

Increasingly binary outcome steps up risk

With significant end-user licensing fees unlikely and cuts to the core business possibly necessary, the fortunes of SCO's shareholders are increasingly tied to a victory or loss against IBM. Yet, with the jury stage of the IBM lawsuit not scheduled to commence until April 2005, SCO is at least two years away from a potential win against IBM. Thus, the near-term downside risk to SCO's shareholders is greater than the upside potential as IBM could conceivably win a motion to dismiss at least portions of SCO's complaint at almost any time during this same period. The legal doctrine that supports this assertion is that juries decide facts, while judges decide matters of law.

Near-term catalysts lean negative

Over the next few months a number of events offer the potential to drive SCO's stock price. Yesterday, SCO was required by a Utah judge's December order to provide with "specificity" to IBM a list of files that form the basis of its complaint. While the materials presented are covered by a protective order, we believe SCO may attempt to release additional details over the next few weeks to bolster its case to the IT community where it appears to be losing the public relations battle as of late based on Linux's momentum. The risk to SCO is that the Linux community, which consists of potentially thousands of free programming experts for every one expert that SCO hires, is able to quickly counter SCO's claims. SCO's management also points to the likely granting of its own motion to compel discovery against IBM and positive responses from its end-user certification letter as other potential near-term catalysts. Negative near-term catalysts include the expected denial of SCO's motion to dismiss the Red Hat lawsuit and IBM potentially filing to dismiss portions of SCO's complaint. The filing of an end-user lawsuit will most likely be touted by both bears and bulls on the stock as a positive for their position. We believe that in total the near-term catalysts are generally negative for SCO.

Why hold SCOX in the face of declining cash and poor comparisons even if one believes SCO will be victorious two years from now?

Deteriorating metrics likely to drive price in 2004

Beyond the ebb and flow associated with a tightly-held, volatile stock, with strong opinions on each side, we believe SCO's stock price direction over the next year, will be dominated by its expected declining financial position. As legal expenses increase with limited offsetting SCOSource revenue, the declining cash balance is likely to become a concern. Furthermore, year-over-year comparisons are likely to be poor starting in April given that the $26 million in SCOSource revenue received from Sun (SUNW: not rated) and Microsoft (MSFT: not rated) is not likely to be repeated. This begs a question for SCO bulls; if an

expected $45 stock price is two years away, but that expectation may drop to single digits at any point in the interim, why assume the risk and hold the stock today when fundamentals like cash per share and revenue growth will get worse before they get better? This risk return equation does not require a judgment on whether SCO's claims are valid and potentially produces higher returns by facilitating a lower entry point and shorter IRR period.

Further model details

Cuts may be needed in the core business just as past areas of strength for SCO come under assault

For FY04 we have also trimmed our expectatins for the core business modestly. It is our belief that SCO's current customers and prospects may increasingly be turned off by the growing litigation swirling around the company. This has also caused us to reduce our revenue growth expectations for FY05. Our prior DCF model had optimtistically assumed 15% revenue growth in FY05. We now believe that results will be flattish at best. The dilemna for SCO is that they may need to reduce core operating expenses to ensure viability through the IBM trial and appeals given the company's hefty legal expenses. However, reductions in areas such as research and development spending may be inopportune given the assault on traditional SCO strongholds like retail software solutions. In the last week, both Microsoft and IBM have announced new retail solutions including a Linux-based offering from IBM.

Discount Rate:	12%					
	2004	**2005**	**2006**	**2007**	**2008**	**perpetuity**
year	1	2	3	4	5	
Y/Y Growth Rate	-25%	-4%	10%	10%	10%	-3%
Rev	$ 59,522	$ 57,338	$ 63,072	$ 69,379	$ 76,317	
Op Margin	-15%	-20%	10%	10%	10%	
Op Inc	(8,868)	(11,414)	6,307	6,938	7,632	
Other Inc.	542	(495)	(622)	(421)	(204)	
Taxes Exp	(667)	(914)	631	694	763	
Net Income	(7,659)	(10,995)	5,055	5,824	6,664	
Amortization	4,680	4,680	5,000	5,000	5,000	
Earnings	$ (2,979)	$ (6,315)	$ 10,055	$ 10,824	$ 11,664	$ 75,430
discounted earnings	$ (2,979)	$ (5,557)	$ 7,786	$ 7,376	$ 6,995	$ 45,235
NPV	$ 58,856					
Net cash	$ 22,975					
Sharecount	16,962					
Target price	**4.82**					

Exhibit 1: SCO Discounted Cash Flow model
Source: Decatur Jones and Company reports

The reduction in estimates drives a drop in our target price from $8 to $5. We would note however, that this target price does not include potential liabilities to SCO should it fail to collect damages from IBM but be

found liable for counterclaims brought by IBM or damages awarded to Red Hat. Nor does this target price contemplate potential dilution from conversion of preferred stock into nearly 3 million shares of common stock.

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SCOX One-year Stock Performance

Exhibit 2: SCO Group Stock Performance
Source: www.reuters.com

Company Description

According to company reports, the SCO Group (Nasdaq: SCOX - News), the owner and licensor of the core UNIX operating system source code, helps millions of customers in more than 82 countries to grow their businesses. Headquartered in Lindon, Utah, SCO has a worldwide network of more than 11,000 resellers and 4,000 developers. SCO Global Services provides reliable, localized support and services to all partners and customers. For more information on SCO products and services, visit http://www.sco.com

Disclosure

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I hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issue(s) as of the date of this report. I further certify that no part of my compensation was, is, or will be directly, or indirectly, related to the specific recommendations or views contained in this research report. By: Dion Cornett

Ratings System

Decatur Jones rates stocks Outperform (expected to produce returns at least 15% higher than the appropriate index over the next twelve months), Market perform (returns within 15% of the appropriate index) and Underperform (returns at least 15% below the appropriate index).

Fiscal Year End October	2001	2002	Jan-03	Apr-03	Jul-03	Oct-03	2003	Jan-04e	Apr-04e	Jul-04e	Oct-04e	2004e	2005e
Revenues:													
Product licensing	$33,878	$52,975	$11,090	$11,122	$10,784	$11,400	$44,396	$11,856	$12,034	$12,214	$12,398	$48,502	$47,400
SCO source licensing				$8,250	$7,300	$10,300	$25,850	$250	$125	$125	$125	$625	$0
Services	$6,563	$11,266	$2,450	$1,997	$1,971	$2,600	$9,018	$2,541	$2,579	$2,618	$2,657	$10,395	$9,938
Total revenues	$40,441	$64,241	$13,540	$21,369	$20,055	$24,290	$79,264	$14,647	$14,738	$14,957	$15,180	$59,522	$57,338
Cost of revenues:													
Cost of products and services	$14,923	$18,316	$2,878	$2,837	$2,490	$3,479	$11,684	$2,908	$2,952	$2,996	$3,041	$11,897	$11,582
Estimated SCOSource legal cost			$0	$2,310	$2,044	$3,884	$8,238	$2,180	$2,510	$2,750	$2,790	$10,230	$12,000
Total cost of revenues	$14,923	$18,316	$2,878	$5,147	$4,534	$7,363	$19,922	$5,088	$5,462	$5,746	$5,831	$22,127	$23,582
Gross profit	*$25,518*	*$45,925*	*$10,662*	*$16,222*	*$15,521*	*$16,927*	*$59,342*	*$9,559*	*$9,276*	*$9,211*	*$9,349*	*$37,395*	*$33,756*
Operating expenses:													
Sales and marketing	$33,858	$29,554	$6,440	$6,051	$5,930	$5,971	$24,392	$5,911	$6,000	$6,090	$6,181	$24,183	$23,753
Research and development	$16,761	$17,558	$2,650	$2,542	$2,950	$2,870	$11,012	$2,841	$2,856	$2,841	$2,827	$11,365	$10,701
General and administrative	$9,257	$9,420	$1,650	$1,462	$1,413	$1,705	$6,230	$1,502	$1,519	$1,511	$1,503	$6,035	$6,035
Amortization Expense	$10,664	$2,853	$700	$700	$895	$895	$3,190	$895	$895	$895	$895	$3,580	$3,580
Restructuring Charge	$3,130	$6,728	($252)	$136	$614	$0	$498	$0	$0	$0	$0	$0	$0
Stock based compensation	$1,975	$1,012	$212	$406	$309	$277	$1,204	$275	$275	$275	$275	$1,100	$1,100
In Process R&D	$1,500												
Write Downs and Other	$82,009	$1,180				$9,370	$9,370						
Total operating expenses	$159,154	$68,305	$11,400	$11,297	$12,111	$21,088	$55,896	$11,425	$11,544	$11,612	$11,682	$46,262	$45,169
Operating Income	*($133,636)*	*($22,380)*	*($738)*	*$4,925*	*$3,410*	*($4,161)*	*$3,446*	*($1,866)*	*($2,268)*	*($2,401)*	*($2,333)*	*($8,868)*	*($11,414)*
Other income (expense):													
Change in preferred derivative						$2,800	$2,800						
Interest Income and Other	$2,587	($218)	$19	($123)	($126)	$86	($144)	$207	$170	$116	$49	$542	($495)
Pre-tax income	($131,049)	($22,598)	($719)	$4,802	$3,284	($1,275)	$6,092	($1,659)	($2,098)	($2,285)	($2,284)	($8,326)	($11,909)
Income taxes	$578	$483	$5	$302	$188	$279	$774	$0	($210)	($229)	($228)	($667)	($914)
Net income	($131,627)	($23,081)	($724)	$4,500	$3,096	($1,554)	$5,318	($1,659)	($1,888)	($2,057)	($2,055)	($7,659)	($10,995)
EPS	($2.74)	($1.79)	($0.06)	$0.33	$0.19	($0.09)	$0.36	($0.09)	($0.11)	($0.12)	($0.11)	($0.43)	($0.60)
S excluding charges and derivative	($0.89)	($1.10)	($0.07)	$0.37	$0.25	$0.31	$0.86	($0.08)	($0.09)	($0.10)	($0.10)	($0.37)	($0.54)
Shares outstanding	48,096	12,893	11,244	13,663	16,180	16,962	14,582	17,600	17,725	17,850	17,975	17,798	18,349
Margin Analysis:													
Total Gross Margin	*63.1%*	*71.5%*	*78.7%*	*75.9%*	*77.4%*	*69.7%*	*74.9%*	*65.3%*	*62.9%*	*61.6%*	*61.6%*	*62.8%*	*58.9%*
Sales and marketing	*83.7%*	*46.0%*	*47.6%*	*28.3%*	*29.6%*	*24.6%*	*30.8%*	*40.4%*	*40.7%*	*40.7%*	*40.7%*	*40.6%*	*41.4%*
Research and development	*41.4%*	*27.3%*	*19.6%*	*11.9%*	*14.7%*	*11.8%*	*13.9%*	*19.4%*	*19.4%*	*19.0%*	*18.6%*	*19.1%*	*18.7%*
General and administrative	*22.9%*	*14.7%*	*12.2%*	*6.8%*	*7.0%*	*7.0%*	*7.9%*	*10.3%*	*10.3%*	*10.1%*	*9.9%*	*10.1%*	*10.5%*
Operating Income	*-330.4%*	*-34.8%*	*-5.5%*	*23.0%*	*17.0%*	*-17.1%*	*4.3%*	*-12.7%*	*-15.4%*	*-16.1%*	*-15.4%*	*-14.9%*	*-19.9%*
Net Income	*-325.5%*	*-35.9%*	*-5.3%*	*21.1%*	*15.4%*	*-6.4%*	*6.7%*	*-11.3%*	*-12.8%*	*-13.8%*	*-13.5%*	*-12.9%*	*-19.2%*
Product y/y Revenue growth		*56%*	*-26%*	*-12%*	*-15%*	*-11%*	*-16%*	*7%*	*8%*	*13%*	*9%*	*9%*	*-2%*
Revenue growth year-over-year		*59%*	*-24%*	*38%*	*30%*	*57%*	*23%*	*8%*	*-31%*	*-25%*	*-38%*	*-25%*	*-4%*
Y/Y Earnings Growth		*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*
All values in thousands except per share data													

All values in thousands except per-share data
Exhibit 3: SCO Group Income Statement
Source: Decatur Jones and Company Reports

Fiscal Year End October	2001	2002	Jan-03	Apr-03	Jul-03	Oct-03	2003	Jan-04e
Current Assets								
Cash	$22,435	$6,589	$4,942	$10,015	$14,661	$68,523		$62,735
Resticted Cash		$1,428	$1,250	$1,779	$1,428	$2,025		$2,000
Accounts Receivable	$16,742	$8,622	$9,489	$8,793	$7,398	$9,282		$8,000
Other Current Assets	$9,381	$4,483	$3,902	$4,392	$2,943	$2,450		$2,500
Total Current Assets	$48,558	$21,122	$19,583	$24,979	$26,430	$82,280		$75,235
Property and Equipment	$6,116	$2,021	$1,742	$1,331	$1,561	$1,148		$1,200
Intangibles	$15,408	$11,258	$10,473	$9,689	$11,431	$10,452		$10,500
Other Assets	$4,777	$3,005	$2,064	$1,873	$3,210	$1,072		$1,500
Total Assets	$74,859	$37,406	$33,862	$37,872	$42,632	$94,952		$88,435
Current Liabilities								
Accounts Payable	$2,881	$2,467	$2,051	$1,978	$1,788	$1,978		$1,900
Accrued Expenses	$13,641	$10,849	$5,700	$5,709	$5,559	$8,506		$6,000
Accrued Comp to law firms						$10,556		0
Current Portion of Deferred revenue	$8,241	$10,056	$9,802	$9,218	$6,822	$5,501		$5,000
Derivative related to convertible						$15,224		$15,224
Other Current Liabilities	$9,394	$4,082	$5,816	$6,620	$6,254	$3,347		$4,000
Total Current Liabilities	$34,157	$27,454	$23,369	$23,525	$20,423	$45,112		$32,124
Long Term Liabilities	$5,925	$1,625	$2,340	$618	$611	$508		$500
Minority Interest	$173	$150	$150	$150	$150	$145		$145
Convertible preferred Stock						$29,671		$30,000
Stockholders Equity	$34,604	$8,177	$8,003	$13,579	$13,579	$19,516		$25,666
Total Liab & Equity	$74,859	$37,406	$33,862	$37,872	$34,763	$94,952		$88,435
Cash per share	$ 0.47	$ 0.51	$ 0.44	$ 0.73	$ 0.91	$ 4.04		
Book Value per Share	$ 0.72	$ 0.63	$ 0.71	$ 0.99	$ 0.84	$ 1.15		
DSO's			63	37	33	34		
All values in thousands except per share data								

All values in thousands except per-share data.
Exhibit 4: SCO Group Balance Sheet
Source: Decatur Jones and Company Reports