Preliminary Fundamental Research
InterDigital Inc. (NYSE:IDCC)

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Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

The first step in our research process is the identification of anomalous insider trading behavior. If found, we then perform a review of financial statements and accounting policies to see if management may be attempting to disguise underlying financial or operating problems, and we will also look at governance practices, to see if they inappropriately benefit the incumbent executives. At the same time, we may perform fundamental analysis with an eye toward identifying overlooked or under appreciated fundamental challenges that may provide an explanation for the unusual or self-serving trading, accounting and/or governance behaviors we have observed. The combination of all these items is the basis for a Full Report which outlines our investment thesis.

Preliminary Fundamental Research summarizes our initial fundamental observations for the subject company that may also include some financial statement analysis. The publication of this report does not necessarily mean a Full Report will be published; but it does contain information that some clients will find useful.

Business Description

InterDigital Inc., through its subsidiaries, engages in the design and development of digital wireless technologies and products for use in cellular and wireless IEEE 802 related products. The Company licenses its technologies to semiconductor companies, and producers of wireless equipment and components, such as 2G, 2.5G, 3G, and IEEE 802 products worldwide. It also offers its SlimChip family of mobile broadband modem solutions to mobile device manufacturers, semiconductor companies, and other equipment producers that manufacture, use, and sell digital cellular products. InterDigital's solutions are incorporated in various products, including mobile devices, such as cellular phones, wireless personal digital assistants and notebook computers, and personal computer memory card international association cards; base stations and other wireless infrastructure equipment; and components for wireless devices. The Company was founded in 1972 and is headquartered in King of Prussia, Pennsylvania.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Technology	**$29.25**	**$1.26B**	**824,636**
Industry:	52 Wk Range:	Trailing P/E:	Shrs Out:
Wireless Communications	**$16.20-$33.69**	**67.40**	**43.22M**
F/T Employees:	FYE:	Forward P/E:	Short % of Float:
275	**31-Dec**	**14.92**	**10.20%**

Summary of Preliminary Fundamental Research for IDCC

- The Company is highly dependent on royalty revenues; 54% of revenue comes from per-unit royalties. Further increasing risk is the fact that 56% of total revenue comes from just three Japanese hand set manufacturers. Sharp and NEC, two of the big three, reported year-over-year declines in sales of 20% and 43%, respectively, for the quarter ended 12/31/08.

- The Company spends a very high percentage of revenue on research and development and patent litigation costs. Patent settlements, which have caused the revenue stream to be lumpy and unpredictable at times but which have aided cash flow significantly, may be winding down, which may have significant implications for cash flow.

- In the 3Q08 conference call, the Company seemed to be backing away from its newest 3G technology called SlimChip, perhaps due to increasing competition and weak economic conditions, and is considering alternatives. Options include sale of assets, acquisition of other assets to increase size or realignment.

- Rapidly changing technology and heavy reliance on a small number of licensees are factors that could put royalty income, upon which the Company is highly dependent, severely at risk. This could put significant pressure on earnings, in that a decline in royalty income would not likely see a concurrent decrease in costs and expenses. To produce the next generation of technology the Company must continue funding R&D, regardless of the decline in revenue. Coupling a decline in revenue with a loss of up-front cash from royalty agreements and the attendant loss of interest income and reduced free cash flow, one can envision a perfect storm blowing over the bottom line.

Summary of Initial Insider Trading Findings

- Although it was a convergence of insider selling that initially drew us to InterDigital, a deeper analysis of the trading profile was not particularly compelling at this time, but there are a few interesting elements of their behavior that do raise questions with us, particularly in light of the business model risks. A few weeks after the Company issued 4Q08 guidance in line with analysts' expectations, the first insider sales began crossing the transom. Between 12/17/08 and 12/24/08 Chairman **Harry Campagna** and Executive V.P. of Standards **Brian Kiernan** each monetized options that were scheduled to expire over the next few months. The 105,000 shares the two collectively sold came as no surprise as InterDigital insiders have historically monetized options immediately before they were set to expire. Shortly after, a series of events in January boosted the shares to a new 52-week high and insiders surfaced with more noteworthy activity.

- On 01/14/09 InterDigital released an SEC 8-K announcing it had finally settled its 3D wireless patent infringement dispute with Samsung Electronics, for which IDCC is to receive $400 million over an 18 month period. The market did not react to this announcement, as IDCC traded sideways for four consecutive sessions, but the shares jumped 11% on 01/21/09 on heavy volume (3x average daily) after a number of analysts upgraded the shares and raised their earnings guidance and price targets. Into the rally two insiders, President and Chief Executive **William Merritt** and Executive V.P. of Communications and Investor Relations **Janet Point** each surfaced with 'pre-arranged' 10b5-1 sales. For Point, the 7,200-share sale was her first since becoming a Section 16 insider last March (she has been the head of IR since January 2000). Merritt's activity is of greater interest to us.

Figure 1. IDCC Daily Closing Price, 02/01/08 through 02/25/09. Red shaded area is where five insiders sold 189,950 shares, 110,000 of which were sold by 2 of the 5 insiders and related to the expiration of options. Source: Reuters and IDCC SEC Filings.

- InterDigital has disclosed the bare minimum with regards to insiders' 10b5-1 plans. They never issue an 8-K or press release when an executive or director enters into a new plan and the only evidence sales are part of a plan come from terse footnotes on the individual Form 4s. The sales of CEO Merritt are no different, but what we do know is that Merritt's 10b5-1 sales have not been executed on any identifiable schedule and two of the last three (07/02/07 and 01/02/08) preceded earnings guidance releases that fell short of the sell-side consensus, helping him to avoid one-month price declines of 34% and 18%, respectively. Merritt's latest sale of 16,500 shares covered only a small percentage of his holdings, but he has never been a high volume trader; his timing is the more noteworthy element.

- A few days later Executive V.P. of Business Development and Product Management **Mark Lemmo**, a 22-year Company veteran, surfaced with his first sales in two years, disposing of 40,000 shares (all common stock) on 01/26/09 and 01/29/09. Lemmo's last trades occurred in January and February of 2007, just weeks before the Company issued 1Q07 earnings guidance below expectations. It should also be noted that neither Merritt's, Point's nor Lemmo's trades were motivated by expiring options. The two options series Merritt monetized had two and three years remaining, while the three different option series Point tapped into were not set to expire until 2011. Needless to say, this is a rare instance of IDCC insiders selling in chorus, made even more notable by the non-expiring options being exercised.

- Despite the limited amount of 10b5-1 information at hand it appears to us as though this management team has a history of establishing short duration (one to three months) 10b5-1 trading plans. These short-lived plans have allowed them to profit on share price momentum, but more importantly, aided in cashing out immediately ahead of negative earnings-related announcements while avoiding the resultant downside. In our estimation the latest sales were part of new 10b5-1 plans opened right after the Samsung news and commenced immediately after. If this is in fact the case, it would suggest InterDigital's executives were in such a rush to sell that they were willing to accept the risk of jeopardizing the safe harbor protection afforded by the Rule.

Discussion of Preliminary Fundamental Research for IDCC

Revenues

IDCC has long been proud of two facets of its business; technological development for the wireless industry and the ability to capture significant stream of royalty revenues. In fact, as recently as the 2Q08 conference call, management made this bold statement, "**the driving force behind the Company's financial success has been and will continue to be our ability to predict the future of wireless and get there ahead of others**" [bolding is ours]. That seemed to have been true in the past, as the cards may be been lined up properly for the Company while the 2G wireless market was in the development stage. Today, however, the Company appears to be at a crossroads. Technology is developing at a faster rate, more competitors are involved, and litigation is a common practice within the industry.

IDCC has been talking about its new SlimChip product family for quite some time. The SlipChip modem is a technology that enhances digital mobility by enabling seamless transitions between multiple networks. Management has been touting the apparent success of the SlimChip product stating on the 1Q08 call, "the first quarter was an exceptionally strong quarter for the launch of our SlimChip products." Later in the call management continues, "We are equally confident in the future of the product program. We have produced a product that most other semiconductor manufacturers have yet to do."

However, that "ability to predict the future" and "to get there ahead of others" seems to have taken a dramatic turn in the 3Q08. In a press release dated October 30, 2008, and on the 3Q08 conference call management does say, "as for our SlimChip product business we are happy with the success in producing a market leading based band solution." However, they then go on to clarify **"**the data centric market itself is also evolving. We targeted the data centric market because it was an attractive niche where we could enter the market, establish a presence and grow over time as the market grew. However, the market grew at a much faster pace attracting very large players before we could firmly establish a presence…Further, the rate of technology change is also accelerating with operators increasing their demands for the next technology releases as customers begin to use more and more data on the go. All of the changes point in the same direction; that the profitable niches in cellular are quickly disappearing…**"**. We then learn that IDCC is considering three options for the 3G modem business: 1) exiting the business; 2) building additional scale in the business through acquisitions, or 3) repositioning the assets.

This change of heart seems a bit confusing especially considering the level of investment that has gone into the business. In fact, one analyst tries to understand really what the reasons are on the 3Q08 call:

> **Analyst:** First off on the SlimChip, just to be clear, was the reason for kind of moving – looking at options for that basically that the manufacturing capacity wasn't there? That you know was it a priority issue at Infineon? What was kind of the main driver there?
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> **Bill Merritt, CEO:** I think the – its probably a couple of things, right. One, it's not really a manufacturing capacity issue because we have access – our second chip is coming out of TSMC and so we've got a good relationship there. It really is being driven by the development scale, right. We had sufficient scale to get us there, but I think everyone's looking at the development team and saying you have to move faster because the market is moving faster. And so, I think that there's a situation where you need to make those decisions very quickly to build that scale because you do have some competitors with scale that are moving out there and you can't let the distance between us and them get greater, you have to start closing that gap. I think second, there – the data centric market where we were targeting has moved from a niche kind of market with less price pressures to more of a mass market type of situation with more price pressures and there you need volume and scale…"
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> **Analyst:** And on that same topic, can you give us some color as to where you see the development spending going on the SlimChip because I know that's been --- you know that's increased the R&D spending over the last few quarters? Is it still going to be at the same level of spending going forward even though you're looking for options for that?
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> **Bill Merritt:** You know I think as Scott mentioned today, you know depending upon which option we choose, I think that development spending in the fourth quarter could be affected by that...

Management then attempts to convince investors that they are firm believers in the business by stating in the closing comments of the 3Q08 call, "I believe there's no better indicator of confidence than where management invests its money and here the investment is in the Company and its future." But is the recent trading by executives, though subtle, suggesting signals contrary to this public statement of confidence? We will continue monitoring the trading behavior carefully, especially in the immediate aftermath of the 4Q08 and full-year earnings next week, whatever their outcome.

While SlimChip is more about the future, a key consideration in gauging the near-term outlook for the shares is the make up of the current revenue streams. Interestingly, 95% of revenues are generated from royalties. In fact, IDCC states in its 2007 SEC Form 10-K that royalties were generated on "approximately one-third of all 3G mobile devices sold world wide." In addition to royalty revenues, IDCC also generates revenues from what they call Technology Product Solutions (these are essentially software licenses and engineering support services). Although this segment has grown rapidly in fiscal 2008, at the end of the 3Q08 only 4% of total revenues were generated from TPS.

Given the dependency upon royalty revenues, it is important to take into consideration a few key points. As mentioned above, IDCC states that they receive royalties on approximately one-third of all 3G mobile devices sold worldwide. That does indeed sound impressive. However, it is important to point out that 56% of total revenues are generated from only three customers. Although the general contribution from these top three customers does seem to fluctuate a bit, their contribution has remained relatively stable over the past year. Here is a look at the contribution the top 3 customers made to total revenue on a quarterly basis in 2008.

Table 1. Percentage Contribution to Total Revenue by Top 3 Customers

	1Q08	2Q08	3Q08
LG Electronics	26%	25%	27%
Sharp	19%	18%	16%
NEC	10%	13%	13%
Total	55%	56%	56%

We have highlighted the contribution from these top customers on a quarterly basis due to the fact that we must also bear in mind how these clients are fairing in the global wireless market. Surprisingly, LG Electronics reported a 20.8% growth in total sales for fiscal 2008 while Sharp and NEC reported year-over-year declines of –20.2% and -43%, respectively, in total revenue growth for the most recent quarter ended December 31, 2008. Not only has demand fallen dramatically, but also the Japanese Yen has strengthened thereby increasing the cost of its goods to foreigners. Although IDCC has not yet released its fiscal 2008 year-end results, it will be interesting to see how the decline in global demand and other economic factors will impact IDCC and its royalty stream. Furthermore, the risks in the 2007 SEC Form 10-K highlight the very fact that licensee revenue is highly concentrated (note: 79% of recurring 2007 revenues was generated from licensees based in Japan) and that any decline in the Japanese market or those markets served by Japan could materially adversely impact future levels of revenue or cash flow.

Taking into consideration the global economic environment is in fact an appropriate segue to the discussion on how IDCC recognizes revenues and establishes contracts with each of its licensees. The description of revenue recognition is of course filled with exceptions and a long list of variables. Suffice it to say, it seems that each contract offers different terms. However, what is clearly defined is the fact that IDCC has four forms of payment for permitting their licensees to use the Company's patented inventions in applications and products. The agreements are as follows:

- ✓ Consideration for Prior Sales: Consideration related to a licensee's product sales from prior periods may result from a negotiated agreement with a licensee that utilized our patented inventions prior to signing a patent license agreement with us or from the resolution of a disagreement or arbitration with a licensee over the specific terms of an existing license agreement.

- ✓ Fixed Fee Royalty Payments: Up-front, non-refundable royalty payments that fulfill the licensee's obligation to us under a patent license agreement, for a specified time period or for the term of the agreement.

- ✓ Prepayments: Up-front, non-refundable royalty payments towards a licensee's future obligations to us related to its expected sales of covered products in future periods. Our licensees' obligations to pay royalties extend beyond the exhaustion of their prepayment balance. Once a licensee exhausts its prepayment balance, we may provide them with the opportunity to make another prepayment toward future sales or it will be required to make current royalty payments.

- ✓ Current Royalty Payments: Royalty payments covering a licensee's obligation to us related to its sales of covered products in the current contractual reporting period.

Two contract types stand out as being subject to market uncertainty: prepayments and current royalty payments. Under the prepayment contract, IDCC is subject to the client's degree of accuracy with regard to estimated product sales. However, once the prepayment balance is exhausted, the language in the SEC Form 10-K seems to imply that there is room to "top-up the account" so to speak to take into consideration rapid changes in market share or product sales.

From the Company's perspective, the upfront royalty payment certainly is attractive both from a cash flow and revenue perspective. However, one wonders if in fact IDCC can truly make up lost ground due to changes in market share on this type of contract. One analyst poses this question on the 1Q08 conference call. CEO Bill Merritt is a bit vague in his response, but certainly emphasizes the importance of receiving the initial prepayment.

> **Analyst:** Two other quick questions. One on LG. With Motorola really kind of collapsing in their handset business, LG grabbing more market share. You know hypothetically, if LG really starts to climb the ladder and grab some market share. What kind of language is in your contract? Can you grab additional revenues from that kind of prepayment schedule if they really start to ship more units and volume out there in the market place?
>
> **Bill Merritt, CEO:** You know, without getting into the specifics of the LG deal, let me just talk about how one typically structures a five-year paid-up deal. And what you typically do in those types of deals, in exchange of some payment – you are getting the benefit of the guaranteed payment. And – so that's your benefit and typically what the licensee is getting is the benefit of being able to produce more volumes, without having to pay additional monies. That is a fairly well balanced structure. What you typically protect against is, you know, a dramatic change like position or something like that. You know, we are pretty far down the path now with LG. We are three years into that deal. I guess this year, next year when it – in 2010. So to the extent there were some added value that they get because it picked up some sales. That certainly also become an element of the next discussion with them on the renewal.

Under the current royalty payment contract, IDCC is more subject to the variables of the global wireless market. That is, the client pays royalties only on those products sold during a certain reporting period and according to the 2Q08 conference call, royalties are paid with a one-quarter lag. Looking at the revenue contribution chart below, we see that 53.7% of total revenues are dependent upon per-unit royalty revenue and that per-unit royalty revenue did indeed fall by 11% in the 3Q08. Both of these facts do not bode well given the current contraction in global consumer spending.

Looking to actual revenue growth, both on a sequential and a year-over-year basis, we see that the drop was significant. One can only imagine what the 4Q08 and 1Q09 will bring especially considering the dismal revenue reports from Sharp and NEC for the quarter ending December 2008. In fact, in the 3Q08 SEC Form 10-Q we read that total recurring patent licensing royalties decreased by 7.4% from the same period last year due to softening demand within the Japanese market. However, when we look just at per-unit royalty revenue we see that the drop is even greater at -14.9% on a year-over-year basis and -16.4% on a sequential basis. According to an article on mobiletechnews.com, the worldwide mobile phone industry did feel the impact of the global financial crisis in the 3Q08. The third quarter "has historically been a ramp-up quarter as manufacturers load their sales channels with handsets in preparation for the holiday season…Handset vendors felt the pressures of the dismal economy in the third quarter of 2008, and as a result, shipments and revenues were down almost across the board."[1]

Table 2. Revenue Composition by Source, % of Total Revenue

	2005	2006	2007	1Q08	2Q08	3Q08
Per-unit Royalty Revenue	60.9%	26.0%	58.5%	58.2%	60.3%	53.7%
Fixed-fee & Amortized Royalty Revenue	21.2%	16.9%	33.8%	37.0%	34.9%	39.9%
Past Infringement & Other Non-recurring Royalties	6.3%	55.7%	6.3%	0.9%	0.5%	2.4%
Technology Solution Revenue	11.6%	1.4%	1.5%	3.9%	4.3%	4.0%
Total Revenue	100%	100%	100%	100%	100%	100%

Another point to highlight from the tables below is that revenue growth has been subject to the swings of patent infringement payments. Although CEO Merritt emphasizes on the 1Q08 conference call that this is a normal part of defending the business, it is nevertheless difficult to obtain a true perspective on what a normal growth rate might be for IDCC. As we will see in the notes below, however, patent disputes seem to be clearing and as a result we may see less volatility in infringement royalty line than in the past. That being said, we will now also more clearly see the impact of the decline in consumer spending as it relates to those products that utilize IDCC technology and the global wireless industry as a whole.

[1] www.mobiletechnews.com "IDC reports 3Q08 mobile phone market results", source: IDC, October 30, 2008.

Table 3. Sequential Revenue Growth by Source

	2005	2006	2007	1Q08	2Q08	3Q08
Per-unit Royalty Revenue	42.4%	25.8%	9.6%	10.9%	8.6%	-16.4%
Fixed-fee & Amortized Royalty Revenue	4.6%	134.9%	-2.6%	-0.9%	-0.9%	7.3%
Past Infringement & Other Non-recurring Royalties	466.6%	2,521%[2]	-94.5%	-86.1%	-40.0%	333.3%
Technology Solution Revenue	6,233%[1]	-63.7%	-50.7%	120.0%	13.6%	-12.0%
Total Revenue	57.3%	194.5%[2]	-51.2%	2.0%	4.8%	-6.13%

[1]In fiscal 2005 85% of Technology Solution Revenue was due to the recognition of revenue under the MUOS program for the US military.

[2]Note: In fiscal 2006 $253m of revenue related to the resolution of disputes with Nokia regarding a 1999 Patent License Agreement.

Table 4. Year-Over-Year Revenue Growth by Source

	2005	2006	2007	1Q08	2Q08	3Q08
Per-unit Royalty Revenue	42.4%	25.8%	9.6%	-15.8%	4.1%	-14.9%
Fixed-fee & Amortized Royalty Revenue	4.6%	134.9%	-2.6%	10.1%	10.2%	5.3%
Past Infringement & Other Non-recurring Royalties	466.6%	2,521%[2]	-94.5%	-94.6%	-83.3%	100%
Technology Solution Revenue	6,233%[1]	-63.7%	-50.7%	120.0%	316.7%	175.0%
Total Revenue	57.3%	194.5%[2]	-51.2%	-17.4%	6.73%	-2.5%

[1]In fiscal 2005 85% of Technology Solution Revenue was due to the recognition of revenue under the MUOS program for the US military.

[2]Note: In fiscal 2006 $253m of revenue related to the resolution of disputes with Nokia regarding a 1999 Patent License Agreement.

Table 5. Sequential Revenue Growth for Peer Group

	2005	2006	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09
IDCC	57.3%	194.5%	-51.2%	2.0%	4.8%	-6.13%	N/A	N/A	N/A
QCOM	16.3%	32.7%	17.9%	5.8%	6.8%	5.9%	20.8%	25.6%	-24.5%
BRCM	11.3%	37.3%	2.9%	0.5%	16.3%	8.1%	-13.2%	23.3%	N/A

Operating Margins

The table below highlights the fact that operating margins on a net basis seem subject to the volatility of arbitration gains and losses. In fiscal 2006, margins are highly skewed due to the receipt of $253 million to resolve outstanding patent issues.

Table 6. IDCC Operating Margins (%)

	2005	2006	2007	1Q08	2Q08	3Q08	2008
Margins as Reported	10.5%	70.0%	9.8%	19.5%	13.4%	23.7%	N/A
Margins Excluding Arbitration & Litigation Contingencies	10.5%	70.0%	20.3%	17.3%	13.4%	18.7%	N/A

For a company that is so dependent upon royalties and patents, operating margins are surprisingly low. On the other hand, IDCC margins do seem to be in the middle of the group compared to Broadcom (BRCM) and Qualcomm (QCOM). Nevertheless, a closer look at patent administration and development expenses reveals that these line items are quite significant both as a percentage of revenues and when compared to the peer group. In fact, the peer group provides only research and development expenses and does not even disclose patent administration costs.

Table 7. IDCC Peer Group Operating Margins (%)

	2005	2006	2007	1Q08	2Q08	3Q08	2008	1Q09
IDCC	10.5%	70.0%	9.8%	19.5%	13.4%	23.7%	N/A	N/A
QCOM	42.1%	35.7%	32.5%	31.0%	32.2%	29.8%	33.5%	29.6%
BRCM	10.9%	6.6%	2.3%	5.5%	10.3%	12.1%	3.7%	N/A

The Company’s patent administration expenses, including litigation expenses, have been running between 20% and 35% of revenues for the past six quarters if not more, again remembering that 2006 is a skewed year.

Table 8. IDCC Patent Administration Expenses as % of Revenues

Patent Admin. Expenses as a % of Revenues	2005	2006	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08
IDCC	30.3%	10.6%	19.5%	32.9%	31.8%	33.4%	26.9%	34.8%	24.2%

When we add development expenses to the equation, we see that nearly 66% of revenues were spent maintaining or developing patents in 2007 and as much as 73.4% of revenues in 2008 (73.4% of revenues was spent in 2Q08). Excluding litigation expenses, development and patent administration expenses were between 40% and 52% of revenues. To find a direct competitor is quite difficult, however we can point to a few examples. Qualcomm (QCOM) is the closest but still generates only 32% of total revenues from licensing and royalties. Broadcom (BRCM) receives even less at 4.5%. Nevertheless, these two companies only spend between 20% and 30% of revenues on research and development, which seems logical considering what percentage of their revenue stream is dedicated to product revenue. Even if we go outside the industry and look at the health care industry, we see that Biogen Idec Inc. (BIIB), which received 29.7% of its revenues from co-promotions and royalties in 2008, is only spending at most 30% of total revenues on research and development.

Table 9. IDCC Peer Group Development Expenses as a % of Sales

Development Expenses as a % of Sales	2005	2006	2007	1Q08	2Q08	3Q08	2008	1Q09
IDCC	38.7%	13.6%[1]	37.2%	41.4%	38.6%	43.7%	N/A	N/A
QCOM	17.8%	20.4%	20.6%	20.9%	21.2%	21.6%	20.5%	24.0%
BRCM	25.5%	30.5%	35.7%	34.5%	31.6%	29.2%	32.2%	N/A

[1]Note: this percentage appears distorted due to the receipt of $253 million from patent disputes.

Cash Flow

In the 2007 SEC Form 10-K discussion on financial position, liquidity and capital requirements, IDCC discloses that in “2007 and 2006, we generated net cash from operating activities of $152.7 million and $314.8 million, respectively.” However, a closer look at cash flow reveals that net income accounted for only 13.1% of total cash generated from operating activities. The increase in the deferred revenue account contributed more than 100% of the cash flow. In fact, the 10-K states that the positive operating cash flow in 2007 arose principally from receipts of approximately $303.4 million related to 2G and 3G patent licensing agreements. “These receipts included $95 million from LG, $41.6 million from Sharp, $32.4 million from NEC, $55.8 million from other licensees that signed new or amended patent agreements in 2007 and $78 million from other existing licensees.” This sounds well and good, but there are a few important qualifications. Firstly, the payments of $95 million from LG were only for three years, with the last payment having been made in the 1Q08. Secondly, there is a small amount of 2G related royalties that took place in 2007 that will disappear in 2008 as well as some unpaid patent royalties ($13.9 million in total). Combined, 36% of the cash flow stream from 2007 and 37% of the 2008 cash flow stream will not recur in 2009.

As we look at the cash flow picture for the first nine months of 2008, we see that $257.7 million was received from licensing and patent agreements. Again, $95 million or 37% was from LG, and, as mentioned, will not recur in 2009. $81.7 million, or 32%, was from current royalty payments, or royalties on a per-unit basis, while the remaining $81 million, or 31% was from pre-payments. To reiterate, 32% of the royalty payments cash flow stream in 2008 was based on a per-unit basis and we can only presume that in this economy these payments will be significantly less in 2009. Considering the revenue reports from Sharp and NEC for the quarter ending December 2008, the picture is not good. Furthermore, net income continued to account for only 21.2% of total cash generated from operating activities.

An analyst on the 1Q08 conference call asks about the free cash flow for the 1Q08. Management is upfront, but the answer reaffirms that without the LG payment IDCC is in a cash flow neutral position, this of course during a period when the economy was thought to still be in good shape and growing.

> **Analyst:** Nice quarter. On the free cash flow of $77 million, how much of that came from the LG settlement?
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> **Scott McQuilkin, CFO:** From the LG payment, we – we got $95 million from them on an annual basis, but there are foreign withholding taxes. So as it ends up being a number in the high 70's. So excluding that in the first quarter our cash flow would have been pretty neutral.

As an aside, in 2006 the cash flow windfall was, as mentioned earlier in this report, due to a patent settlement with Nokia for $253 million.

Looking forward, many could argue that with 3G and even more advanced technologies, the adoption and replacement rate for new mobile devices is likely to increase. However, IDCC itself points out – there are also now more competing technologies and royalty rates are coming down. In the 2007 SEC Form 10-K, IDCC states that, "certain licensees and others in the wireless industry, individually and collectively, are demanding that royalty rates for 2G and 3G patents be lower than historic royalty rates, and in some cases, that the aggregate royalty rates for 2G and 3G products be capped…Both the increasing number of patent holders of 3G and future technology and the efforts, if successful, by certain industry members and groups to reduce and/or place caps on royalty rates could result in a decrease in the royalty rates we receive for use of our patented inventions, thereby decreasing future anticipated revenue and cash flow." Although this risk is certainly not new, it is nonetheless one that should be taken into consideration, especially given the amount of litigation that is currently taking place.

Further exacerbating the cash flow issue is the fact that historically interest income has comprised as much as 44% of net income. As one might imagine, in these financial markets, interest income has fallen quite significantly. In fact, in the 3Q08 interest income fell by 46% to $1.1 million versus $2.1million from the same period one year ago and by 60% for the nine-month period ending September 30, 2008 to $2.8 million from $7.0 million for the same period one year ago. In addition, in 2007 IDCC made a $5.0 million investment in Kineto Wireless. This investment was written down in the 1Q08 by $0.7 million based on a lower valuation. Despite this, a new round of financing took place with IDCC, as well as several other unnamed investors, investing an additional $0.7 million in Kineto.

Suffice it to say, putting this all together it seems that cash flow could become quite tight in 2008.

Balance Sheet

We made several observations regarding the Company's most recent balance sheet that we thought were worth sharing with clients:

- ✓ **Cash & Equivalents:** Cash and equivalents have fallen by 21% since the end of fiscal 2007. However, IDCC 's balance sheet remains in decent shape with cash and equivalents accounting for 42% of total assets at the end of the 3Q08 versus 33.2% of total assets at the end of 2007. One presumes that much of the decline is a result of the decline in financial markets. In fact, new to the 3Q08 SEC Form 10-Q is the following disclosure, "We regularly review our cash and short-term investment positions. In light of the recent economic conditions, we updated this review as of October 30, 2008. We have not identified any material cash or short-term impairments, although the portfolio's overall rate of return has decreased along with the interest rates on the investments within the portfolio."

- ✓ **Accounts Receivable:** Accounts receivable fell significantly in the 1Q08 and has remained low throughout fiscal 2008. In the 1Q08 accounts receivable fell by 70.9% to $37.96 million from $130.9 million at the end of 2007. By the end of the 3Q08 accounts receivable stood at $30.9 million, a 76% drop from December 2007.

  Interestingly, unbilled amounts increased to $2.1 million at the end of the 3Q08 versus $0.3 million for the same period one year ago. Although the dollar amounts are relatively small, the percentage increase at 600% is quite significant. Even more interesting is the fact that accounts receivable had been quite stable at $131.9 million and $130.8 million, respectively, in fiscal 2006 and 2007 but stood at only $19.5 million at the end of 2005. The 2007 SEC Form 10-K disclosed that as of December 31, 2007, two customers accounted for 73% and 15% of the accounts receivable balance. One assumes the larger customer has fulfilled its accounts receivable obligation, although no other disclosure is made in either the 2006 SEC Form 10-K or any of the recent SEC Form 10-Qs.

- ✓ **Deferred Revenues:** According to the most recent SEC Form 10-K, a decrease in deferred revenue will be dependent upon the level of per-unit royalties reported against prepaid balances. As a result, one would assume that a decrease in the rate of change in the deferred revenue account implies a lower number of units sold by licensees. Unfortunately, detailed disclosure on the increases and decreases of the deferred revenue account are not given. Deferred revenues, short and long-term, totaled $296.4 million or 66.4% of total liabilities and equity at the end of the 3Q08 versus $303.4 million or 56.7% at the end of 2007. Deferred revenues recognized in each quarter for fiscal 2008 are similar to those levels recognized for fiscal 2007.

- ✓ **Total Debt:** There do not appear to be any risks with regard to the Company's capital structure. Total debt-to-equity and total debt-to-capital have been extremely low since 2006. At the end of the 3Q08 total debt-to-equity and total debt-to-capital stood at 3.3% and 3.2%, respectively. It should be noted, however, that equity has fallen significantly since 2006. At the end of 2006 shareholder's equity stood at $275.5 million but fell by 67.4% by the end of the 3Q08 to $89.8 million. Although the cash flow statement reveals that management has been consistently buying back shares, it is nonetheless a point to keep in mind, especially considering the fact that the impacts of the current economic environment are only just beginning to be reflected in the Company's financial statements.

Other Risks

There are no new risk disclosures in the fiscal 2008 10Qs. The risks outlined in the 2007 and 2008 SEC Form 10-Ks and generally relate to patent infringement issues. In addition, some of the risks outlined in the 2007 10-K seemed to have come to fruition in the current environment:

- ✓ New to the 2007 SEC Form 10-K under the heading "Our Future Financial Condition and Operating Results Could Fluctuate Significantly", is the following statement: "Our revenue and cash flow also could be affected by: (i) the unwillingness of any licensee to satisfy all of their royalty obligations on the terms we expect or a decline in the financial condition of any licensee; or (ii) the failure of 2G/2.5G and 3G sales to meet market forecasts due to global economic conditions, political instability, competitive technologies, or otherwise." On the surface, this disclosure seems rather general. However, given the increase in litigation expenses one wonders if there is indeed some underlying unwillingness to satisfy royalty obligations. Additionally, the inability to "meet market forecasts due to global economic conditions" has certainly become a reality.

- ✓ As mentioned in the discussion on cash flow, the following risk is not new, however it is important certainly in light of the fact that IDCC is so dependent upon royalties. "Royalty rates could decrease."

- ✓ Risks related to uncertainty regarding patent litigation have been a part of the IDCC story for some time, but they seem to be diminishing in number and size.

  Two cases that analysts have been following for some time concern ongoing litigation with Samsung and Nokia. In fact, each of the three most recent conference call transcripts is dominated by the litigation between IDCC and Samsung and Nokia. The litigation essentially deals with the fact that certain handsets were sold without paying for royalties. At one point the cases were consolidated and then were recently de-consolidated. IDCC and Samsung recently reached an agreement on November 24, 2008 whereby Samsung agreed to pay IDCC $400 million in royalties for patents and was granted licenses to the Company's 2G mobile technology indefinitely and 3G mobile telecom technology until 2012. All other arbitrations and litigations have been terminated between Samsung and IDCC. The new agreement was signed on January 14, 2009 effective November 24, 2008.