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Piper Jaffray & Co.

Reason for Report:
Industry Overview

Related Companies:	Share Price:
AAPL	83.94
ADBE	38.44
ADSK	44.72
AVID	32.90

Technology

HD Post Production Mkt Moving Forward; Avid Still At Center Of The Transition

KEY POINTS: Our survey of 161 post production professionals at last week's Hollywood Post Alliance conference indicates that HD post production is gaining greater adoption and Avid remains at the center of the transition.

HD Post Transition Moving Forward; Editors Still Focusing On Avid. Last week we spoke with and surveyed 161 post production professionals at the Hollywood Post Alliance (HPA) meeting. The HPA is a group of post production professionals that are at the leading edge of the industry and are probably a better representation of where the industry is headed in the coming quarters than where the industry is today. We believe this is one of the largest surveys conducted related to trends in the post production industry and the sample of those surveyed includes many of the largest studios, post production houses, resellers, and other industry experts. The focus of our survey was as follows:

- How far is the industry through transitioning post production editing tools to high definition?
- What portion of editing work is being done in high def today?
- What post editing tools are being used most?
- Are editors switching from their current systems to Apple?
- What will spending on post production editing tools in CY07 look like compared to CY06?

The key take-aways from the 161 post production professionals are as follows (see details on pg 2):

- 50% of editing work among leading edge editors is now being done in HD.
- Editors in our sample say they are 57% of the way through transitioning their tools to HD, but we believe the industry-wide average is lower, likely in the 30%-40% range, given our sample is on the leading edge of the transition.
- The majority of pro editors are using Avid's tools, followed by Apple, with Autodesk and Adobe a distant 3rd and 4th. Specifically, 48% are using Avid, 32% using Apple's *Final Cut*, 9% Autodesk Media & Entertainment tools, 5% Adobe *Premiere*, and 6% other offerings.
- While there has been much discussion of Apple taking share from Avid in post production, only 6% of Avid users said they are considering switching to Apple in the next 12 months.
- Post production professionals expect to spend more on editing tools in CY07 vs. CY06. On average, editors expect to spend 10% more in CY07, which is slightly above our expectations for Avid's pro video segment to grow 6.4% y/y in CY07.

RISKS

Risks include the fact that shares of these companies are highly volatile and will likely be sensitive to fluctuations in spending.

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Details Of Our Survey Of 161 Post Production Professionals. Last week we spoke with and surveyed 161 post production professionals at the Hollywood Post Alliance (HPA) meeting. The HPA is a group of post production professionals that are at the leading edge of the industry and are probably a better representation of where the industry is headed in the coming quarters than where the industry is today. We believe this is one of the largest surveys conducted related to trends in the post production industry and the sample of those surveyed includes many of the largest studios, post production houses, resellers and other industry experts. The focus of our survey was as follows:

- **How far is the industry through transitioning post production editing tools to high definition?**
- **What portion of editing work is being done in high def today?**
- **What post editing tools are being used most?**
- **Are editors switching from their current systems to Apple?**
- **What will spending on post production editing tools in CY07 look like compared to CY06?**

How Far Is The Industry Through Transitioning Post Production Editing Tools To HD? Post production professionals at the HPA meeting are on the cutting edge of the industry and indicated that, on average, they are 57% of the way through transitioning their post production editing tools to high def. We believe the industry-wide average is in the 30%-40% range, which is what we have heard in talking to users at the IBC and NAB tradeshows in the last year. But clearly this transition is well underway and as more and more content is released in HD and more work is done in HD, those that have not already upgraded their tools to edit in HD will feel pressure to do so. In other words, we expect the upgrade of post production editing tools to HD will accelerate vs. decelerate compared to the first 30%-40% of the transition.

What Portion Of Editing Work Is Being Done In High Def Today? We would again emphasize that our sample of post production professionals at HPA are at the leading edge of the industry. On average, respondents indicated that 50% of their work is being done in HD today. We believe the industry wide average is 10% to 15% lower than what this group has indicated. As a sidepoint, one network representative at the event indicated that 15% to 25% of all commercials on the network are now in HD. This datapoint emphasizes that those on the leading edge of the industry are already doing half of their work in HD, which means the rest of the industry will not be far behind as content owners demand that more of what goes on air is high def.

What Post Production Editing Tools Are Professionals Using Most? Avid continues to be the leader in professional post production. Not surprisingly, Apple's *Final Cut* ranks behind Avid as the second most used post production editing tool, with Autodesk and Adobe a distant third and fourth. Specifically, 48% of post production professionals indicated that they use Avid as their primary editing tool, while 32% said Apple's *Final Cut* is their primary editor. 9% of our sample are using mostly Autodesk Media & Entertainment and 5% do the bulk of their work in Adobe's *Premiere*. As we have seen in previous surveys with post production professionals, Avid is in the pole position in this market and is well positioned to capture the benefit of continued upgrades to HD.

Are Editors Switching From Their Current Systems To Apple? There has been a lot of talk about Avid losing market share in post production to Apple. We believe there is some truth to this, but primarily at the low end of the market, with higher volume, low revenue sales. Our previous surveys have shown that professional editors that use Avid will stick with Avid and this survey reaffirmed this view. Of the 48% of post production professionals that are using Avid, only 6% indicated that they are considering switching to Apple in the next 12 months. In other words, the vast majority of professional editors are loyal to Avid.

Expectations For Spending On Post Production Editing Tools In CY07 vs. CY06. Almost all (89%) of the post production professionals in our survey said that they will spend the same or more on editing tools in CY07 vs. CY06. Specifically, 54% expect to spend more in CY07, 35% expect their spending to be flat in CY07 and 11% believe they will spend less in CY07 vs. CY06. On average, our sample said they will spend 9.7% more on post production editing systems in CY07 than in CY06. This is slightly ahead of our expectation for Avid's pro video segment revenue growth in CY07 of 6.4%. We believe, given Avid's position in this market, that the company should be able to grow post production at 10% or greater in CY07.

Comparison Of HPA 2007 With NAB 2006 & IBC 2006:**Recap Of Thoughts From Post Production Professionals At IBC Tradeshow In September-06:**

- In Sep-06 we attended the IBC tradeshow in Amsterdam. The conference offers a chance to speak with European post production professionals regarding spending intentions and trends in the market. We spoke with 35 post pros.
- On average, post production pros were doing 28% of their work in HD. Also, most expected their post production technology related spending to be flat or increase in CY07 vs. CY06.
- For the first time in many years, Avid was not present at the IBC tradeshow. The company decided to focus its European marketing efforts on regional events. Given the significant presence of Avid competitors at IBC, it is difficult to say what the right strategy is for the company in Europe.

Key Takeaways From IBC:

- Nearly 70% of the 35 post pros we spoke with said that they were editing in HD at that time. Of those doing some editing in HD, on average 28% of their work was being done in HD. At the 2005 IBC tradeshow, post pros indicated that 22% of their work was in HD. This is similar to what we heard from U.S. based post pros when we spoke with 20 at the NAB tradeshow in April 2006. Specifically, at NAB, post pros said that 25%-35% of their work was being done in HD.
- 83% of post pros were expecting to spend the same amount or more on post production tools in CY07 vs. CY06. This was up from our IBC 2005 survey, when only 53% were expecting spending to be flat-to-up in CY06 vs. CY05. We believe this was likely the result of demand for HD content intensifying in Europe.
- Of those post pros that expected to spend more in CY07 vs. CY06, they expected to divide their budgets among the following vendors: Apple (42%), Autodesk M&E (33%), Avid (21%), and other (17%).

Signs Of Apple Market Share Gains Were Not Significantly Evident In Our Survey At IBC 2006. Of the 60% of post pros who were using Apple's *Final Cut*, only 11% indicated that they had switched from Avid to Apple. Most (89%) *Final Cut* users started on the product or switched from a non-Avid product to *Final Cut*.

Recap Of Thoughts From Post Production Professionals At NAB Tradeshow In April-06:

In April 2006 we attended the NAB tradeshow in Las Vegas. The event is focused on electronic media and attracts many post production and broadcast professionals. At the show, we spoke with 25 post and broadcast pros (20 post & 5 broadcast) regarding the systems they were using, thoughts on upgrade cycles in the industry and the industry's progression in these cycles, expected changes in technology spending in CY06, and thoughts on specific vendor's products.

Post Production Pros Expected 14% Spending Increase In CY06 vs. CY05 At NAB 2006. On average, the 20 post pros we spoke with at NAB 2006 were expecting to spend 14% more in CY06 on editing tools than they did in CY05 (we were modeling for Avid's video segment revenue to grow 4% y/y in CY06). The primary reason for the expectations of an increase was the continuation of upgrades to HD editing tools. Similar to the response we had gotten in the 6-12 months prior to NAB 2006, at the show we heard that post pros, on average, were 25%-35% of the way through the transition to HD, this left significant room for more spending in this category as post houses get fully outfitted. As usual, the key vendors highlighted were Avid and Apple. We only heard from 1 post pro (out of 20) that said they would be switching from Avid to Apple (*Final Cut*) over the next year following NAB 2006, so we did not expect any significant market share changes. It is also important to note, that post houses were hiring; 50% of the post pros we spoke with indicated that editor headcount was expected to go up in the next 6 months following the show.

Broadcaster Transition Still Under Way. We are clearly still in the first half of the transition of broadcast newsrooms from analog to digital workflow systems. At NAB 2006, we spoke with 5 broadcasters regarding expected spending trends in CY06. This was an extremely small sample, but we found that, on average, this handful of broadcasters expected to spend 30% more in CY06 than in CY05. The primary reason for increased spending within this sample of broadcasters was that several were in the process of upgrading from analog to digital newsroom environments. As expected, the primary vendors cited as beneficiaries of this spending were Avid and Thomson (Grass Valley Group).

Specific Quotes From Broadcast And Post Production Professionals At NAB 2006.**• Post Production:**

-"Not all of our customers are demanding that the work be done in HD right now, but they will be within the next three years."

- "We are strictly an Avid facility, we don't anticipate using *Final Cut* at all. We do use *Adobe AfterEffects* for a few things, but otherwise we stick with Avid."

- "We are adding people because we have had such a steady stream of work, we are actually turning post projects away, given we just don't have the bandwidth."

- "Our transition to high def editing tools has not really started, we will probably start getting the tools in place for this over the next two to three years."

• **Broadcast:**

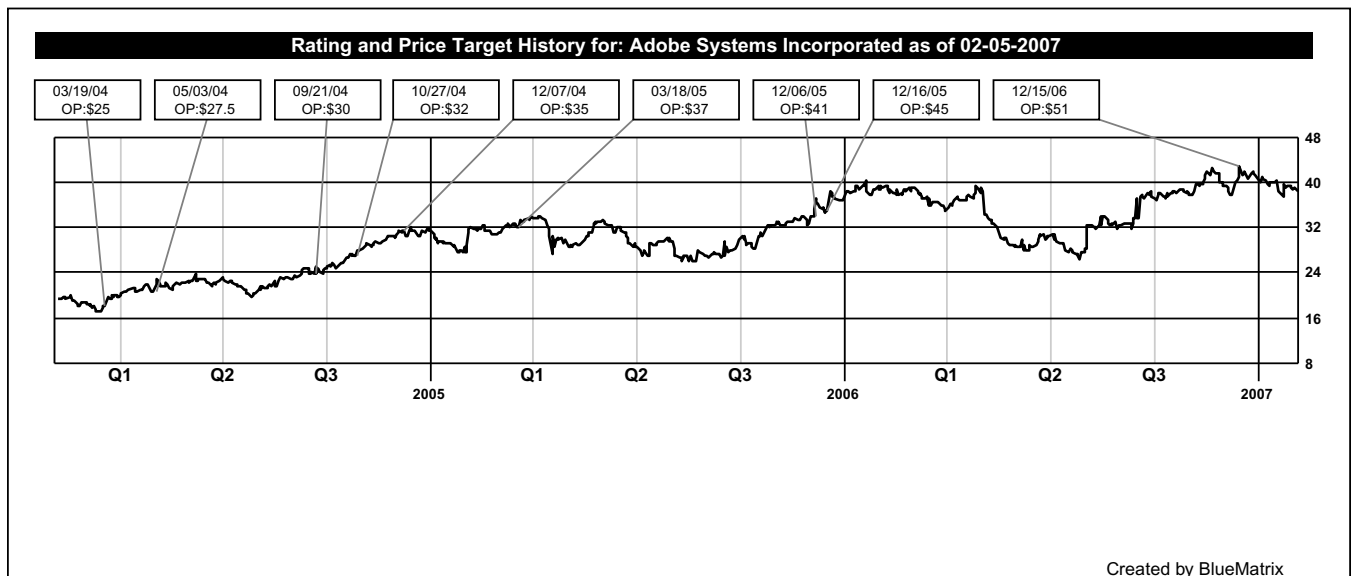
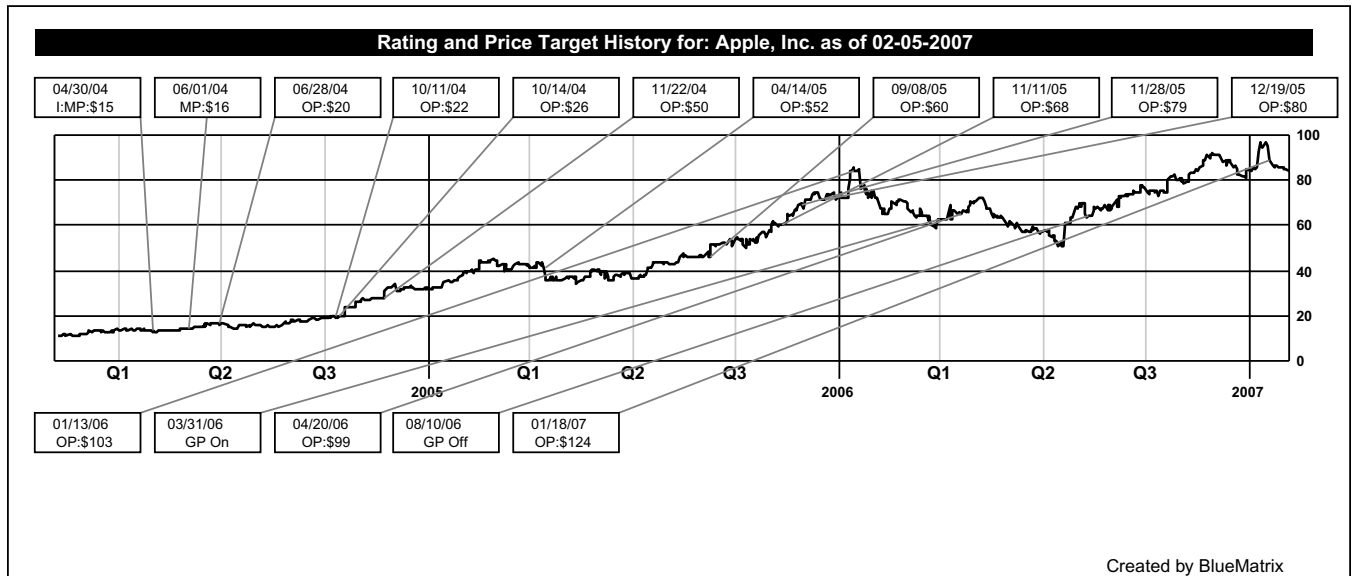
- "We will be spending a lot more on broadcast technology in CY06, because we are basically revamping the whole studio."

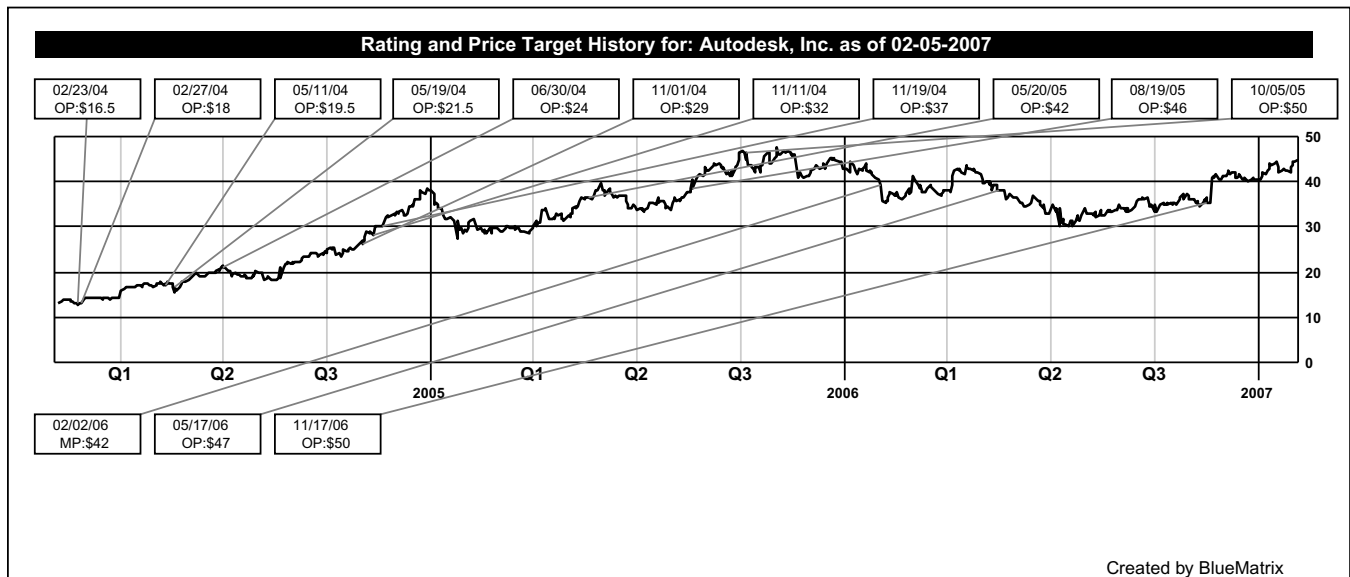
- "We are in the midst of the transition from an analog newsroom to digital, so our spending will be up significantly in 2006, compared to 2005."

Company Specific Information & Risks:

- **Apple -- Outperform -- \$124 Price Target (40x CY07E EPS).** Risks include the fact that Apple is highly dependent on spending trends in the education, consumer, and creative markets.
- **Adobe -- Outperform -- \$51 Price Target (35x FY07E EPS).** Key risks include, but are not limited to, timing of products, overall health of the graphics market, and unforeseen changes in *Mac* and PC computing platforms.
- **Autodesk -- Outperform -- \$50 Price Target (28x CY07E EPS).** The design market is very cyclical; if we enter a period of weakness, it could create difficulty in the sale of design software. ADSK shares are typically quite volatile.
- **Avid -- Outperform -- \$48 Price Target (26.5x CY07E EPS).** Avid revenue may be adversely affected by weak advertising and broadcasting markets. It is difficult to estimate when customer spending trends may shift.

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			Count	Percent
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