

**PhotoChannel Networks, Inc. (PNWIF)**

**Buy**

GROW WITH US<sup>SM</sup>

November 6, 2007

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**Initiating Coverage with a Buy Rating**

**Key Metrics (CAD\$)**

Price:	\$3.85
Rating:	Buy
52-Week Range:	\$2.05-4.88
Cash (M):	\$19.6
Debt (M):	\$0
Debt/Capital:	0%
Book Value/Share:	\$0.68

**Market Data (CAD\$)**

Market Cap (M):	\$124.7
Enterprise Value (M):	\$105.1
Dil. shares Out. (M):	32.4
Float (M):	NA
10-Day Avg. Volume:	109,000
Institutional Ownership:	NA

**Stock Performance**



Source: BigCharts.com

**Valuation (FY08E)**

EV/Sales:	6.3x
EV/EBITDA:	80.8x
PEG Ratio:	NM

**Company Description**

*PhotoChannel Networks provides services that link consumer digital media (photos, music, games, etc.) to local retailers — most notably the processing, storing, uploading and sending of consumers' digital photos. Following the acquisition of Pixology in July, the company can now provide retailers with a complete integrated digital photofinishing solution including home (online), in-store (kiosks) and mobile.*

**Investment Conclusion**

In our opinion, PhotoChannel Networks is poised to become a leading provider to the digital photofinishing market through its offering of a fully-integrated solution to retailers. With digital print revenues estimated to eclipse \$100B by 2010, we believe the company's variable revenue model (with 90%+ gross margins on transaction revenues) should drive increasing profitability in the years ahead. With our estimates for a 50% increase in revenue and a 500% increase in EBITDA in FY09, we believe a 20-25x EBITDA multiple is reasonable — yielding a potential valuation range of \$4.50-5.50.

**Summary**

- **Growing market opportunity.** According to PMA Marketing Research, the number of digital prints made by consumers has increased to an estimated 15.3M in 2007 from 500,000 in 2000, while the number of traditional film prints has declined from 29.9M to 9.0M. With that, IDC Research predicts that digital print revenue will increase to \$107B by the end of the decade from \$38B now.
- **Provides fully-integrated solution.** Following the acquisition of Pixology in July, PhotoChannel now provides its retail customers with a fully-integrated digital photofinishing solution, including home (online ordering for in-store pick-up), in-store (kiosks) and mobile (uploading and ordering through mobile phones).
- **Strong retail customer base.** PhotoChannel has succeeded in signing agreements with strong retail partners, including CVS/pharmacy, Kmart, Wal-Mart Canada and Costco Canada.
- **Potential for significant operating leverage.** As PhotoChannel does not operate any production labs (but only processes the online operations en route to the retailers' own labs), the company has a relatively fixed cost structure, generating gross margins from transaction-based revenues above 90%. Therefore, as digital print and gifts revenues ramp — through new retail partners and same-store growth — we project PhotoChannel could see operating margins expand from (22.6%) in FY07 to 28.1% in FY09.

**MCF Estimates (CAD\$)**

	FY07E	FY08E	FY09E
REVS. (M)			
1Q	\$1.5	\$3.8	
2Q	1.3	3.8	
3Q	1.3A	4.4	
4Q	3.4	4.7	
<b>FY (Sep)</b>	<b>\$7.5</b>	<b>\$16.7</b>	<b>\$24.9</b>
EV/S	14.0x	6.3x	4.2x
EBITDA			
1Q	\$0.1	\$0.1	
2Q	(0.6)	0.1	
3Q	(0.3)A	0.5	
4Q	(0.3)	0.7	
<b>FY (Sep)</b>	<b>(\$1.2)</b>	<b>\$1.3</b>	<b>\$7.6</b>
EV/EBITDA	NM	80.8x	13.8x

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PhotoChannel Networks provides retailers with a fully-integrated solution to address the growing demands of consumers to create prints and specialized gifts around their digital photos. With the accelerating decline in the market for traditional film-based photofinishing, retailers are attempting to better utilize the in-store photofinishing mini-labs they already have in place. PhotoChannel's solution allows those retailers to provide digital photofinishing services to consumers through the Internet (online ordering on those retailers' own websites for in-store pick-up), in-store kiosks and mobile phones.

According to PMA Market Research, the number of digital cameras sold in the U.S. has increased from 400,000 in 1996 to an estimated 25 million in 2007, while the number of traditional cameras sold has decreased from 15.1 million to 1.2 million over that same period. With that trend and the advent of online photo sharing, the number of digital prints has increased from 500,000 in 2000 to an estimated 15.3 million in 2007 with IDC Research predicting that digital print revenues (including prints and specialized gifts) will increase to \$107 billion by the end of the decade from about \$38 billion currently.

We are projecting strong revenue growth and even stronger EBITDA growth as the company's existing retail customers ramp their digital photofinishing revenues (from increased customer awareness and usage) and as the company successfully lands additional retail customers. We are projecting revenue to increase from \$7.5 million in FY07 to \$24.9 million in FY09, while EBITDA should increase from (\$1.2 million) to \$7.6 million over that same period. Given the strong projected revenue and EBITDA ramp, we are comfortable applying an EBITDA multiple of 20-25x on our FY09 estimate — yielding a potential valuation range of \$4.50-5.50.

### Recommendation Highlights

**Growing market opportunity.** According to PMA Marketing Research, the number of digital prints made by consumers has increased to an estimated 15.3 million in 2007 from 500,000 in 2000, while the number of traditional film prints has declined from 29.9 million to 9.0 million. With that, IDC Research predicts that digital print revenues will increase to \$107 billion by the end of the decade from \$38 billion currently.

**Provides fully-integrated solution.** Following the acquisition of Pixology in July, PhotoChannel now provides its retail customers with a fully-integrated digital photofinishing solution, including home (online ordering for in-store pick-up), in-store (kiosks) and mobile (uploading and ordering through mobile phones).

**Strong retail customer base.** PhotoChannel has succeeded in signing agreements with strong retail partners, including CVS/pharmacy (CVS \$41.35, Not Rated), Kmart, Wal-Mart Canada and Costco Canada. Given PhotoChannel's established success in Canada with a number of leading U.S.-based retailers, we would not be surprised if PhotoChannel began pitching these retailers' U.S. location contracts as they come up for bid.

**Potential for significant operating leverage.** As PhotoChannel does not operate any production labs (but only processes the online operations en route to the retailers' own labs), the company has a relatively fixed cost structure, generating gross margins from transaction-based revenues above 90%. Therefore, as the number of digital prints and gifts ramps — through new retail partners and same-store growth — we project PhotoChannel could see operating margins expand from (10.3%) in FY07 to 38.8% in FY09.

**Project ramping profitability estimated to start in FY08.** Following the acquisition of Pixology along with the company's core business just now hitting the breakeven point, we project that PhotoChannel will demonstrate ramping profitability starting in FY08, with EBITDA projected to improve from (\$1.2 million) in FY07 to \$1.3 million in FY08 and \$7.6 million in FY09.

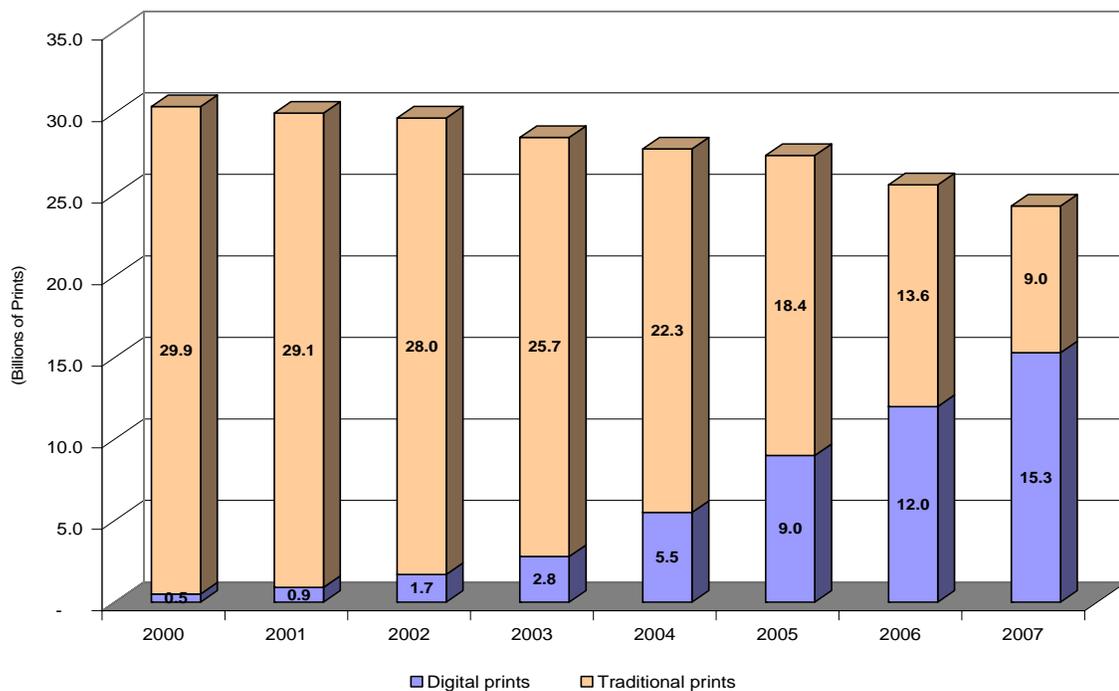
## Remember Buying Rolls of Film? — The Growing Digital Photo Industry

It should not come as a surprise to anyone that the digital photo industry continues to ramp higher at the expense of the traditional roll-based film industry — something made even more apparent by the continued implosion of various Eastman Kodak (EK \$24.95, Not Rated) factory buildings taking place almost nightly on the evening news. According to PMA Marketing Research, the number of digital cameras sold in the U.S. has increased from 400,000 cameras in 1996 to an estimated 25 million cameras in 2007 — while the number of traditional cameras sold has declined from 15.1 million cameras to an estimated 1.2 million cameras, with the number of traditional rolls of film sold annually declining from 744 million rolls to only 121 million rolls. With those trends firmly in place, the traditional film processing and printing industry (i.e., dropping off your 24- and 36-print rolls of film at the local one-hour photo store) has seen revenues plummet since the start of the decade — from \$6.23 billion in 2000 to an estimated \$1.89 billion in 2007.

When the use of digital cameras and the digital photography/photo-sharing market began to take off around 2000, many analysts believed that consumers would be more inclined to save those digital pictures on their computers without ever having any printed. However, while consumers are more than likely only printing a fraction of the total number of digital pictures taken, the digital photo printing market has experienced some remarkable growth over the past few years. In fact, according to PMA Marketing Research, the number of digital prints made by consumers has increased from only 500,000 prints in 2000 to an estimated 15.3 million prints in 2007 (while the number of traditional prints developed has declined from 29.9 million prints to 9.0 million prints over that same period).

An even more impressive statistic is that IDC Research predicts that digital print revenues will increase to \$107 billion by the end of the decade from \$38 billion now.

### Growth in Digital Prints Made by U.S. Consumers

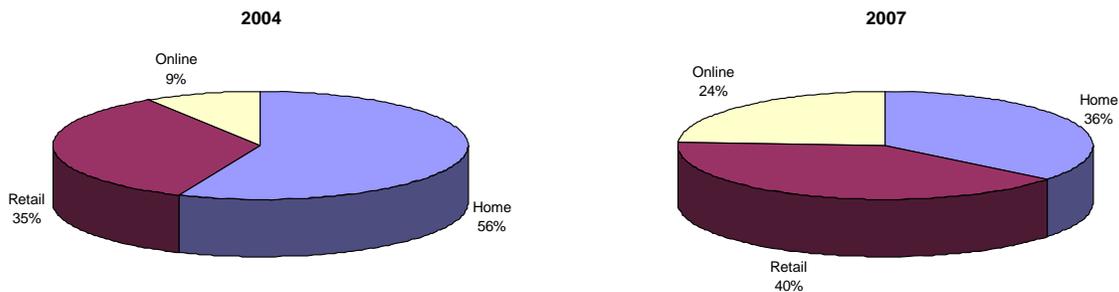


Source: PMA Marketing Research

More important to us, with our initiation of coverage of PhotoChannel, is the trend towards consumers placing an increasing number of digital photo printing orders online (to pick the photos up at a store or have the photos mailed to them) as opposed to printing the pictures themselves at home. Not only does printing digital pictures at home become a higher cost option for consumers (considering the cost of buying the printer, ink and paper), but the quality of the printed digital photos is lower than what can be accomplished (in less time as well) at a retail location. In addition, by using an online site, people are able to easily store their digital photos online for access later or to share with friends and family. Even though the overall number of digital prints made at home continues to increase and is expected to reach 5.5 billion prints this year, home printing's growth rate is expected to slow to only 11% in 2007 (down from a 42% growth rate during 2005) with home printing's share of the market dropping to 36% in 2007 from 56% in 2004.

On the other hand, the number of digital prints ordered by consumers online (including orders to be shipped to consumers and to be picked up at a retail store) is projected to increase to 3.7 billion prints in 2007 — up from 1.2 billion prints in 2005 and a 54% increase from the 2.4 billion prints in 2006. This would give this printing method an estimated 24% market share in 2007, up from only 9% in 2004. Of the 2.4 billion prints ordered online in 2006, an estimated 43% of these prints were picked up by consumers at the store (with the remaining prints delivered by mail).

### Methods Used by Consumers for Making Digital Prints



Source: PMA Marketing Research

Even though it may seem obvious that consumers would probably prefer to have their pictures mailed to them, we actually believe that PhotoChannel's model could prove to be the superior one for three main reasons: 1) a lower cost per print when shipping/ mailing costs are taken into consideration; 2) consumers are able to pick up their pictures in as little as an hour as opposed to waiting days through the mail; and 3) consumers can pick up their pictures at a store (i.e., drug store or supermarket) where they have other shopping to do — helping to consolidate trips.

### PhotoChannel's Business Model

PhotoChannel has developed a system that provides retailers with a seamless way to integrate their in-store photofinishing operations with their existing customer-facing websites. Through the retailers' own branded websites, consumers are able to upload and store their digital photos — and then use the website to order prints as well as special gift items made from those digital photos (e.g., calendars, coffee mugs, t-shirts, etc.).

## CVS/pharmacy Digital Photo Website Using PhotoChannel

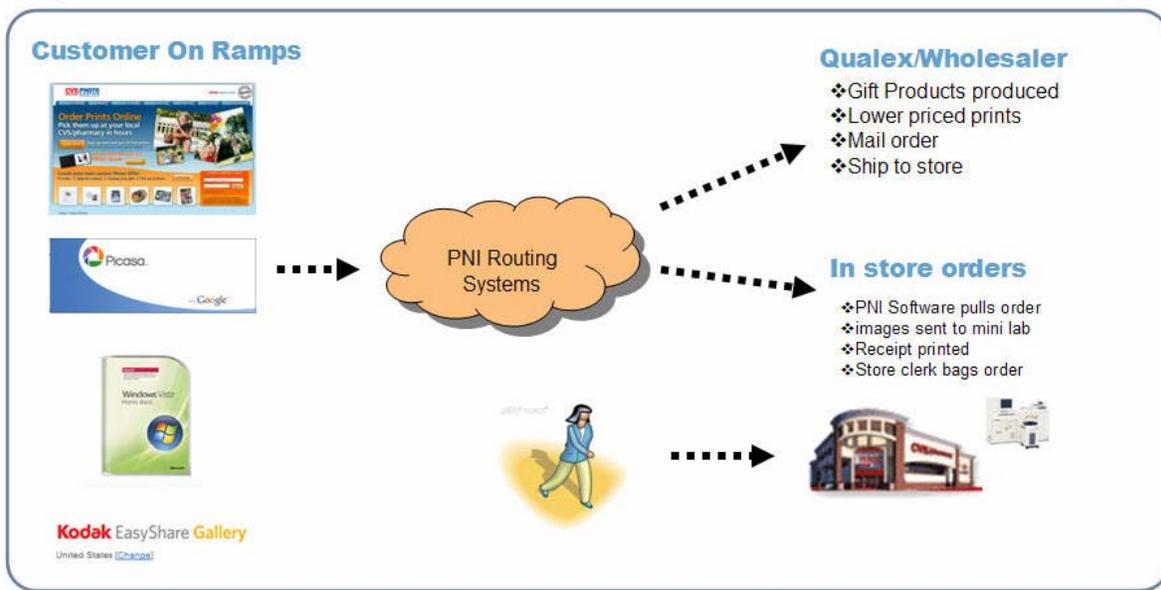
The screenshot displays the CVS/pharmacy Digital Photo Center website. At the top, the CVS pharmacy logo and 'PHOTO CENTER' are visible, along with a 'Kodak digital prints' logo and a '100% Money Back Guarantee' seal. A navigation menu includes links for 'MY PHOTO CENTER', 'ORDER PRINTS', 'ORDER GIFTS & MORE', 'ORGANIZE PHOTOS', 'SHARE PHOTOS', 'ORDER STATUS', and 'PRODUCTS & PRICING'. The main banner features the text 'Order Prints Online' and 'Pick them up at your local CVS/pharmacy in hours', with a 'START NOW' button and a price of 'Digital prints for 19¢ each'. Below this, there are three promotional tiles: 'Enlargement Sale!' for 5x7 and 8x10 prints, 'Gifts and Greeting Cards for Every Occasion!', and a sign-in section for existing members. The footer contains links for 'Privacy', 'Terms of Service', and 'CVS/pharmacy'.

Source: Company website

Once a customer orders his digital prints, he is then able to select the specific retailer location where he would like to pick up his prints — usually in as little as an hour and most likely a nearby location where he already makes other purchases. This is probably the same place he used to drop off his traditional film for development. And instead of having to use a separate online site (e.g., Snapfish or KODAK Gallery), the customer is able to complete his digital print order at the same time he is completing his other online shopping through that same retailer. Or, if he is not shopping online but planning on doing his shopping at that retailer, he can pick up the digital prints the next time he visits that store.

Further, the ordering process through PhotoChannel is not only seamless to the customer, but also simple for the retailer to handle and process. First, the customer uploads his digital photos to the retailer/PhotoChannel website and places his print order. PhotoChannel then routes the online order to that retail location chosen by the customer and that store's own photo mini-lab (typically already in place from the older days of film-based photofinishing) processes the order — and it is then ready for the customer to pick up. Through PhotoChannel's preferred partner agreement with Qualex (a wholly-owned subsidiary of Eastman Kodak), the company is also able to provide services for those retail locations without their own photo mini-lab. In those cases, the customer's online order is routed to Qualex, which then prints the digital images and physically ships the prints to the store for pick-up by the customer (obviously, in these cases, the prints would not be ready for pick up in an hour).

PhotoChannel's Order Flow



Source: PhotoChannel Networks

Besides installation, membership, archiving and professional revenues, we estimate that the predominant proportion of PhotoChannel's revenue going forward will be generated through a variable transaction-based model. We project that transaction-based revenues will increase from 41% of total revenue in FY06 to 73% of total revenue by FY09. For transaction-based revenues, PhotoChannel receives a fixed fee per print from its retail customers — which is about \$0.02 for an average 4x6" digital print. In addition, the company receives a percentage of the retail price for any specialized gift item (e.g., calendar, mug, etc.), which we believe ends up being around 10% of the retail purchase price. Specialized gift items are a growing part of the digital print industry as consumers have realized the many creative ways they can use their digital photos. In fact, Shutterfly (SFLY \$32.11, Not Rated) has continued to see a significant ramp in specialized gift revenues, growing from 28% of total revenue in 2003 to 45% in the most recently reported quarter.

The good news is that PhotoChannel's cost structure is relatively fixed as the company does not operate its own photofinishing lab or process the actual print orders — PhotoChannel only provides the technology and the seamless infrastructure for its retail partners' digital photofinishing services. Therefore, PhotoChannel benefits significantly on increasing digital print and specialized gift revenues through its retail customers — with the higher price point specialized gift items driving higher revenues and margins. We estimate PhotoChannel's gross margins on transaction-based revenues to be greater than 90%.

### Competitive Industry — But PhotoChannel is Poised to Take Additional Share, In Our View

Aside from the home printing market (which has been experiencing a continual erosion in market share), there are a number of competitors that offer consumers the ability to order/print digital pictures online to receive them in the mail as well as competitors that also run the software (similar to PhotoChannel's) where consumers can order through a retailers' website to pick pictures up at the store.

There are three main online competitors providing consumers with the ability to receive their digital prints through the mail.

- **KODAK Gallery (Ofoto)** — Ofoto was launched in December 1999 and became a wholly-owned subsidiary of Eastman Kodak in June 2001 — and later changed its name to KODAK Gallery in March 2005. According to the company, KODAK Gallery has approximately 60 million members. KODAK Gallery also offers its members the option of same-day digital print pick-up at CVS/pharmacy locations nationwide — which is offered through the company's relationship with PhotoChannel.
- **Shutterfly** — Shutterfly completed its IPO in September 2006, currently has a market capitalization of approximately \$828 million and analysts estimate the company will generate \$180 million in revenue in 2007 and \$243 million in 2008. In the most recent quarter, Shutterfly had 844,000 transacting customers and completed 1.7 million orders with an average order size of \$19.63. Since the company's inception, Shutterfly has fulfilled more than 19.0 million orders, sold 610 million prints and stored about 1.5 billion digital photos.
- **Snapfish** — Snapfish was launched in April 2000 and acquired by Hewlett-Packard (HPQ \$52.54, Not Rated) in May 2005 for a reported \$180 million. According to the company, Snapfish has more than 40 million members (up from 14 million members at the time of the company's acquisition) and more than 2 billion unique digital photos stored online. Similar to PhotoChannel, Snapfish also currently powers the online services for a number of retailers, including Wal-Mart (WMT \$44.03, Not Rated), Walgreens (WAG \$38.68, Not Rated), and Costco (COST \$65.92, Not Rated).

In our opinion, each of these three online websites essentially offers the same services — printing digital photos, mailing them out relatively quickly and creating personalized digital photo gifts (e.g., calendars, coffee mugs, t-shirts, etc.). With that in mind, we believe the only real way for each of these websites to differentiate themselves is through pricing (both from each other and from the in-store pick up services offered by PhotoChannel). As we demonstrate in the table below, the per-print prices offered by the online sites can look appealing on their own as compared to the prices for PhotoChannel. However, this is before shipping charges are considered, which makes the comparison more realistic.

#### Total Cost Comparison of PhotoChannel vs. Online Competitors

Online Digital Printing Services	Price Per Print	Cost for 50 Prints	Shipping Charges	Total Cost of Order
Snapfish	\$ 0.12	\$ 6.00	\$ 3.44	\$ 9.44
KODAK Gallery (Ofoto)	\$ 0.15	\$ 7.50	\$ 3.35	\$ 10.85
Shutterfly	\$ 0.19	\$ 9.50	\$ 2.99	\$ 12.49
PhotoChannel's Retail Partners	Price Per Print	Cost for 50 Prints	Shipping Charges	Total Cost of Order
Eckerd's/Rite-Aid	\$ 0.15	\$ 7.50	\$ 0.00	\$ 7.50
CVS/pharmacy	\$ 0.15	\$ 7.50	\$ 0.00	\$ 7.50
K-Mart	\$ 0.19	\$ 9.50	\$ 0.00	\$ 9.50

Sources: Company websites

In addition, both KODAK Gallery and Shutterfly offer consumers the choice of picking up their digital prints at a Target (TGT \$57.91, Not Rated) location — charging \$10.00 for a 50-print order, which is slightly less than the cost of receiving the prints through the mail, but still more expensive than PhotoChannel's option.

We believe PhotoChannel's services offer consumers a number of advantages over the online competitors, including: 1) typically lower pricing for digital prints once other online websites' shipping charges are included; 2) the ability to pick up your digital prints in as little as one hour (as opposed to approximately 2-4 days for the online websites); 3) being able to kill two birds with one stone by picking up the digital prints at a retail location where the consumer can complete regular shopping chores simultaneously; and 4) driving and retaining traffic at the retail partner's website as the digital photo order is completed on (for example) CVS' existing website and not another third-party's website. However, even if the pricing from one of PhotoChannel's retail partners ends up being the same (or maybe even slightly higher) than what is offered through one of the competing online services, we believe consumers will find the convenience of being able to pick up the prints that same day along with their regular day-to-day shopping to be worth it. In addition, because PhotoChannel controls the back-end engine of each of the retail partner's online digital print center, the PhotoChannel offering blends into the retailer's website through that retailer's own branding.

**Strong Customer Base — With Numerous Opportunities Looming**

Over the past 2-3 years, PhotoChannel has scored a number of significant retail partner wins — helping to improve the company's revenue and move towards profitability, but also, and more importantly in our opinion, to solidify the company's position in the eyes of those retail partners that it has yet to win. PhotoChannel's services are currently offered in more than 13,000 retail locations throughout the U.S., Canada and the U.K. — with about 6,500 of these locations currently offering one-hour pick up service.

**Current Announced PhotoChannel Retail Customers**

United States	Canada	United Kingdom
CVS/pharmacy (6,200 locations)	Wal-Mart (278 locations)	ASDA (Wal-Mart) (340 locations)
Kmart (1,388 locations)	Costco (68 locations)	Tesco (1,988 locations)
Eckerd Drugs (1,516 locations)	Loblaw (1,000 locations)	Boots (2,550 locations)
	Shoppers Drug Mart (1,000 locations)	
	Black's (110 locations)	

Sources: PhotoChannel Networks and Company reports

With online digital printing relatively still in its infancy, many of the company's retail customers have only seen a small percentage of their overall digital photofinishing revenues (and an even smaller percentage of their total photofinishing revenues) move online. We believe this should continue to provide PhotoChannel with strong growth opportunities within its existing customer base as those retailers continue to market to their customer bases about the benefits of ordering their digital prints online as opposed to doing so within the store itself. As an example, we understand that although CVS/pharmacy (currently PhotoChannel's largest customer) generates about 50-60% of its photofinishing revenues from digital prints, only 4% of those

digital revenues are generated online. We also understand that Wal-Mart Canada and Costco Canada are generating only about 10-12% of their digital photofinishing revenues online as well.

In addition, given PhotoChannel's established success in Canada with a number of leading U.S.-based retailers (notably, Wal-Mart and Costco), we would not be surprised if PhotoChannel began pitching (and hopefully winning) these retailers' U.S. location contracts as they come up for bid. We believe that PhotoChannel offers a number of distinct competitive advantages to potential retailers, including: 1) offering a full suite of ordering solutions for customers with online, in-store and mobile options; and 2) offering a strong technology infrastructure that was built and scalable specifically for this ordering process (as opposed to competing systems that have been adapted to this model). In our opinion, the most promising U.S. retailers that could come into play within the next 6-18 months are:

- **Costco (U.S.)** — Costco is currently a retail customer of Snapfish (Hewlett-Packard). There are 385 Costco locations in the U.S. using Snapfish's online ordering system. We understand this contract has already been placed up for bid recently. If PhotoChannel were to gain Costco as a retail customer, we estimate it would have the potential to generate annual transactional revenues of between \$8-10 million immediately upon integration.
- **Wal-Mart (U.S.)** — Wal-Mart is currently a retail customer of Snapfish (Hewlett-Packard) per a contract signed in 2005. There are about 3,300 Wal-Mart locations in the U.S. If PhotoChannel were to gain Wal-Mart as a retail customer, we estimate it would have the potential to generate annual transactional revenues of between \$12-15 million immediately upon integration.
- **Sam's Club** — Sam's Club is currently a retail customer of Snapfish (Hewlett-Packard) per a contract signed in 2005. There are 584 Sam's Club locations in the U.S. using Fuji's online ordering system. We understand this contract has already been placed up for bid recently. If PhotoChannel were to gain Sam's Club as a retail customer, we estimate it would have the potential to generate annual transactional revenues of between \$2-3 million immediately upon integration.

With each of these three potential customers, we believe the integration to PhotoChannel's network could be accomplished relatively easily given that they are already up and running on another online ordering network. More importantly, we estimate that these transactional revenues would likely flow through PhotoChannel with gross margins of at least 90% with relatively little, if any, additional overhead costs needed once they are integrated.

In addition, we believe the company's strong relationship with Eastman Kodak could potentially open up a number of additional opportunities for growth in the coming years — as Kodak is continuously searching for ways to build up its online/digital photo presence given the continued decline in film-based photography that had been the foundation of the company's business model. With the recent acquisition of Pixology, we believe PhotoChannel will look to take advantage of the company's kiosk technology — possibly as a focus for the upcoming 2008 Olympics in Beijing. Think of the possibility of digital photo kiosks at the Olympics where people could upload their photos during the day and have the prints delivered by Kodak to their hotel rooms that day or sent electronically to all of their friends. In addition, given the strong relationship formed between Kodak and PhotoChannel, we would not be surprised if Kodak eventually acquired PhotoChannel to gain access to the company's digital technology (similar to the acquisition of Snapfish by Hewlett-Packard).

## Acquisition of Pixology

On July 3, 2007, PhotoChannel announced the completion of its previously-announced acquisition of Pixology (originally announced on April 25, 2007). Pixology is one of the leading companies in the U.K. and European digital photography markets and has also developed strong complementary in-store photo kiosk technologies. Although this acquisition only just closed in July (and Pixology's results will be integrated for the first time in 4Q07 results), we believe there are numerous benefits to PhotoChannel upon the company's full integration, including:

- **Drives penetration into new territories** — With PhotoChannel being based in Canada and operating predominantly in North America (with plans to expand into Latin America, Asia and Australia) and Pixology being based in the U.K. and operating predominately in the U.K. and U.S., the integration of the two should provide for: 1) the push of each other's operations into new territories served by the other company; and 2) a more successful push into Europe from Pixology's offices in the U.K.
- **Provides complete product offering to retailers** — We believe the combination of PhotoChannel's scalable online platform and Pixology's in-store kiosks will allow PhotoChannel to provide its retailers with an integrated product offering enabling customers to complete their digital image printing orders at home (on-line), in-store (kiosks) and by mobile product. In addition, with PhotoChannel's long-term plans to penetrate additional market segments (e.g., music, games and mobile content), we believe having an integrated kiosk offering will help bring that to reality sooner.

Pixology was acquired for \$17.65 million in cash, which is about 2.1x our estimate for Pixology's FY08 revenue of about \$8.2 million. However, at the time of the acquisition's closing, Pixology had about \$8.1 million of cash on the balance sheet, leading to a net acquisition price of about \$9.6 million — or only about 1.2x our FY08 revenue estimate.

### Pixology's In-Store Digital Photo Kiosk



Source: PhotoChannel Networks

## Using the Existing Infrastructure to Tackle New Product Lines

With PhotoChannel having high-speed access into each of its retail customers and those retail customers each having their own in-store processing mini-labs, we believe PhotoChannel management will look to better utilize the existing infrastructure to introduce additional product lines into those stores — generating incremental high-margin revenue streams for the company.

- **Music** — PhotoChannel's digital media platform lets consumers choose from licensed music tracks to either download directly to their computer or use to create their own customized CD. Should a consumer choose to create a customized CD, the order can be sent to his local retailer to be picked up in as little as an hour — printed with professional looking jewel case jackets with the song titles/artists.
- **Games** — PhotoChannel's digital media platform lets consumers purchase the top PC and downloadable Internet games and have them produced onto CDs or DVDs at their local retail location in as little as an hour for pick-up (including jewel case inserts, jewel case covers, instructions and disc image). Given the margins charged by video game retailers to cover their overhead costs, we believe this could provide a less expensive way for consumers to purchase games — and pick them up where they complete their usual shopping and pick up their digital prints.
- **Mobility** — PhotoChannel's digital media platform lets the company's retail customers offer ring tones and other mobile content directly to their own customers (as opposed to those customers only being able to access these services from their own mobile carrier). We believe this could provide another revenue stream for the retailers as some consumers may prefer to purchase mobile content along with their other purchases from that retailer instead of making a separate visit to the mobile carriers' site.

## Investment Risks

**Competitive landscape.** The digital photofinishing market has become increasingly competitive, with many of PhotoChannel's competitors having much more financial resources to use to both pitch for new retail customers as well as to retain their existing retail customers. In our view, the main competitors to monitor in this regard are Snapfish (backed by the strength of Hewlett-Packard), Shutterfly (\$95 million in cash as of the last quarter), and KODAK Gallery. We would be especially concerned with Snapfish given their hold on a number of the larger retail accounts in the industry and our belief that management may be willing to overspend to retain those accounts.

**Concentrated customer base.** PhotoChannel's revenues are generated by a small number of retail customers with CVS/pharmacy and Wal-Mart Canada generating an estimated 50% of results in the most recent quarter (this would drop to about 20% following the acquisition of Pixology, which was not consolidated during that quarter). Even though we expect the company to successfully diversify its customer base in the coming quarters, the loss of any one of these major customers could have a negative impact on the company's overall results (especially given the significant positive/negative operating leverage in the company's business model).

## Key Management Profiles

According to information from the company:

**Peter Fitzgerald (Chairman & CEO)** — Peter Fitzgerald joined the PhotoChannel Board of Directors in August 2001 and became Chairman in 2004. Mr. Fitzgerald took control as the President & CEO of PhotoChannel in March 2005. Prior to PhotoChannel, he was CEO of Gretag Imaging where he built the company into one of the world's leading manufacturers of imaging equipment and systems before leaving to pursue personal interests. Previous to Gretag, Mr. Fitzgerald was CEO of Qualex, the Kodak photo-processing subsidiary, which he led for over seven years. While he was CEO of Qualex, Mr. Fitzgerald retained his active role as Vice President within Eastman Kodak where, among other titles, he carried the role of General Manager, Worldwide Consumer Imaging Services. Mr. Fitzgerald has a Masters degree of Science in Business Administration at Massachusetts Institute of Technology, is a Graduate of the PMD Program at Harvard Business School, and is a Fellow of the Charter Association of Certified Accountants.

**Aaron Rallo (CTO)** — Aaron Rallo joined PhotoChannel in November 2004 as Chief Technology Officer and Vice President of Product Development. With his proven technical record and in-depth experience in the imaging market, Mr. Rallo leads the PNI development team as the company fulfills its strategy of deploying solutions for retailers and wireless carriers. Most recently, Mr. Rallo worked at Microsoft Corporation within the Windows Printing and Imaging team. Prior to Microsoft, he spent eight years at Fujifilm eSystems (formerly AGT) as Vice President of Web Development and Network Operations. Mr. Rallo received his BS, Computer Science from the Rochester Institute of Technology.

**Robert Chisholm (CFO)** — Robert Chisholm joined PhotoChannel in 2001 and is responsible for managing the company's finances, public market listings, investor relations and overseeing contract negotiations. Mr. Chisholm brings over 20 years of experience in finance and administration. Prior to PhotoChannel, he was Chief Financial Officer for SCS Solars Computing Systems, a publicly traded Vancouver based software developer and electronic integrator for wholesale travel suppliers. Mr. Chisholm holds a professional accounting designation from the Certified Management Accountants of Canada and received his BBA with a major in accounting from Saint Francis Xavier University in Nova Scotia.

## Estimates and Valuation — Leveraging a Fixed Cost Model

Over the coming years, we believe that the most important driver to PhotoChannel's improving profitability is the company's fixed cost model, where an estimated 90%+ of the incremental transaction-based revenues flow straight to pre-tax income. Knowing that — combined with our belief that PhotoChannel will be successful in landing additional customers in the quarters to come — is behind our projection that PhotoChannel's operating margin will increase from (22.6%) in FY07 to 28.1% in FY09.

**FY07.** With FY07 behind the company (ended September 2007), but not yet reported, we are not expecting anything too different from the trends seen through 3Q with the addition of Pixology's results. We are estimating FY07 revenue of \$7.5 million — representing an increase of 85% over FY06 levels. We project improving profitability trends in 4Q (with the greater level of transaction revenues), but still estimate negative EBITDA for the full year of (\$1.2 million) and a loss per share of (\$0.09). As a note, 4Q07 revenues will show a significant increase compared to previous quarters as this is the first quarter including the results from the Pixology acquisition.

**FY08.** In FY08, we believe PhotoChannel should not only experience continued transaction ramps with the company's existing retail customer base, but should gain new retail customers throughout the year as well as see the full-year benefit of including Pixology's results. With that, we are estimating FY08 revenue of \$16.7 million — representing an increase of 121% over FY07 levels. We estimate that PhotoChannel will turn both EBITDA and EPS positive in 1Q08. We are projecting full year EBITDA of \$1.3 million along with EPS of \$0.03.

**FY09.** In FY09, we also believe PhotoChannel should not only experience continued transaction ramps with the company's existing retail customer base, but should also gain new retail customers throughout the year. With that, we are estimating FY09 revenue of \$24.9 million — representing an increase of 50% over FY08 levels. We estimate that PhotoChannel will experience continued increases in EBITDA and profitability as high-margin transaction revenues continue to move higher. We are projecting full year EBITDA of \$7.6 million along with EPS of \$0.19.

We are projecting revenue growth of 121% in FY08 and 50% in FY09. The FY09 revenue growth estimate is organic as both FY08 and FY09 will have full years of Pixology results included. We are projecting EBITDA and EPS growth of roughly 500% in FY09 as the growth is coming from a small base (the company is projected to turn both EBITDA and EPS positive during FY08). These strong growth rates are driven by continued growth with PhotoChannel's current retail customer base (as more of each retailer's photo processing business moves online) as well as the likely addition of new retail customers to the company's roster. With the projected imminent move into profitability and expected accelerated profitability ramp from that point forward given the company's leveragable operating model, we are comfortable using a EV-to-EBITDA multiple of 20-25x on our FY09 EBITDA estimate of \$7.6 million. This yields a potential valuation range of \$4.50-5.50 — representing upside potential of 20-45% from current levels.

We are initiating coverage of PhotoChannel Networks, Inc. (PNWIF) with a Buy rating.

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PhotoChannel Networks, Inc.

Consolidated Statements of Loss and Deficit  
(\$CAD in thousands except per share amounts)

Fiscal Year: September	2006			2007E			2008E			Fiscal Year				
	Q1 Dec	Q2 Mar	Q3 Jun	Q4 Sep	Q1A Dec	Q2A Mar	Q3A Jun	Q4E Sep	2004	2005	2006	2007E	2008E	2009E
Transaction commission fees	\$ 234	\$ 310	\$ 483	\$ 661	\$ 1,044	\$ 718	\$ 809	\$ 1,874	\$ 961	\$ 708	\$ 1,697	\$ 4,445	\$ 10,003	\$ 19,257
Installation fees	79	291	477	397	143	280	452	991	189	676	1,240	1,595	4,047	4,197
Membership fees	159	170	197	226	232	235	199	189	97	519	751	866	843	917
Archives fees	30	30	30	21	15	15	15	15	57	108	112	80	60	60
Professional fees	41	30	128	86	87	70	97	343	60	105	282	597	1,420	1,488
<b>Total revenues</b>	<b>543</b>	<b>831</b>	<b>1,311</b>	<b>1,391</b>	<b>1,521</b>	<b>1,318</b>	<b>1,273</b>	<b>3,422</b>	<b>763</b>	<b>2,117</b>	<b>4,075</b>	<b>7,534</b>	<b>16,673</b>	<b>24,919</b>
Network delivery expenses	205	411	617	567	330	442	307	1,182	327	899	1,801	2,241	4,990	5,726
Gross profit	338	420	693	823	1,191	876	966	2,240	436	1,218	2,274	5,293	11,742	19,193
Operating expenses:														
Research and development	396	579	760	586	595	730	700	1,332	1,279	1,622	2,300	3,356	5,738	6,458
General and administrative	322	378	524	248	390	547	447	975	1,421	1,765	1,473	2,369	3,555	3,904
Sales and marketing	156	197	347	39	150	218	151	273	642	696	738	793	1,149	1,243
Amortization	77	79	107	140	110	123	128	131	171	304	403	492	551	596
Total expenses	951	1,233	1,738	992	1,245	1,618	1,425	2,711	3,514	4,386	4,913	7,000	10,992	12,201
Operating income (loss)	(613)	(813)	(1,045)	(169)	(54)	(742)	(459)	(451)	(3,076)	(3,169)	(2,639)	(1,706)	750	6,992
Interest and other income (expense), net	(639)	(24)	(939)	(29)	56	(619)	(331)	(309)	(2,907)	(2,864)	(2,237)	(1,214)	1,301	7,589
Foreign exchange (loss) gain	(4)	12	8	17	(1)	26	189	150	7	34	364	400	400	475
Income (loss) before taxes	(615)	(806)	(1,026)	(185)	18	(1)	(1,369)	-	19	13	(27)	(1,353)	-	-
Income tax expense (benefit)	(615)	(806)	(1,026)	(185)	(37)	(718)	(1,640)	(301)	(3,052)	(3,148)	(2,632)	(2,695)	1,150	7,467
Net income (loss)	(615)	(806)	(1,026)	(185)	(37)	(718)	(1,640)	(301)	(3,052)	(3,148)	(2,632)	(2,695)	1,150	7,467
Diluted EPS	(\$0.03)	(\$0.04)	(\$0.04)	(\$0.01)	(\$0.00)	(\$0.03)	(\$0.05)	(\$0.01)	(\$0.21)	(\$0.18)	(\$0.12)	(\$0.09)	\$0.03	\$0.19
Shares outstanding (000)	18,765	19,810	22,988	24,149	24,149	25,415	32,404	33,316	14,874	17,868	22,805	28,821	39,775	39,775
Percent of revenues	37.8%	49.5%	47.1%	40.8%	21.7%	39.5%	24.1%	34.0%	42.9%	42.5%	44.2%	29.7%	29.6%	23.0%
Network delivery expenses	62.2%	50.5%	52.9%	59.2%	78.3%	66.5%	75.9%	66.0%	57.1%	57.6%	55.8%	70.3%	70.4%	77.0%
Operating expenses:														
Research and development	72.9%	69.6%	58.0%	40.7%	39.1%	55.4%	55.0%	38.9%	167.6%	76.6%	56.4%	44.5%	34.4%	25.9%
General and administrative	59.4%	45.5%	40.0%	17.8%	25.7%	41.5%	35.1%	28.5%	186.3%	83.4%	36.1%	31.3%	21.3%	15.7%
Sales and marketing	28.7%	23.6%	26.5%	2.8%	9.9%	16.6%	11.8%	8.0%	84.1%	32.9%	18.1%	10.5%	6.9%	5.0%
Amortization	14.2%	9.5%	8.1%	10.0%	7.2%	9.3%	10.1%	3.8%	22.5%	14.4%	9.9%	6.5%	3.3%	2.4%
Total expenses	175.2%	148.3%	132.6%	71.3%	81.9%	122.8%	112.0%	79.2%	460.5%	207.2%	120.6%	92.9%	65.9%	49.0%
Operating income (loss)	-113.0%	-97.8%	-79.7%	-12.1%	-3.6%	-56.3%	-36.1%	-13.2%	-403.4%	-149.7%	-64.8%	-22.6%	4.5%	28.1%
EBITDA	-93.7%	-83.3%	-71.6%	-2.1%	3.7%	-47.0%	-26.0%	-9.3%	-380.9%	-135.3%	-54.9%	-16.1%	7.8%	30.5%
Interest and other income (expense), net	-0.6%	1.5%	0.6%	1.2%	0.0%	2.0%	14.8%	4.4%	0.9%	0.3%	0.8%	4.8%	2.4%	1.9%
Foreign exchange (loss) gain	0.2%	-0.6%	0.8%	-2.4%	1.2%	-0.1%	-107.6%	0.0%	2.5%	0.6%	-0.7%	-18.0%	0.0%	0.0%
Income (loss) before taxes	-113.4%	-97.0%	-78.3%	-13.3%	-2.4%	-54.4%	-128.8%	-8.8%	-400.0%	-148.7%	-64.6%	-35.8%	6.9%	30.0%
Income tax expense (benefit)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net income (loss)	-113.4%	-97.0%	-78.3%	-13.3%	-2.4%	-54.4%	-128.8%	-8.8%	-400.0%	-148.7%	-64.6%	-35.8%	6.9%	30.0%
Year-over-year growth														
Total revenues	23.2%	49.8%	132.0%	150.0%	180.3%	58.6%	-2.9%	146.1%	198.6%	177.3%	92.5%	84.9%	121.3%	49.5%
EBITDA	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	483.2%
Diluted EPS	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	N/M	549.2%

11/01/07

Source: Company reports and Merriman Curhan Ford & Co. estimates

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PhotoChannel Networks, Inc. (PNWIF)

Buy

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PhotoChannel Networks, Inc.

Balance Sheets

(\$CAD in 000s, except per share figures)

	2005	2006				2007				2008				2009
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
<b>Assets</b>														
Current assets:														
Cash and cash equivalents	187	2,022	3,304	20,703	19,585	9,839	9,839	9,565	9,588	9,671	10,112	10,112	16,215	
Cash held in trust	0	0	0	0	54	54	54	54	54	54	54	54	54	
Accounts receivable	418	1,312	1,021	755	1,158	2,738	2,738	3,018	3,069	3,484	3,766	3,766	5,310	
Inventory	71	80	85	76	82	205	205	226	230	261	282	282	398	
Prepaid expenses	62	76	313	147	263	374	374	370	377	380	401	401	448	
Total current assets	738	3,490	4,724	21,681	21,141	13,210	13,210	13,233	13,319	13,880	14,615	14,615	22,426	
Capital assets	870	1,236	1,566	1,613	1,611	3,430	3,430	3,446	3,460	3,495	3,529	3,529	3,782	
Goodwill	0	0	0	0	0	7,750	7,750	7,750	7,750	7,750	7,750	7,750	7,750	
Deferred charges	0	157	140	379	816	816	816	816	816	816	816	816	816	
<b>TOTAL ASSETS</b>	<b>1,608</b>	<b>4,883</b>	<b>6,430</b>	<b>23,673</b>	<b>23,568</b>	<b>25,206</b>	<b>25,206</b>	<b>25,245</b>	<b>25,344</b>	<b>25,921</b>	<b>26,710</b>	<b>26,710</b>	<b>34,775</b>	
<b>Liabilities and Stockholders' Equity</b>														
Current liabilities:														
Accounts payable and accrued liabilities	1,138	1,222	1,194	2,443	1,440	3,181	3,181	3,142	3,207	3,312	3,406	3,406	3,810	
Deferred revenue	188	180	164	182	144	342	342	377	384	436	471	471	664	
Total current liabilities	1,326	1,402	1,358	2,626	1,584	3,523	3,523	3,519	3,590	3,747	3,877	3,877	4,474	
Deferred revenue	0	47	37	22	47	47	47	47	47	47	47	47	47	
Total liabilities	1,326	1,449	1,395	2,648	1,631	3,571	3,571	3,567	3,638	3,795	3,924	3,924	4,521	
Capital stock	43,625	49,116	50,809	62,314	65,388	65,388	65,388	65,388	65,388	65,388	65,388	65,388	65,388	
Contributed surplus	9,303	9,959	10,078	10,279	9,909	9,909	9,909	9,909	9,909	9,909	9,909	9,909	9,909	
Warrants	699	338	163	5,165	5,011	5,011	5,011	5,011	5,011	5,011	5,011	5,011	5,011	
Deficit	(53,346)	(55,978)	(56,015)	(56,733)	(58,372)	(58,673)	(58,630)	(58,630)	(58,602)	(58,182)	(57,523)	(57,523)	(60,055)	
Total stockholders' equity	282	3,435	5,035	21,026	21,936	21,636	21,679	21,679	21,707	22,127	22,786	22,786	30,253	
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 1,608</b>	<b>\$ 4,883</b>	<b>\$ 6,430</b>	<b>\$ 23,673</b>	<b>\$ 23,568</b>	<b>\$ 25,206</b>	<b>\$ 25,206</b>	<b>\$ 25,245</b>	<b>\$ 25,344</b>	<b>\$ 25,921</b>	<b>\$ 26,710</b>	<b>\$ 26,710</b>	<b>\$ 34,775</b>	

11/01/07

Source: Company reports and Merriman Curhan Ford & Co. estimates

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PhotoChannel Networks, Inc. (PNWIF)

Buy

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**PhotoChannel Networks, Inc.**  
Consolidated Statements of Cash Flows  
(\$CAD in 000s, except per share figures)

	2007 Quarterly Detail				2008 Quarterly Detail				2009				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4					
<b>Cash flows from operating activities:</b>													
Net (loss) gain for the period	\$ (3,148)	\$ (2,632)	\$ (37)	\$ (718)	\$ (1,640)	\$ (301)	\$ (2,695)	\$ 43	\$ 28	\$ 420	\$ 659	\$ 1,150	\$ 7,467
Depreciation and amortization	304	403	110	123	128	131	492	134	136	139	142	551	596
Stock-based compensation expense	124	215	119	201	168	0	489	0	0	0	0	0	0
Foreign exchange loss	0	0	0	0	1,371	0	1,371	0	0	0	0	0	0
Loss (gain) on disposal of property, plant and equipment	(7)	3	0	0	0	0	0	0	0	0	0	0	0
Net change in non-cash working capital items	(97)	(894)	0	0	0	(1,580)	(1,580)	(281)	(51)	(415)	(282)	(1,028)	(1,544)
Accounts receivable	(115)	(23)	0	0	0	(1,23)	(123)	(21)	(4)	(31)	(21)	(77)	(116)
Prepaid expenses	0	(157)	0	0	0	(11)	(112)	5	(8)	(12)	(11)	(26)	(46)
Deferred charges	562	84	12	1,455	(1,485)	1,741	1,724	(39)	65	105	94	225	404
Accounts payable and accrued liabilities	12	39	0	0	0	198	198	35	6	52	35	129	193
Deferred revenue	(2,383)	(2,954)	204	1,062	(1,457)	(45)	(236)	(124)	173	258	616	923	6,953
<b>Net cash provided by operating activities</b>													
<b>Cash flows from investing activities:</b>													
Cash held in trust	0	0	0	(17,457)	17,403	0	(54)	0	0	0	0	0	0
Deferred charges	0	0	0	0	(477)	0	(477)	0	0	0	0	0	0
Acquisition of Pixology	0	0	0	0	0	(9,550)	(9,550)	0	0	0	0	0	0
(Purchase) disposal of property, plant and equipment	(517)	(772)	(440)	(170)	(126)	(150)	(886)	(150)	(150)	(175)	(175)	(650)	(850)
<b>Net cash provided by investing activities</b>													
<b>Cash flows from financing activities:</b>													
Issuance of common shares and warrants - net proceeds	1,849	4,074	0	16,186	0	0	16,186	0	0	0	0	0	0
Issuance of common shares on exercise of warrants and options	245	1,496	1,517	322	2,383	0	4,222	0	0	0	0	0	0
Repayment of loans receivable	18	0	0	0	0	0	0	0	0	0	0	0	0
<b>Net cash provided by financing activities</b>													
Effect of foreign exchange on cash and cash equivalents	0	0	0	0	(1,387)	0	(1,387)	0	0	0	0	0	0
Net increase (decrease) in cash and cash equivalents	(769)	1,835	1,282	(58)	16,338	(9,745)	7,817	(274)	23	83	441	273	6,103
Cash and cash equivalents at beginning of period	956	187	2,022	3,304	3,246	19,585	2,022	9,839	9,585	9,588	9,671	9,839	10,112
<b>Cash and cash equivalents at end of period</b>													
	\$ 187	\$ 2,022	\$ 3,304	\$ 3,246	\$ 19,585	\$ 9,839	\$ 9,839	\$ 9,565	\$ 9,588	\$ 9,671	\$ 10,112	\$ 10,112	\$ 16,215

11/01/07

Source: Company reports and Merriman Curhan Ford & Co. estimates

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- MCF & Co. makes a market in PNWIF and as such buys and sells from customers on a principal basis.
- Eric Wold owns 15,000 PNWIF shares.
- MCF & Co. and/or its officers, principals employees, or owners own options, rights, or warrants to purchase PNWIF.
- No MCF & Co. employee serves on the board of directors of PhotoChannel Networks Inc.
- Neither Eric Wold nor a member of his household serves on the board of directors of PhotoChannel Networks Inc.
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Rating	Percent of Universe	No. of Stocks	Description	Percent of companies under research coverage from which MCF & Co. received compensation for investment banking services provided in the previous 12 months or expects to receive or intends to seek in the next three months
Buy	70%	129	MCF & Co. expects the stock price to appreciate 10% or more over the next 12 months. Initiate or increase position.	13%
Neutral	27%	49	MCF & Co believes the stock price is fairly valued at current levels. Maintain position or take no action.	2%
Sell	3%	6	MCF & Co. expects the stock price to depreciate over the next 12 months. Sell or decrease position.	0%

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