

EQUITY RESEARCH REPORT



MidNet, Inc.
OTCBB : MIDX

Carl Ports, CFA – Analyst
August 2, 2004

Close as of: August 2, 2004
DJIA: 10,179.16
S&P 500: 1,106.62
NASDAQ Composite: 1,892.09
Russell 2000: 551.93

SPECULATIVE Buy

Stock Price:	\$2.85	Market Cap.:	\$43.4 M	TTM P/E	N/A
52 Week Price Range:	\$0.35 – 3.65	Shares Outstanding:	15.2 M	Current Ratio	54.0
Industry/Sector:	Telecom. Svcs	Float (est):	1.05 M	Fiscal Year	Dec.
3-mo. Avg. Vol. (est.)	9,000				

BASIS FOR RECOMMENDATION

- We are initiating a **Speculative Buy** rating for MidNet, Inc. (OTCBB: MIDX). The Company's "Middle Network™" is a neutral, multi-company high-bandwidth network that is industry independent, allowing corporations within the entertainment industry to do business in a private, reliable and cost effective manner. The digital solution provided by MidNet has advantages over expensive and slow parcel couriers, limited-use private networks, and the unsecured and often congested Internet. The inability of larger competitors to offer a similar service that meets the unique need for a vendor neutral solution, coupled with MidNet management's long-term established industry relationships, has created a formidable barrier to entry into this market.
- Long-term client relationship within the entertainment industry has created a first mover advantage:** Over the last three years, MidNet's executives have collaborated with entertainment executives as to the requirements for a private, reliable and cost effective network. Prior to this, MidNet's co-founders, through a consulting contract, established a prototype network for MGM Studios that successfully operated for one year, connecting Vancouver, Canada and Los Angeles. The first of its kind, this network was utilized to provide dailies services for two TV series productions: Stargate SG-1 and Outer Limits. According to management, several other companies have attempted to build networks to service the entertainment industry and have experienced difficulties due to financial and/or operational shortcomings.
- Strong competitive advantages relative to established telecom service providers:** For privacy and operational reasons, media and entertainment companies require a neutral network free from any ownership by the studios themselves, or by established technology and communications companies. A network owned by a competitor raises concerns over the priority, reliability and confidentiality of data delivered over the network. This effectively rules out larger telecommunications companies such as Sprint and Verizon, which often connect several competing networks, and precludes funding a smaller company such as MidNet. The



highly collaborative media community needs a digital asset management solution that is independent and free from competitive interests. We believe this opportunity is not well understood.

- **MidNet capitalizes on the low-cost, overbuilt private telecommunications infrastructure.** The enormous glut of fiber optic cable installed during the recent telecommunications boom over the previous decade has resulted in capacity usage rates that are a fraction of the cost available only a few years ago.
- **Proven through test trials, The Middle Network™ solution offers cost reductions, improved efficiency, and a competitive pricing structure when compared to the physical or current electronic transport of entertainment data from one location to another.**
- **No long-term debt and conservative use of cash** Unlike many other telecom related companies, MidNet has no long-term debt, very little current debt, and is running extremely lean, with a monthly burn rate of approximately \$50k. According to management, the past exercise of warrants totaling \$1.1 million will fund a conservative service rollout of the network.

BUSINESS OVERVIEW

Since 2002, MidNet, Inc. has focused on the emerging opportunity to provide fully private network services to a variety of industries, beginning with entertainment/media. The Company's goal is to follow-up its initial focus on the media industry and offer similar services to the much larger energy, government, and medical industries. MidNet plans to have 24 customers within its first year of operations and projected revenue of \$1.3 million. This is forecasted to be achieved through a network with points-of-presence (POPs) in seven key media centers (Vancouver, Toronto, Los Angeles, Chicago, New York, Montreal, and London, England). A POP is a location where a telecommunications switch has been established to route data to other locations. Phase II is planned to include Seattle, Portland, and San Francisco. Primary prospects include: media replicators (Deluxe, Technicolor, Bertelsmann), film and television studios (MGM, Disney, Warner, Paramount, Fox, Universal, Sony), and broadcast networks (ABC, NBC, CBC, DirecTV).

MidNet intends to initially focus on what it considers to be core anchor accounts; these larger studios, which have a variety of relationships with several smaller post-production specialists. For example, studios and movie producers collaborate and contract audio and editing shops to finalize the creation of a major motion picture. Often, these operations are scattered around the globe, as movies are produced in a variety of locations. Twenty-four anchor accounts have been targeted and MidNet has finalized the necessary contractual/legal documentation required to garner customer agreement. An additional 180 of these accounts have been identified and targeted during a second phase marketing campaign. Momentum will build with each additional contract signed. It is common for movie budgets to run at \$100 thousand per day. The ability to quickly transmit and collaborate through a digital network can decrease the amount of time to complete a film and result in an enormous cost savings to the industry.

MidNet estimates a three-month lead-time to establish a customer connection. To some extent, the Company is dependent on the telcos to wire their POPs; however, a service order of this level is not estimated to take longer than six weeks to complete. Internal workflow issues need to be resolved to fully

utilize the capabilities of a private digital network and can vary from one studio to another. Nevertheless, the process of sending data over the network can be as simple as sending an email with a file attachment. Currently, the Company has switches purchased for all major cities and can establish physical connections as dictated by customer demand. Management plans to install the first two switches in Los Angeles and Vancouver.

THE MARKET

The Middle Network[™] - A *Truly Private Network*

The Middle Network[™] represents the missing link between high-speed, network infrastructures and the corporate customer. Through the Middle Network[™], the disadvantages of using the Internet and the high costs of single company private networks are overcome. The Internet, which utilizes the public or shared networks, is incapable of delivering high quality private data that is required by many industries. The Middle Network[™] utilizes its own private network in contrast with Internet Virtual Private Networks (“VPNs”) (which connect two or more private networks over a publicly accessed network). MidNet’s “peer to peer” topology is capable of connecting an entire industry. Because costs to lease telecommunication infrastructures have drastically declined, the Middle Network[™] is now an affordable solution for those desiring a truly private and high-speed network. Private networks are commonly used to exchange critical information between vendors, suppliers, and business partners, who may have huge physical distance between them. The Middle Network[™] fills the gap between the infrastructure and the client. Remarkable potential cost savings arise due to a variety of reasons, including:

- **Lower support costs:** When a company establishes its own private network the service providers charge for support in addition to the company’s own internal support staff. When a company is connected to The Middle Network[™] there is no requirement for support costs.
- **No required network investment:** The use of The Middle Network[™] does not require the customer to make an investment in telecommunications infrastructure. Modem pools, remote-access servers, and other WAN equipment can be eliminated.
- **Less expensive than a VPN:** VPNs, although currently utilized to transmit digital data in a variety of industries, are notoriously expensive. For this and other reasons mentioned elsewhere in this report, we believe the alternative offered by MidNet will be highly welcomed by the major studios as a more viable solution where the switching costs can be miniscule relative to the longer term cost savings. MGM is a proven example of the level of potential interest in this service.

Digital Asset Management Solutions

Digital asset management (DAM) is a comprehensive term that includes not only the digital delivery of data via public or private networks, but also the storage and management of that information. The consumer demand for digital content continues to increase; studios are meeting this demand with bigger films, bigger budgets, and frequent new titles. Demand has created substantial competition between the major studios, and subsequently, has changed the life cycle and distribution methods of content.

While the exact size of MidNet's revenue opportunity within the entertainment/media, oil and gas, and other target markets is difficult to quantify, we believe the opportunity is very large and it is easy to see why this is a multi-billion dollar opportunity. We already know the revenue and profit potential for vendors offering DAM solutions is high. According to Frost & Sullivan, the revenue potential within the media industry for collaborative media creation services has been estimated at \$1.5 billion annually with market acceptance at 10% and growth forecasted at 50% per annum. According to GISTICS research, an average of \$8,200 per person per year is spent on file management activities, including search, verification, organization, backup and security. MidNet is focused on delivering its network to enable an overall data management solution. The Middle Network™ component of these solutions is estimated to be roughly 50% of collaborative expenditures.

Enormous amounts of data shipped on a regular basis between studios and production companies around the world to produce the constant stream of movies, television programming, and documentaries is huge, and there are large cost savings to be achieved through faster, more secure transmission of this information, as well as increased collaboration through greater videoconferencing capabilities. Similarly, within the oil service industry, terabyte-sized files of valuable seismic data are transmitted through the traditional parcel courier; this is very slow, involves greater administrative burden, and there is greater potential for damaged files during delivery.

File Management: DAM offers the solution to slow, ineffective, and uneconomical methods of information gathering, transmittal, storage, and delivery. Creative professionals spend an average of one out of every ten hours of their time on file management, and searches alone can account for a full third of that time. In the entertainment industry, it is not uncommon for a film search and licensing process to encompass an entire month. According to Canto Software, the ability to locate media files using current methods is very poor; on average, media file searches yield positive results only 65% of the time, whereas DAM solutions can improve those results to 95%.

Digital Cinema: The transmission of digital content to the cinema has enormous potential; approximately 133,000 potential screens worldwide are able to convert to digital. Industry leaders have been developing a new "electronic cinema" to replace the celluloid movie reel. Forrester forecasts that the new digital projectors can be common in movie theatres within three years, and can become the new industry standard by 2007. Thus, digital cinema technology presents enormous benefits over celluloid reels and projectors in the areas of convenience, unit cost savings, and quality. The digital cinema era can offer advantages such as shorter lead-times in bringing films to market and switching times on changing projectors over from one film to another. Considering that there are about 5,000 prints shipped domestically, the cost savings potential is enormous; according to the National Association of Theatre Owners, digital cinema could save the industry up to \$600 million per year.

Oil Service Industry: Oil service companies transmit a high volume of large, three-dimensional and seismic data files from one location to another. Currently, many companies still send these files via physical delivery, which is inherently slow and has the potential to result in damage or theft. Due to these inefficiencies, management has indicated to us that they are receiving a high level of interest from two significant unnamed companies. Presentations have been made and a consultant has been hired to thoroughly investigate this opportunity.

Competitive Factors

Within the entertainment/media industry, neither the studios themselves, nor other network service providers have achieved a universally accepted approach to the use of a single private network. Although several companies offer telecom services similar to MidNet, we believe many of them are hampered by heavy investments in older technologies or have partisan commitments to specific technology solutions. Consequently, they either have high debt loads or are unable to offer a solution that is neutral to all parties (i.e. the users of the network have a financial interest in the network itself). Studios, which have created their own internal networks, have run into a similar problem because competing studios have not wanted to share a network either established or owned by a competing network or media company. This provides a unique opportunity for MidNet, which does not need to make expensive network investments, is able to offer a neutral solution to all participants, and has already established a working relationship with MGM.

Although there is nothing to prohibit competitors from entering the markets for private network services, once customers have been signed up, switching costs can be high. We believe that a customer is very unlikely to change its workflow and switch to another solution unless it can improve its existing cost structure by 20+%. Because MidNet is already providing a low cost service, we do not foresee how this can be possible given current technological capabilities.

MANAGEMENT

Tilo Kunz – Founder, Chairman and Chief Operating Officer: Mr. Kunz is responsible for product / service design, business case development, strategic relationships, and service implementation. For the past seven years Mr. Kunz has specialized in network based media applications. Mr. Kunz has held numerous positions in the communications and data networking industries, including sales and marketing, network design and systems integration, purchasing, managerial accounting, and senior management. Mr. Kunz received a Diploma of Technical Sales, Marketing Management, and Small Business from the British Columbia Institute of Technology in 1989.

Ruedi Aschwanden – Founder, Chief Technology Officer: Mr. Aschwanden has designed the network architecture and software-based configuration and network solutions for The Middle Network™ and successfully implemented the Media Asset Management pilot system for MGM studios. Prior to designing The Middle Network™, he was Director of Technology for Multiactive Technologies Inc. in Vancouver, where his team won the prestigious 1999 Software and Information Association “Codie Award” for “Best Internet Commerce Software” over finalists such as Microsoft, Adobe and NetPerceptions, and the 1999 BC Technology Industries Association award for “Excellence in Product Innovation”. He has backgrounds in electronics engineering and computer science, and holds a Masters Degree in Business Administration from the Simon Fraser University Vancouver, BC, in 1996. His prior experience includes the design and production of analog and digital hardware and software for a variety of industries including post-production studios.

Peter Fentiman – President and Chief Executive Officer: Mr. Fentiman is primarily responsible for financial and administrative management, investor communications, and government. He is currently the President of Fenco Communications, a management consulting firm specializing in the development of public companies. Previously, he was President of Canadian operations for Satellite Conferencing

International Inc., a public company in the business of two-way interactive videoconferencing. In this role, he successfully negotiated cross border links between AT&T, BC Tel and Telsat Canada, to establish videoconferencing between facilities in Canada and the United States. Mr. Fentiman is a graduate of Eastern Ontario Institute of Technology in Business Administration.

Ken Fasnacht – Chief Financial Officer: Mr. Fasnacht is a certified public accountant with more than 20 years of finance, accounting and tax experience in private and public companies. Mr. Fasnacht worked for KPMG LLP for many years in their Houston, London, England and Atlanta offices serving clients in a variety of industries with particular emphasis on corporate and international tax and consulting services. After relocating to the Pacific Northwest, Mr. Fasnacht joined Moss Adams LLP, a large West coast-based regional public accounting firm where he provided consulting and tax services to the firm's largest clients, with particular expertise serving high technology companies, many SEC registrants, with operations in the U.S. and Canada. Recent experience includes the position of CFO for a high technology start-up company that developed a web-based point-of-sale system for the hospitality industry and Director of Finance for a casino managing and overseeing the turnaround of the company's finance and accounting functions. Mr. Fasnacht graduated from the University of Houston with a BBA in Accounting.

Tom Locke – Executive Vice President of Strategic Planning: Mr. Locke is responsible for short and long term strategic planning for MidNet. He has over 20 years of corporate level experience in the entertainment industry and over the past seven years has studied and consulted on the use and impact of the Internet in business. As Managing Partner of Hub Consulting Services, he is responsible for industry relations for Command Post & Transfer Corporation, a public company in the film and entertainment industry, specializing in fully integrated, film based digital postproduction. Previously, he was President and Chief Executive Officer of Gastown Post & Transfer, Western Canada's largest independent postproduction facility. Gastown, which evolved into Rainmaker Digital Pictures Corporation, also provides a complete range of digital postproduction services for national and international film, television and video producers. From 1989 through 1994, Mr. Locke chaired film missions for U.S. producers interested in shooting feature films and episodic television in British Columbia. This activity is recognized as one of the key undertakings that has led to BC's billion-dollar film industry today. Mr. Locke sits on numerous provincial, national and international boards covering a wide range of interests and holds an MBA from York University in Toronto.

Curtis Staples –Executive Vice President of Business Development: Mr. Staples is responsible for customer relations and marketing for MidNet. He has 18 years of senior executive experience in the post-production and distribution fulfillment sectors of the motion picture and television industry. Currently, he is principal consultant of "x2y", a Vancouver based business development resource for facilities and services companies in the entertainment sector. Previously, he was Vice President of business development for Sonic Foundry, Inc. where he played a principal role in directing the Company's expansion and growth into emerging opportunities within the entertainment sector.

FINANCIAL INFORMATION

Revenue and Capital Requirements. MidNet is a development stage company, with its financial results reflecting that status. To date, no revenues or earnings have been billed or booked for the Company's services. Although MidNet is a development stage company without established operations or revenues, according to management the Company is funded for an initial, conservative service rollout; additional

funding can facilitate a more aggressive development plan. An initial investment of \$1.1 million has been secured through the exercise of warrants and can enable the Company to begin commercialization with POPs in four major cities (LA, Vancouver, Toronto, Chicago). Management estimates that an additional \$10 million would be required for a more aggressive campaign. Current cash on hand (\$996k as of 3/31/04 – June 30 number to be released in the coming weeks), and any additional capital raised will at least partially be utilized to lease network capacity, establish network connections, as well as to hire and train employees. The remaining cash will be used to fund working capital needs. However, the Company has no long-term debt and very little current debt, and is running extremely lean, with a monthly burn rate of approximately \$50k.

OUTLOOK/VALUATION

Valuing a start-up with solid potential is a daunting task at best. We have not put together our traditional earnings model because the timing and amount of revenue cannot be estimated with any reasonable certainty at this time. Even for established multi-billion dollar companies, traditional valuation measures often provide little insight into how a stock will perform in the future. Therefore, we are not placing a specific price target for the stock. Although we believe that MidNet has an excellent management team focused on a potentially large opportunity, and also possesses a solid business model with significant barriers to entry, we do not customarily establish a valuation and resulting price target for companies with this level of low visibility. The timely execution of the Company's business plan is paramount; MidNet is currently in the startup phase and does not have a historical track record of usage rates, revenues, or customer account growth which we believe are critical in establishing a valuation. Therefore, we look to the next few months as critical to the development of the Company and plan to update the investment community as more information becomes available.

The market has placed a much larger valuation on the stock today than it did in 2003. The stock has appreciated strongly from under \$1.00 to its current price of \$2.85, and we suspect this is largely the result of investor anticipation of a pending initial service rollout and greater awareness of the Company's potential in general. Although we have not been able to determine the exact size of MidNet's target markets, the current market cap of \$46 million is likely to prove conservative if the Company is successful in tapping the \$1.5 billion total market for collaborative media services alone, not to mention the revenue opportunities outside this industry, which we believe to be significantly larger. Consequently, the positive stock price momentum should continue as concrete customer agreements are signed and progress is made in penetrating markets outside the entertainment industry.

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