

Earthport plc

May 2007

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Index: **Aim**

Sector: **Technology**

Key points

- Earthport "across the chasm"
- Evidence of strong and accelerating transaction growth, with significant progress in the US
- Driving a large and unique opportunity in a fast growing sector
- High operating leverage in overhauled technology platform
- Priced on history, not the present or future

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Earthport plc



Company Description: Earthport is an international payments company providing companies with the capability to move funds globally through an automated network (via API), connecting to over 190 countries. Integral to this system is Earthport's ability to settle payments in local currency and to provide companies with access to a global network of segregated client accounts whereby Earthport can offer smaller companies the same service and low-cost funds transfer as global multi-nationals receive. This service is further enhanced by Earthport's recent acceptance into SWIFT. The network would be very difficult to replicate following recent tightening of regulations, and gives Earthport a very strong competitive advantage.

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EPO

Date:	29/05/2007
Share price p	30
52 week High/Low p	40/19.5
Market cap £m	16
Shares in issue, m	51.9
Year to June 30	Pre-tax £m
2004	-2.8
2005	-7.1
2006	-2.1

STRONG SIGNS OF GROWTH

Earthport, which has had a history of underperforming through poor management and business development false starts, saw trading in the first four months of the current calendar year show a strong acceleration in transaction volumes, as both new and existing clients continued to migrate their business over to Earthport's payments gateway. Since January 1 2007, Earthport has almost doubled transaction volume and has signed significant new clients awaiting implementation by the end of the June 2007 fiscal year.

While the company has not put out projections yet, management has indicated they are on target to achieve internal sales growth forecasts. Earthport has made significant progress in the United States where the company has signed up several key channel partners, like GIACT Systems (www.giact.com) and Virtual Automated Technologies (VAT) (www.vatproducts.com), both of which have extensive customer bases, whereby existing contracts indicate potential transaction volumes approaching 1 million per month.

Earthport has made a significant step in the last year by positioning itself as an alternative to the existing corporate banking network for small to medium sized companies, (up to \$1bn turnover), with international payment needs. Earthport has shed its tendency to try and be all things to all people in the payments industry (ex. eWallet, Credit Card Processor, mobile banking platform) and has returned to its roots as a bank-to-bank money transfer network with a focus on companies that do a high number of low-value transactions and thus must be sensitive to the high costs and the poor customer service smaller firms get from traditional corporate banks.

This represents a dramatic resurgence in Earthport's fortunes, and stems from the rigorous restructuring and reorganisation that the new management team commenced in the summer of 2005.

These are still early days, and while potential transaction volumes are huge, the timing and profile of their growth pattern can be uncertain. The company has improved its product offering to include settlement in local currency and thus has added an entire new revenue stream in the form of foreign exchange (FX), which benefits both the Earthport client and their customers and of course Earthport. In the last few months, a growing percentage of revenues have been from FX.

Earthport is quoted on AIM and investors should be aware that share traded on AIM are subject to lighter due diligence than shares quoted on the main market and are therefore more likely to carry a higher degree of risk than main market companies.

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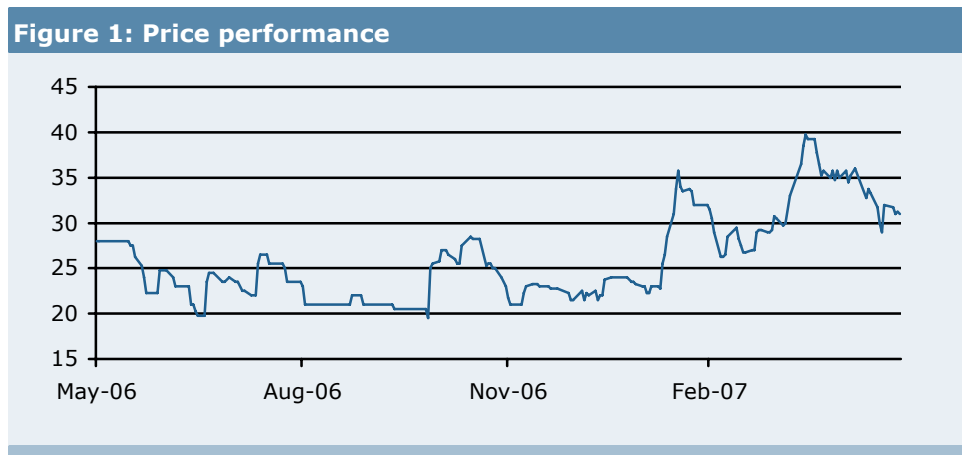
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The revenue flow is recurring, thus growth occurs on an existing level of revenue. In addition the margins are high and can be increased as the build up of the liquidity in the Earthport system allows for more international transactions to be satisfied by local movements.

Although relatively unaffected by increasing volumes, as a money transfer business Earthport must maintain a reasonably high fixed-cost base in order to support the banking grade IBM WebSphere platform underpinning Earthport’s system. Noel Jones, former Chief Software Architect at UBS, has substantially upgraded the system and it is now a key differentiator to sophisticated technology and banking industry groups. In addition the technology played a critical role in obtaining membership of SWIFT and acts as a critical barrier for aspiring competitors.

Compelling Value Given Growth Prospects

Even with the recent upturn in the stock price and the general increased profile of the international payments sector as is evident in several large transactions that have occurred including the Coinstar/TMT transaction, the sale of Moneybookers and the acquisition of First Data Corporation by private equity house KKR, Earthport’s shares are still priced to reflect legacy issues.



ADVFN

KEY INVESTMENT POINTS

We believe that the company has defined its targets as those that will yield, on successful sign up as clients, good revenue streams at attractive acquisition costs. Although the current management team is still in the early phase of seeing the realisation of potential success turn into growing transaction volumes and hence increasing revenues, there are a number of strongly positive factors which should underpin the company’s model:

- Earthport’s banking and technology platform, developed internally, and the end-product of an accumulated spend by the company of £70m, is a disruptive technology in the international payments field, promising to reduce fees and settlement times for global money movements;
- Earthport makes local payments through its global network of segregated client accounts, now exceptionally difficult to set up, allowing it to make

payments to over 190 countries, collections from over 38, and in 20 currencies;

- The unique technology platform has been systematically overhauled and markedly strengthened, and the migration to the IBM WebSphere environment facilitates the development of a fully automated system which will readily allow additional bank account integrations, comfortable integration with clients' systems and higher levels of functionality;
- There is a large operating leverage inherent in the platform, and the low cost of computer hardware means that capacity can be dramatically increased for a relatively small spend;
- The SWIFT network connection will extend Earthport's reach into countries in which it has no segregated client accounts, and lower the cost to Earthport of those transactions.

Earthport's network of segregated client accounts is a key differentiator in the highly complex payments market. Earthport has established a network of segregated client accounts via large multi-national banks allowing them to move client money seamlessly around the world and provide a single interface for the middle sized market flow of funds.

In a trading statement for Q3 issued on April 20 2007, the company announced acceleration in year-on-year growth of transaction volumes, with December 2006 being 38% higher than December 2005, January 2007 was 111% ahead of the previous year, and February 2007 was 122% up. Thus there are strong signs that Earthport is gaining traction and success in the market is reachable.

COMPANY OVERVIEW

Earthport is an international electronics payments and collections provider, moving money to and from different locations around the world. The company does this through its key asset: a liquidity network set up with major banks (Barclays, HSBC, SEB, Citibank, ANZ, Standard Chartered, RZB) where Earthport has established segregated client accounts. These are different from traditional corporate bank accounts in that segregated client accounts allow Earthport to move other people's money through an automated interface (API) to over 190 countries and settle in 20 currencies by providing merchants with their own white-labelled version of the Earthport payments gateway.

The typical practice for delivering international payments is to originate payments from an account in one country to a destination account in another country via a messaging/clearing mechanism (SWIFT, BACS, ACH). What is unique about the Earthport platform, is that it shifts this paradigm by using a network of local client accounts (supplemented by traditional clearing mechanisms where Earthport does not have a local account) tied together through Earthport's proprietary technology application, to allow them to provide money movement services whereby local accounts held in multiple countries and various currencies enable the network to make international payments via its local presence. As liquidity grows within the system money will only move locally, this will eliminate international transfer fees, recipient charges, and predatory FX pricing.

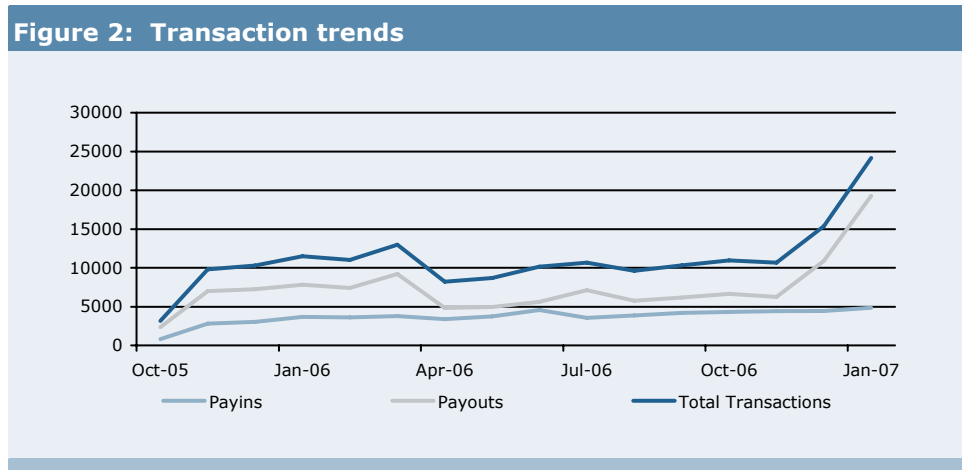
Furthermore, as they have newly installed electronic banking systems, it is the emerging markets, (which are some of the fastest growing economies in the

world) that are highly suited to this process of electronic bank-to-bank- transfer via a network of local accounts guaranteeing cleared funds at the other end of the network, thus eliminating international charges, credit card repudiation and fraud and excess FX fees.

Channel Partnership Strategy Taking Hold

Since the middle of 2006, Earthport has narrowed its focus to target channel partners, with an established track record in the payments industry, looking for a cross-border funds transfer platform. Earthport has repositioned itself as a back-end payments utility. Its partners, provide a variety of edge services, including prepaid cards, eWallets, payroll processors, send-money-home and foreign exchange to name a few, with the ability to extend their reach globally through a single interface with Earthport.

Consequently a new sales team has been brought in to recruit channel partners. Early results are very encouraging. The following represents the recent upward trend in transaction volume this year:



Source: Earthport

Strong Shareholder Base

Earthport has enjoyed a good degree of shareholder and customer support, particularly in difficult times. Following recent funding rounds, Earthport has significantly improved its shareholding structure, with 55% of the stock being taken up by new investors over the past 18 months. Notable shareholders include Noble, Artemis, Millenium and Man Financial.

It is also worth noting that when David Fife, the CEO, joined the company to finish the restructuring and drive the operations (a former investment banker, who started his career at Goldman Sachs) he personally invested £300,000 in the recent £2,000,000 financing that the company closed in December.

INTERIM RESULTS AND TRADING STATEMENT

The 6 months to 31 December 2006 saw a marked improvement in Earthport's trading, reflecting the benefits of restructuring and reorganisation, and important commercial and technical achievements.

Financially, turnover increased 51% to £403k (£266k as restated) over the 2nd half of the previous year as a result of increased transaction volumes from existing customers and new customers. The operating loss fell by 16% to £2.2m, (£2.7m loss as restated) compared to the 2nd half of the previous financial year, despite continued investment in the technology platform, and the pre-tax loss was £2.4m, 30% lower than the loss of £2.9m (as restated) in the 2nd half of last year.

Earthport secured additional long-term debt of £400,000 and raised a further £2.3m through issue of equity (£1.5m was received after the period end). £4.7m of warrants lapsed in the 6 months, and so far since February 2007 the company has raised a further £2.3m through equity issues at rising prices.

The trend in accelerating transaction volumes was clearly seen in the trading update for the first quarter of 2007. Year on year growths in transaction volumes for December 2006, January 2007 and February 2007 were 38%, 111% and 122% respectively, and on a month-to-month basis February 2007's transaction volume was 60% higher than December 2006's.

Recent commercial milestones

Over the past 12 months Earthport has announced a number of new clients and that it has joined SWIFT and SETS. The key milestones are summarised below:

- **SWIFT** acceptance and integration giving Earthport larger and more cost effective footprint outside of its current list of local trust accounts.
- **NuSkin** launch in South African market where Earthport will be the international payment mechanism for sales commissions to affiliates in the local marketplace
- **GIACT Systems** now live with first client, SafePay Solutions, a comprehensive eCommerce payment platform where Earthport will be the preferred payment mechanism (icon) for international payments.
- **Xoom** about to go live where Earthport will serve as the banking platform for this send-money-home business in markets outside their existing banking relationships.
- **VAT** about to go live to provide for payroll processing and monthly commission payments throughout their network of affiliates.

SWIFT membership

SWIFT (Society for Worldwide Interbank Financial Telecommunications) is the industry-owned cooperative providing secure, standardised messaging services and interface software to financial institutions in over 200 countries, including banks, investment managers and broker-dealers. Membership of SWIFT (announced in October 2006) through a Member Administered Closed User Group extends Earthport's reach, and is significant in that the company is the first payments company to be given membership.

Given the broad coverage of the SWIFT network, membership gives Earthport access to territories and currencies not covered by its own network. Membership gives Earthport some important benefits, including:

- Improved communications with banks via SWIFT Free Format messages – which will help resolve queries and tracking and tracing funds;
- A reduction in the development time and resources in the integration of banks;
- Improved account opening process in that initial communications can be made by SWIFT;
- Centralised and standardised reporting, including the ability to receive intra-day and per-movement reporting;
- Direct access to inter-bank transfers.

These factors together will significantly enhance Earthport's ability to provide cost-effective, fast and secure payments to customers world wide.

In another move connecting Earthport to the mainstream financial markets, the company joined SETSmm in March 2007. This LSE platform allows firm buyers and sellers to place orders, and has increased turnover in the stock.

New clients

Earthport became the global payments partner to US-based BurnLounge in May 2006, under an initial 5 year agreement with the community based digital music download service. BurnLounge provides record labels and artists with a fan-driven promotional channel, with the music service allowing customers to preview and purchase music, and if subscribers, they can sell music through their own custom pages. BurnLounge is still at a relatively early stage in its commercialization.

The potential value of Earthport's payments network to middle market companies is highlighted by the agreement with NuSkin announced in December 2006. Nu Skin is a direct selling company with 2006 revenues of over US\$1bn, marketing skin care, nutritional and well-being products, and technology (particularly photographic-related). Nu Skin has a global network of over 800,000 distributors, and Earthport enables Nu Skin to pay distributors in their local currency via the Earthport payments gateway and have just gone live with payouts to South Africa as a first project.

Also in December 2006, Earthport became the international payment services partner for Giact Systems, a US-based provider of a wide range of merchant credit processing options including standard retail solutions as well as solutions for all types of online businesses, International/offshore accounts and high risk merchants.

Giact plans to use Earthport's payments network to meet the demand for international services from its existing clients, and use it as the basis for marketing its services to new clients.

The pursuit by the company of suitable channel partners led to the agreement announced in January 2007 with Virtual Automated Technologies Inc (VAT) to provide international payments services.

VAT is a global payment solutions provider, and its proprietary SpeedyWallet™ software allows links stored-value cards and other unique global payment

programmes to the Internet. VAT offers an innovative and comprehensive web-enabled solution for the transmission and management of global payments. Of immediate interest in terms of the agreement is TravelPay™, the first service that VAT plans to expand through the Earthport network.

TravelPay is a new solution to the travel industry's problems of settling low value international payments. While large value payments in the travel industry are handled by the Global Distribution Systems (GDS), GDS cannot economically handle typical small payments such as booking commission from a hotel to a travel agent. With the current average cost in the industry of commission payment/ collection transfer being around US\$30, the payments arising out of many short hotel stays, for example, are either not collected or paid by cheque.

In the TravelPay approach, a hotel receiving a booking via an overseas agent will deposit funds using a local bank transfer into a local Earthport bank account. As soon as the funds are cleared, the travel agents e-wallet will be updated to show the arrival of the funds which can be withdrawn or left in the e-wallet. TravelPay™ offers an 80% cost reduction on processing booking agent fees, and can generally settle accounts within 24 hours. Overall, TravelPay™ offers significant benefits for the travel industry reservation system and the booking agents.

A representative sample of Earthport's clients is shown below:



Source :Earthport

Strategy - The New Sales Focus

The sales and marketing resource is focused on markets where there is a proven demand for the company's services, and developing channel partners with an established track record servicing the payments market. Earthport believes it can provide middle market companies with a high number of low value transactions with a simple to use and cost-effective bank-to-bank international money transfer utility where traditional banks have failed to focus or develop a cost-effective model for servicing.

Originally Earthport aimed at the centre of funds management, entering discussions with Barclays, for example, but found that to go head-to-head with BACS, SWIFT, etc could only succeed if the political inertia in this market could be

overcome. This was deemed to be unlikely in any reasonable timeframe. However, the company identified more attainable targets around the edges of the funds transfer market where electronic payments have to be made:

- Gaming (non-US)
- Retail & Multi Level Marketing
- Travel
- eCommerce
- Send Money Home
- Foreign Exchange

The revenue model

Earthport has three revenue streams:

- Per transaction fees for making payments in local currency. Through the global network of domestic bank accounts, including many segregated client accounts, Earthport settles in the local currency at a flat fee per transaction. If a customer makes a payment demand for a country not in the network, Earthport can use SWIFT which costs the company less than traditional international payment methods;
- Foreign exchange – Earthport takes a competitive percentage fee on all FX conversions made on the system when it settles in local currency;
- Fees for integrating the IT systems of customers with the Earthport platform.

Transactions comprise:

- Payout – pay money to a customer account
- Payin – customers pay money into an Earthport account, and Earthport routes this to the appropriate merchant
- Loading – charges to card vendors and processors to load value.

Revenues from FX are difficult to forecast but potentially they could represent a significant percentage of the total figure and management has indicated that Foreign Exchange (FX) is an increasing percentage of their monthly revenue.

The payments market

The May 2006 ACI study on the Global Electronic Payments market saw electronic transactions growing at a CAGR of 12.9% in the period to 2009, from a global level of 210 billion in 2004. Thus in the 10 years between 1999 and 2009, the number of electronic payment transactions is expected to more than triple from 117 billion to 384 billion.

Within this framework of a strongly growing global market, VOCA Limited (formerly BACS Ltd) forecasts the volume of international payments is expected to increase by around 55% in the next 5 years. The VOCA study of June 2006 highlighted the following responses concerning the international payments market – Earthport’s main sector of the payments market:

- 81% of businesses surveyed responded that international payments are very important to their business;

- 93% said that their company was making the same or more international payments than last year;
- 66% of businesses believed that international payments were too costly.

Earthport is thus uniquely positioned to meet this growing need through its international network, inherent competitiveness and automation. Consequently the company targets middle market entities with international reach, particularly those with high volume/ low value transactions. These would include:

- International marketing companies paying or collecting from a network of affiliates;
- Medium to large companies paying supplier invoices or receiving payments;
- Money transfer companies sending remittances internationally.

Investment Activity in the Payments Sector

Several acquisitions in the sector point to Earthport's investment potential.

- **Intuit/Digital Insight** – a recently announced transaction for \$1.37 billion.

Intuit Inc announced the acquisition of Digital Insight on February 7, 2007. Intuit, a leading provider of strongly-branded business and financial management solutions to small and mid-sized businesses, and Digital Insight, a leading technology provider in online banking, together will aim to provide an interactive financial management offering that will strengthen the relationship between small businesses and their financial institutions. The combined companies will serve 5,000 financial institutions, nearly 25 million consumers and 7 million small businesses

- **TSAI/P&H** – August 2006 acquisition for \$150m.

Transaction Systems Architects, Inc (TSAI) provides software that facilitates electronic payments by providing consumers and companies with access to their money, and its products are used in processing credit card, debit card, e-commerce, smart card, money transfer, bulk payment clearing and settlement transactions. P&H Solutions Inc is an industry leader in Web-based corporate cash management with around 100 customers including 12 of the top 25 US banks.

TSAI had initiated a strategy to build a global solutions business providing payments software, domain expertise services in payments, and payments software as a service, and the P&H acquisition provides management expertise in operating an enterprise business banking platform. Thus the deal has a significant ASP component, and represents a strategic opportunity to leverage business banking capabilities.

- **Spectrum Equity and Bain Capital/iPay** – Recently (December 2006) closed recapitalization transaction in Internet consumer bill payments.

Spectrum Equity and Bain Capital ventures became majority shareholders in iPay, a leading independent provider of Internet bill payment services to the banking sector with a solution used by over 1,100 financial institutions. Underpinned by embedded subscriber growth, this true ASP model looks poised for continued growth.

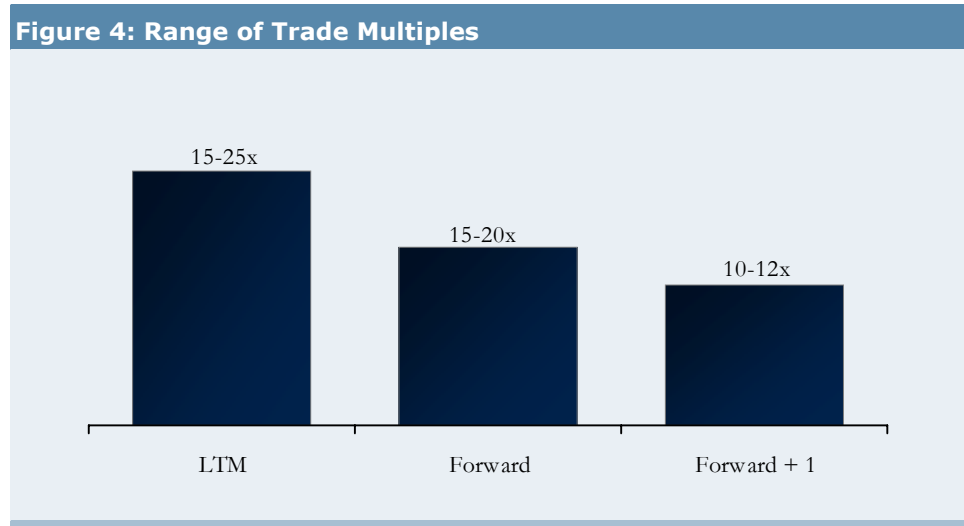
- **Online Resources/Princeton eCom** –announced (May 2006) transaction for \$180m in cash with earnout of \$10m.

Princeton eCom is an electronics payments provider to financial institutions and billers, and through acquiring this company, Online Resources Corporation, a

leading provider of Internet financial services, will create a combined company serving around 2,200 financial institutions and 1,600 billers. At the time of the transaction, Princeton eCom was expected to generate over \$40 million in 2006 revenue and \$8 million in 2006 EBITDA.

- **Fiserv/BillMatrix** – Transaction announced in July 2005 for approximately \$350 million.

Fiserv provides information management systems and services to the financial and health benefits industries and has more than 16,000 clients worldwide, including banks, credit unions and insurance companies. Billmatrix, founded in 1994, provides billers with an outsourced payment solution that allows their customers to get immediate credit for bills paid online or over the telephone using electronic cheques, debit or credit cards. Billmatrix has more than 120 clients including utilities, telecommunications providers, insurance companies and lenders. This transaction provided an entry point for Fiserv into attractive direct payment market. At the time of the transaction, BillMatrix was expected to generate \$90 million in 2006 revenue and \$41 million in 2006 EBITDA.



Source: Earthport

Technology overhaul

When Noel Jones first assessed the system his conclusion was that while the software was good in that it performed correctly, the JAVA platform it was running on was not sufficiently reliable or robust enough for the task, particularly with the anticipated growth in transaction volumes. The platform itself comprised a variety of platforms, and whilst there was a distribution of failures within the platform, the system as a whole basically worked.

The architecture was successfully migrated to an IBM WebSphere application server platform in December 2006, thus providing improved availability, security, reliability and scalability.

However, investigation of the software revealed a number of problems. Firstly, it had been created and contributed to by several people over a number of years, it was undocumented and there was very little automated testing incorporated or developed.

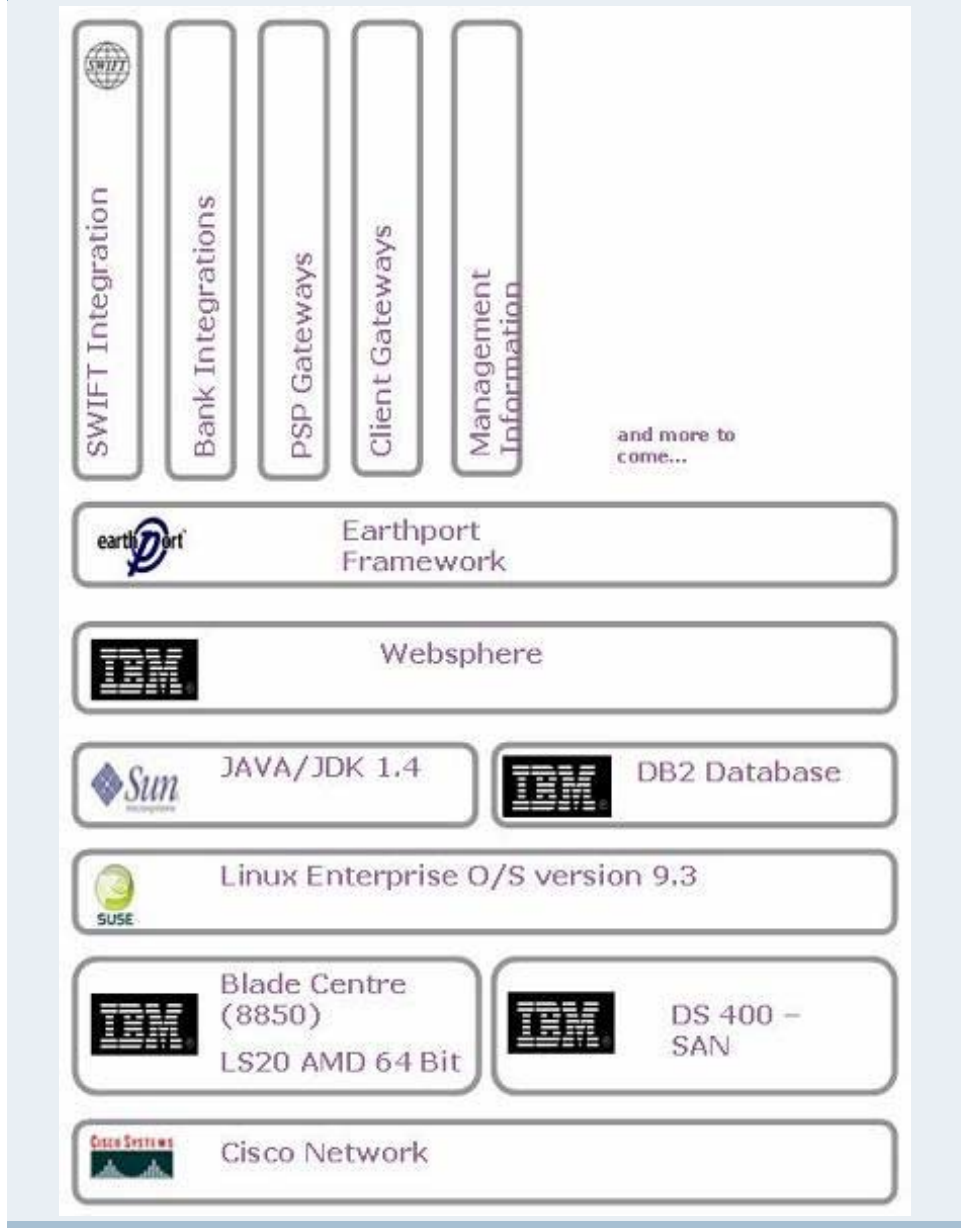
The technical team thus had to keep the system running while putting it in a modern scalable platform. They succeeded in producing a highly scalable system that uses commodity hardware and that can use readily available low-cost servers to make significant increments in the system's capacity (currently a £5k server will add 48% capacity), and which is 99.9% reliable. As the software is now overhauled and documented, software engineers require far less time to get to a position where they can actually make additions and changes. There is now automated testing on every change in the code.

By Q1 2007 three technical upgrades had been made to the platform, including the first phase of the implementation of SWIFT and the implementation of the FX strategy.

The platform is illustrated in the following table, and was designed to meet the following objectives:

- Standards based approach using an approved security model with disaster recovery;
- Shared modular, reusable architecture for all services;
- Planned evolution, with the potential for regular enhancement;
- Scalable to handle significant growth in payment volumes

Figure 5: Earthport Technology Stack



Source: Earthport

PROSPECTS

The current market capitalisation of £16.2m reflects Earthport’s past, but in our opinion not the company’s future potential. With an international network of banks that is unlikely to be cost-effectively reproduced by any would-be competitors, an overhauled technology platform that can be scaled easily and cheaply, and a growing client list with accelerating transaction volumes, we believe that the ratings and values achieved by the acquisition targets mentioned earlier should be in Earthport’s reach should the company continue to execute well on its refocused strategy.

I certify that this report represents my own opinions
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