

DivX may be setting the standard on new compression technology

by Mike Freeman

Walking into DivX's San Diego headquarters, it's hard to miss a deja vu vibe from the Internet bubble of 1999.

There's the casual attire - employees walking around in T-shirts and baggy jeans, shorts and flip-flops.

There's the Space Age furnishings and game tables, relics of the defunct Internet music company MP3.com, which used to occupy the building.

SHRINKING EXPANSION - Employees who worked on launching DivX's Stage 6 display a surfboard they received as congratulations for a job well done. Stage 6 is like YouTube, but it focuses on high-quality user-generated videos. CNS Photo by Howard Lipin. There's the warp-speed conversation and digital-speak about online communities and reinventing the way media - particularly video - is consumed.

And there's the swagger.

"In our 20-year plan, we specifically focused on being the largest company in San Diego - bigger than Qualcomm, bigger than Sempra - in terms of market capitalization, but also in those cases in terms of head count," said R. Jordan Greenhall, the 34-year-old Harvard-educated lawyer who is DivX's co-founder and chief executive.

That's a bold prediction for a company whose \$15.4 million in revenue last quarter was less than 1 percent of Qualcomm's \$2 billion in quarterly sales.

Still, some on Wall Street are taking DivX's potential seriously.

Since its initial public offering in September, DivX's shares are up nearly 75 percent. That ranks it among 25 best-performing stocks of companies that went public in the past 12 months, according to IPOHome.com, a division of Renaissance Capital.

The investor interest in DivX is somewhat unusual because its business is not easy to understand. It's also risky. Several competitors have much deeper pockets, including Microsoft and Apple. In addition, DivX relies heavily on a few large customers, including Google and Philips. A loss of either would hurt the company significantly.

Finally, its users historically downloaded its technology to ship pirated movies over the Internet. That legacy could make movie studios and other content providers wary of doing business with the company.

Despite that, analysts think DivX is maneuvering to capitalize on the Internet video craze, particularly as it matures.

"Their technology is bridging the gap between the home computer and the living room," said Robert Adams, an analyst with Montgomery & Co. in San Francisco. "The interesting thing is they have a significant customer base that's adopted the technology."

DivX makes a software package, called a codec, for compressing and decompressing high-quality digital video. Many video files, particularly full-length movies, are huge. A typical DVD clocks in at 4.7 gigabytes. Downloading such a large file online, even with broadband connections, would take hours.

With DivX and other compression software, digital video files are shrunk by cutting out redundant material. DivX claims its technology can squeeze a full-length DVD down to about one-tenth its original size while maintaining high quality.

"You can use DivX to put two hours of DVD-quality video on a CD-ROM," Greenhall said.

DivX's roots are in the hacker underground. Jerome Rota, a video technician living in France, invented the first version of the DivX in 1999 by adapting a beta version of Windows Media Player.

Rota allowed the code to be downloaded from a Web site. It caught fire in geek-dom, and soon Rota was getting offers to go into business.

One of those offers came from Greenhall, who was an executive at MP3.com at the time. After several chat room conversations, Greenhall, Rota and other partners formed a stealth company without meeting face to face. When a reporter from The Wall Street Journal tracked them down, they came out of the closet and named the venture DivX. Rota moved to San Diego.

The newspaper story appeared under the headline "The Napsterization of Movies." Indeed, DivX became the compression software of choice for people pirating copyrighted movies online - mostly at college campuses with their super high-speed Internet networks.

DivX reworked the compression technology to strip out Window Media elements. It also adopted digital rights management protocols to protect copyrighted material, essentially going legit.

Over the past couple years, DivX has pursued a strategy of getting its technology licensed by makers of DVD players. According to Greenhall, the grass-roots group of DivX users demanded that DVD makers include DivX so they could watch their DivX-format videos on their televisions.

DivX's compression technology is on 50 million devices, with DVD makers such as Philips, Samsung, JVC, Toshiba and LG Electronics leading the way. In Europe, about 80 percent of the DVD players contain DivX software. In the U.S., it's about 20 percent.

Licensing to these manufacturers makes up about 80 percent of DivX's revenue. The rest comes from a deal with Google, which pays DivX to offer its Firefox Web browser to customers downloading DivX's compression software.

DVD players are just the beginning for the licensing program, said Greenhall. The company has licensing deals with two digital-camera makers. It aims to get its compression technology into phones and other devices.

The idea is for DivX to stake its claim as the only compression technology that will enable high-quality video to be played on TVs, phones and cameras and a host of other gadgets.

"We want to create the operating system for the digital lifestyle," Greenhall said. "We're going to bring the Internet to the living room, and what's important is building this common media language."

DivX has a head start. While companies like Apple and Microsoft compete today, they previously only dabbled in high-quality video compression in favor of streaming and other techniques that required less bandwidth - in part because they felt the market wasn't ready, according to analysts.

That allowed DivX to get a technical jump, Greenhall said. "A computer has an Intel processor that costs \$300 and operates at four gigahertz," he said. "A DVD player as a \$3 processor that works at 32 megahertz. That's a big gap. Making sure video works on one as well as the other is a big challenge."

But analysts say technology has less to do with DivX's position in the industry than the sheer number of tech-savvy computer users who already downloaded DivX to encode their digital video.

"The thing that DivX has that others don't is not a technical thing," said Van Baker, a San Jose-based analyst for Gartner, an industry research firm. "All of the (compression) codecs are pretty similar. What DivX has in the marketplace is a following. There's a lot of content out there coded in DivX."

The company says its software has been downloaded more than 180 million times. This large customer base may result in the DivX compression codec's becoming the de facto industry standard, said Robert Stone, an analyst with Cowen & Co. in Boston.

Of course, some of these customers have used DivX to acquire and send pirated video. Because of this legacy, big movie studios will balk at allowing their content to be delivered online via DivX technology when they eventually adopt digital distribution of movies in a significant way.

Analysts, however, say DivX doesn't need Hollywood. Studios, which make billions on DVD sales, aren't likely to move aggressively to Internet distribution anytime soon, they say. And home broadband connections in the U.S. probably need to get faster before downloading full-length Hollywood movies makes sense.

But the surge in user-generated video on sites such as YouTube, coupled with independent movies and foreign films, leaves plenty of room for a company the size of DivX to make money, analysts say.

"Could they be frozen out from the major studio releases? Yeah," said Baker. "But that probably doesn't matter, because the days when the major media companies dominate media consumption are over."

Recently, DivX launched a new service called Stage 6. The Web site is essentially like YouTube, but it focuses on high-quality user-generated videos. People using the site must download DivX software, which is free for a basic version and costs about \$20 for a professional version.

Gerry Kaufhold, a principal analyst with technology research firm In-Stat of Phoenix, said DivX could expand its licensing business and tap other sources of advertising revenue.

"For them to have a sustainable business, they have to make enough money to pay their costs and have enough left over for a profit," said Kaufhold. "They can achieve that with a fairly moderate number, given their size. So if they keep on keeping on, the market eventually winds up as the same spot they're at. In the meantime, if they can maintain positive cash flow, they're good to go for now."

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