

Crossroads Systems, Inc.

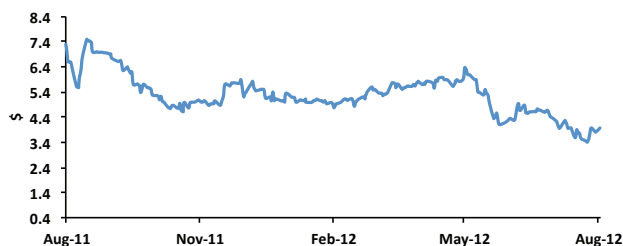
RESEARCH UPDATE | AUGUST 16, 2012

Company Details



Company	Crossroads Systems, Inc.
Headquarters	Austin, TX
Employees	Approximately 100
Fiscal Year End	October 31
Listing	CRDS (NASDAQCM)

Price Performance



	YTD	3m	6m	12m
Return	-22.16%	-26.55%	-16.36%	-46.13%
Last Price	\$4.04			
Date of Price	8/15/12			
52-week Range	\$3.20 - \$7.86			
Shares Outstanding (mm)	11.07			

Analyst Information

Ankur Desai

Director of Investment Research

MDB Capital Group

310-526-5036

adesai@mdb.com

Please read the disclosures beginning on page 9 for important required information, including analyst certification.

Investment Summary

Below is our assessment of a recent material announcement relating to Crossroads Systems, Inc. ("Crossroads" or the "Company"). Crossroads is entering the commercialization phase of its StrongBox appliance ("StrongBox"), a network-attached storage ("NAS") appliance (consisting of both hardware and software) that utilizes the 5th generation of the linear tape-open ("LTO") standard.

On August 2nd, 2012, Crossroads announced that it had entered into a professional services agreement with Iron Mountain Information Management, Inc. ("Iron Mountain"). As part of the agreement, Iron Mountain purchased \$3 million worth of Crossroads common stock at an average purchase price of \$5.15, which represents a premium of 31.7% over the previous day's closing price; it is also paying for \$2.2 million of development costs. We view the Iron Mountain investment as the most positive announcement the Company has made since it transitioned to a focus on commercializing StrongBox.

Validation of Technology and Business

Iron Mountain is an enterprise-level company with significant resources, so we expect that it evaluated several alternatives before deciding to sign this agreement. In addition, it appears that Iron Mountain is placing a large degree of importance on how to modernize its offerings. We believe that the fact that Iron Mountain chose to partner with Crossroads represents a powerful validation of the StrongBox technology and Crossroads' ability to support it.

Powerful Market Opportunity

We do not yet know exactly how the economics of the parties' go-to-market approach will work. However, we know that Iron Mountain has approximately 156,000 customers in 35 countries, including more than 97% of the Fortune 1000. Being able to address a customer base of that size and composition should jumpstart Crossroads' entry to the marketplace.

Cash Position

The addition of \$5.2 million in cash to the Company's account will strengthen its financial position and extend its cash runway, which should have a positive impact on its ability to attract customers going forward.



Details

Background

Under the professional services agreement, Iron Mountain agreed to purchase 582,524 shares of Crossroads' stock for \$3 million, for an average per-share price of \$5.15. In addition, Iron Mountain has agreed to pay \$2.2 million for certain of the Company's non-recurring engineering expenses, of which it had already paid \$1.1 million as of July 31, 2012.

We view the Iron Mountain investment as the most positive announcement the Company has made since it transitioned to a focus on commercializing StrongBox, as it provides bullish indicators on several different fronts.

Validation of Technology and Business

We believe this agreement represents a powerful validation of the Company's StrongBox technology by a respected leader in data management and archival. Iron Mountain's purchase price of \$5.15 per share of Crossroads common equity represents a premium of 31.7% over the previous day's closing price of \$3.91 per share.

Iron Mountain is a major player in the information security industry. It provides information protection and storage services to approximately 156,000 customers in 35 countries, including more than 97% of the Fortune 1000. It had revenues of approximately \$3 billion in fiscal 2011, and currently has a market capitalization of approximately \$5.6 billion.

Recent evidence suggests that Iron Mountain is considering how to transition this large, healthy business to keep up with a new technological backdrop. A large part of Iron Mountain's market offering consists of the physical storage of records based on paper, film and tape—what Iron Mountain calls its "Hard Copy" business.

As its customers move to digitize these records, Iron Mountain has made overtures into the digital space. However, it has not had success in making this transition to date. Recently, Iron Mountain attempted to grow into cloud storage with its Virtual File Store service, which provided features such as email management and archiving, eDiscovery, and backup/recovery. In April of 2011, Iron Mountain abandoned this business, writing off \$284 million as impairment charges. The following week, Iron Mountain replaced CEO Bob Brennan. We believe that this agreement represents Iron Mountain's newest effort to modernize its business. We also believe that, given recent history, Iron Mountain's management likely takes this newest effort very seriously. (Crossroads management indicated that the parties negotiated this agreement for approximately two years, which further signals to us that Iron Mountain took this decision very seriously.)

Since Iron Mountain has such broad market reach, we believe its selection of Crossroads as a channel partner represents a complete validation of the StrongBox and Crossroads' ability to support it. Iron Mountain would certainly have evaluated all of the other options in the digital storage space—from Hierarchical Storage Management providers to other firms that support the LTO standard. This is a very bullish signal for Crossroads, and should reduce the risk premium investors place on its stock.

Details

Powerful Market Opportunity

This relationship should jump-start Crossroads' entry to the marketplace. Though we have not yet been able to discern exactly how the two companies will work together in the channel, we see two very plausible options.

First, Crossroads could sell StrongBoxes to Iron Mountain, and Iron Mountain could use those StrongBoxes to offer its customers remote data archival that is always online. Alternatively, Crossroads could use Iron Mountain as a go-to-market partner, and sell StrongBoxes directly to Iron Mountain's customers; in that scenario, Iron Mountain would largely provide support services to the customers, including data ingestion, data retention policies, and troubleshooting.

Considering the size and composition of Iron Mountain's customer base, either model represents a huge opportunity for Crossroads. We will continue to monitor as Crossroads and Iron Mountain disclose details about the specific economics of their business partnership. In any case, however, we believe that the market opportunity inherent in this agreement should reduce the risk premium investors place around Crossroads successfully entering the marketplace with StrongBox.

Cash Position

The additional funding will provide strength to Crossroads' balance sheet, which will be critical as the Company continues to pursue enterprise sales. As we noted in our initiation report on Crossroads dated June 1, 2012, it is often important for enterprise players to see that its suppliers have strong financial positions, so they know that these suppliers will survive to provide ongoing product support. The addition of \$5.2 million in cash to the Company's account serves to strengthen its financial position and extend its cash runway, which should have a positive impact on its ability to attract customers going forward.

Risk Factors

Competitive Risk

The data storage market is very competitive, and includes large enterprise level players in both tape-based and disk-based storage solutions working to develop and enhance new technologies. Data storage players include both LTFS vendors (such as IBM and Quantum) as well as traditional, disk-based hierarchical storage management (“HSM”) vendors.

The storage business is an important one for many of these large players. So we expect they will exert their market power and resources to defend and grow their market position. If Crossroads is able to continue to generate positive momentum by making more announcements like the Iron Mountain agreement, that would serve to diminish this risk.

Customer Acquisition Risk

Enterprise customers may be reluctant to award a major contract to a company as small as Crossroads. However, we note that the Iron Mountain agreement, as well as Crossroads’ other recent channel partnerships with Fujitsu and Fujifilm, mitigate this risk by providing significant technology validation and putting the face of a larger, more established company on Crossroads’ technology.

Marketing Risk

Crossroads will have to make a compelling case differentiating StrongBox from the other LTFS and HSM products in order to gain traction in the marketplace. It clearly was able to do so with Iron Mountain; however, if the Company is unable to continue to educate its target customers on the benefits of its technological advantage, the value of that advantage may diminish.

Sales Risk

In addition to pursuing channel partners such as Iron Mountain, Crossroads is currently in the process of scaling up a team to sell StrongBox direct to end users. If the Company is unable to adequately staff, train, and deploy this sales force in a timely manner, this could undermine its ability to sell StrongBox in the near term.

Financing Risk

Though the Company may not need to significantly increase its capital expenditures to support the growth of StrongBox, it will need to increase operating expenses with respect to headcount to build its direct sales force. The cash proceeds from the Iron Mountain agreement should help mitigate this risk. In addition, Crossroads is pursuing a sale of key data storage patents for its legacy products (the “972 Patent Family”), which should provide more growth capital.

Management Risk

Crossroads’ management has demonstrated its strength in the development phase of its technology. We also believe that the Iron Mountain agreement demonstrates management’s capability to transition to a commercialization phase. However, investors should consider the risks inherent in this transition.

Licensing Risk

Crossroads is currently involved as plaintiff in two separate patent lawsuits regarding the 972 Patent Family. A negative judgment in these lawsuits may diminish its ability to further secure licensing revenues and impair the planned sale of the 972 Patent Family.

Risk Factors

Key Customer Risk

A significant portion of Crossroads' current revenue comes from HP. However, these revenues are from the Company's legacy products. The fact that the focus of Crossroads' business going forward will be on StrongBox mitigates this risk significantly.

Disruptive Technology Risk

The storage industry is a place of significant innovation, which means there is always a risk that new technologies might disrupt the way we think about storage altogether. This is a risk to Crossroads, much as it would be to any enterprise storage provider.

Crossroads Systems, Inc.: Historical Balance Sheet														
(\$ in thousands)	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12
Assets														
Cash & Near Cash Items	5,888	5,285	5,623	5,297	5,851	6,588	6,152	13,811	14,703	8,513	4,591	7,336	7,227	9,544
Short term Investments	-	-	-	-	-	-	-	-	-	4,200	4,864	3,385	1,992	350
Accounts & Notes Receivable	4,173	3,758	3,480	5,124	2,124	2,452	2,817	5,607	2,953	2,840	2,599	2,659	2,943	2,343
Net Inventories	252	155	147	111	91	106	68	93	167	164	287	188	350	284
Other Current Assets	257	350	262	423	424	299	304	293	227	1,286	872	297	272	310
Total Current Assets	10,570	9,548	9,512	10,955	8,490	9,425	9,341	19,804	18,050	17,003	13,213	13,865	12,784	12,831
Net Fixed Assets	1,283	1,107	986	830	723	653	596	575	610	1,188	1,262	1,320	1,274	1,474
Net Intangible Assets	2,297	2,032	1,767	1,502	1,237	972	707	739	427	204	157	110	63	16
Investment in Subsidiaries	968	968	940	940	940	940	940	-	-	-	-	-	-	-
Other Long-Term Assets	75	69	69	69	57	56	57	60	55	57	64	56	34	38
Total Long-Term Assets	4,623	4,176	3,762	3,341	2,957	2,621	2,300	1,374	1,092	1,449	1,483	1,486	1,371	1,528
Total Assets	15,193	13,724	13,274	14,296	11,447	12,046	11,641	21,178	19,142	18,452	14,696	15,351	14,155	14,359
Liabilities & Shareholders' Equity														
Accounts Payable	889	864	1,030	1,036	550	1,073	884	990	663	1,803	1,128	2,228	821	1,060
Accrued Expenses	1,381	1,264	1,629	1,877	1,209	1,436	1,459	2,271	1,617	1,524	1,612	2,156	1,675	2,579
Accrued Warranty Costs	30	28	22	18	16	19	28	-	-	-	-	-	-	-
Deferred Revenue	261	362	333	199	185	307	1,510	1,517	1,250	2,315	1,567	1,009	1,528	1,437
Other Short-Term Liabilities	2,024	2,024	1,973	1,973	1,973	1,973	1,973	1,973	1,973	1,973	1,973	1,973	2,597	2,927
Total Current Liabilities	4,585	4,542	4,987	5,103	3,933	4,808	5,854	6,751	5,503	7,615	6,280	7,366	6,621	8,003
Long-Term Liabilities	-	43	81	59	110	105	88	103	112	35	127	126	1,629	2,134
Total Long-Term Liabilities	45	43	81	59	110	105	88	103	112	35	127	126	1,629	2,134
Total Liabilities	4,630	4,585	5,068	5,162	4,043	4,913	5,942	6,854	5,615	7,650	6,407	7,492	8,250	10,137
Total Equity	10,563	9,139	8,206	9,134	7,404	7,133	5,699	14,324	13,527	10,802	8,289	7,859	5,905	4,222
Total Liabilities & Equity	15,193	13,724	13,274	14,296	11,447	12,046	11,641	21,178	19,142	18,452	14,696	15,351	14,155	14,359

Crossroads Systems, Inc: Historical Income Statement

(\$ in thousands, except per share data)	1Q09A	2Q09A	3Q09	4Q09	FY09	1Q10	2Q10	3Q10	4Q10	FY10	1Q11	2Q11	3Q11	4Q11	FY11	1Q12	2Q12
Total Revenue	3,246	3,737	3,861	6,004	16,848	2,722	5,043	3,159	5,444	16,368	3,601	2,577	2,577	6,232	14,987	2,579	3,453
Cost of Revenue	653	572	594	848	2,667	265	1,071	429	727	2,492	503	367	297	1,498	2,665	317	392
Gross Profit	2,593	3,165	3,267	5,156	14,181	2,457	3,972	2,730	4,717	13,876	3,098	2,210	2,280	4,734	12,322	2,262	3,061
Sales and marketing	1,564	1,453	1,164	1,210	5,391	1,323	1,322	1,217	1,409	5,271	1,215	1,175	1,295	1,533	5,218	1,409	1,534
Research and development	2,487	2,267	2,320	2,309	9,383	2,280	2,185	2,129	2,312	8,906	2,117	2,820	2,917	2,847	10,701	2,757	2,662
General and administrative	233	559	460	572	1,824	662	570	579	812	2,523	647	835	665	1,010	3,157	762	833
FAS 123R and stock based compensation	283	118	191	-	592	-	-	-	-	-	-	-	-	-	-	-	-
Business restructuring expense	217	-	-	-	217	-	-	-	-	-	-	-	-	-	-	-	-
Amortization of intangibles	284	265	265	265	1,079	312	312	312	312	1,248	312	224	47	48	631	47	47
Total Operating Expenses	5,068	4,662	4,400	4,356	18,486	4,577	4,389	4,237	4,845	18,048	4,291	5,054	4,924	5,438	19,707	4,975	5,076
Operating Income (Loss)	(2,475)	(1,497)	(1,133)	800	(4,305)	(2,120)	(417)	(1,507)	(128)	(4,172)	(1,193)	(2,844)	(2,644)	(704)	(7,385)	(2,713)	(2,015)
Interest income (expense), net	(22)	(48)	(7)	(25)	(102)	(24)	(23)	(24)	(42)	(113)	(31)	(24)	(29)	(20)	(104)	(50)	(53)
Other income (expense)	-	-	-	(0)	(0)	-	-	-	(1)	(1)	(7)	-	-	1	(6)	14	1
Income (Loss) before income taxes	(2,497)	(1,545)	(1,140)	775	(4,407)	(2,144)	(440)	(1,531)	(171)	(4,286)	(1,231)	(2,868)	(2,673)	(723)	(7,495)	(2,749)	(2,067)
Provision for (benefit from) income taxes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income (Loss)	(2,497)	(1,545)	(1,140)	775	(4,407)	(2,144)	(440)	(1,531)	(171)	(4,286)	(1,231)	(2,868)	(2,673)	(723)	(7,495)	(2,749)	(2,067)
EPS diluted	(\$0.35)	(\$0.21)	(\$0.16)	\$0.11	(\$0.61)	(\$0.29)	(\$0.06)	(\$0.20)	(\$0.02)	(\$0.56)	(\$0.12)	(\$0.27)	(\$0.25)	(\$0.07)	(\$0.69)	(\$0.25)	(\$0.19)
Weighted Average Shares fully diluted	7,198	7,242	7,276	7,349	7,258	7,300	7,533	7,607	7,834	7,586	10,669	10,711	10,868	10,908	10,820	10,974	11,048

Crossroads Systems, Inc.: Historical Statement of Cash Flows

(\$ in thousands, except per share data)	1009	2009	3009	4009	FY09	1010	2010	3010	4010	FY10	1011	2011	3011	4011	FY11	1012	2012
Cash From Operating Activities																	
Net Income	(2,497)	(1,545)	(1,140)	775	(4,407)	(2,144)	(440)	(1,531)	(171)	(4,286)	(1,231)	(2,868)	(2,673)	(724)	(7,496)	(2,749)	(2,067)
Depreciation & Amortization	232	224	202	181	839	163	148	127	115	553	100	127	149	159	535	161	175
Business restructuring expenses	217	-	-	(217)	-	-	-	-	-	-	-	-	-	-	-	-	-
Amortization of intangible assets	284	265	265	265	1,079	312	312	312	312	1,248	312	224	46	48	630	47	47
Loss (gain) on disposal of fixed assets	-	-	1	-	1	-	-	-	-	-	6	-	-	-	6	(15)	-
Stock based compensation	283	119	190	124	716	392	124	55	193	764	82	83	137	575	877	763	416
Provision for doubtful accounts receivable	1	1	-	(72)	(70)	(12)	(2)	(2)	-	(16)	-	1	-	(9)	(8)	33	(3)
Provision for excess and obsolete inventory	24	32	51	1	108	(2)	(4)	28	(2)	20	-	(3)	4	4	5	-	-
Changes in Non Cash Capital	380	250	704	(1,569)	(235)	2,174	748	729	(2,113)	1,538	1,856	707	(558)	1,564	3,569	(1,480)	1,539
Cash From Operations	(1,076)	(654)	273	(512)	(1,969)	883	886	(282)	(1,666)	(179)	1,125	(1,729)	(2,895)	1,617	(1,882)	(3,240)	107
Cash From Investing Activities																	
Purchase of Property and Equipment	(71)	(53)	(79)	(13)	(216)	(85)	(78)	(69)	(88)	(320)	(142)	(702)	(223)	(222)	(1,289)	(119)	(371)
Purchase of held-to-maturity investments	-	-	-	-	-	-	-	-	-	-	-	(4,511)	(2,159)	-	(6,970)	(185)	-
Maturity of held-to-maturity investments	-	-	-	-	-	-	-	-	-	-	-	311	1,495	1,478	3,284	1,578	1,642
Cash From Investing Activities	(71)	(53)	(79)	(13)	(216)	(85)	(78)	(69)	(88)	(320)	(142)	(4,902)	(887)	1,256	(4,675)	1,274	1,271
Cash from Financing Activities																	
Proceeds from issuance of common stock	1	-	-	-	1	-	-	-	9,178	9,178	1	58	3	82	144	34	107
Proceeds from borrowing on term loan	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2,000	1,000
Paydown of Line of Credit	-	-	(51)	-	(51)	-	-	-	-	-	-	-	-	-	-	-	-
Cash from Financing Activities	1	-	(51)	-	(50)	-	-	-	9,178	9,178	1	58	3	82	144	2,034	910
Effect of exchange rate on cash	(52)	104	195	198	445	(244)	(92)	(64)	235	(165)	(92)	383	(144)	(210)	(63)	(177)	29
Net Changes in Cash	(1,198)	(603)	338	(327)	(1,790)	554	716	(415)	7,659	8,514	892	(6,190)	(3,923)	2,745	(6,476)	(109)	2,317

Disclosures

Analyst Certification

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Headquarters

401 Wilshire Boulevard
Suite 1020
Santa Monica, CA 90401
310.526.5000

New York

1350 Avenue of the Americas
2nd Floor
New York, NY 10019
310.526.5000

Managua

Embajada de Mexico,
una cuadra arriba,
a la esquina, casa #100
Managua, Nicaragua
310.526.5000



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