**BUY**
**USD 29.81**

**MID CAP**

# SmartForce

**SMTF**

## Highlights from Management's Presentation at the CSFB Global Services Growth Conference in Phoenix, Arizona

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- Greg Priest, SmartForce's president and CEO, and David Drummond, the CFO, presented to a standing-room only crowd at the CSFB Global Services Growth Conference in Phoenix, Arizona, on Tuesday, March 20.
- Management provided an upbeat presentation, painting a positive outlook for the company as well as the industry in general. We continue to be impressed with this well-run e-learning company, and we are comfortable with our near-term projections, which are within the company's previously released guidance.
- The stock was under significant pressure on March 20, down almost 20% at one point, but we remain confident that our investment thesis is intact, and we address investor concerns in the balance of this report.
- We believe there is solid visibility to our first quarter 2001 revenue and EPS estimates of $60 million and $0.03, respectively. We reiterate our Buy rating.

| Price 3/20/01[1] | Target (12 Months) | Dividend | Yield | Mkt. Value (Millions) | 52-Week Price Range |
|---|---|---|---|---|---|
| USD 29.81 | $56 | — | — | $1,544.2 | $60.88–27.38 |

| | Annual EPS | Prev. EPS | Abs. P/E | Rel. P/E |
|---|---|---|---|---|
| **12/02E** | $0.72 | — | 41.4X | 225% |
| **12/01E** | 0.30 | | | |
| **12/00A** | (0.39) | | | |

| | March | June | September | December | FY End |
|---|---|---|---|---|---|
| **2001E** | $0.03 | $0.06 | $0.08 | $0.13 | Dec. 31 |
| **2000A** | (0.20) | (0.15) | (0.06) | 0.01 | |

| | | | | | |
|---|---|---|---|---|---|
| **ROIC (12/01E)** | 16.0% | **Total Debt** | — | **Book Value/Share (12/00)** | $4.19 |
| **WACC (12/01E)** | 13.7% | **Debt/Total Capital** | — | **Common Shares** | 51.8 mil. |
| **EP Trend[2]** | Positive | **Est. 5-Yr. EPS Growth** | 30% | **Est. 5-Yr. Div. Growth** | — |

[1]On 3/20/01 DJIA closed at 9720.3 and S&P 500 at 1142.6.
[2]Economic profit trend.

**SmartForce, formerly CBT Systems, is a leading provider of integrated e-learning solutions to Global 3000 corporations. The company provides an e-learning platform that helps businesses deploy soft skills, business skills, and IT training, as well as customer-specific content, to an extended enterprise of employees, customers, suppliers, and other business partners.**

## Investment Summary

Greg Priest, SmartForce's president and CEO, and David Drummond, the CFO, presented to a standing-room only audience at the CSFB Global Services Growth Conference in Phoenix, Arizona, on Tuesday, March 20. Management provided an upbeat presentation, painting a positive outlook for the company as well as the industry in general. We continue to be impressed with this well-run e-learning company, and we are comfortable with our near-term projections, which are within the company's previously released guidance. We believe the company is gaining traction in the rapidly emerging e-learning industry. In fact, management noted that it has yet to experience any negative effects of the slowing U.S. economy, a situation we intend to watch closely.

### Highlights from SMTF's Presentation

- As recently as a couple of years ago, third-party providers such as SMTF could reach only a small portion (approximately 5-10%) of the $100 billion U.S. corporate training market. The company mentioned several fundamental dynamics that are "opening up" the rest of the training market. These include shorter business life cycles, a greater focus by companies on core competencies, companies pursuing new business strategies and mission-critical initiatives, the emergence of the extended enterprise, and an increased globalization of business.

- SMTF's growth strategy includes building out its e-learning architecture, migrating its existing customers from its legacy behind-the-firewall solution (long term approximately 20% of revenues) to e-learning, and significantly growing the average contract size.

- The company mentioned that it is winning larger contracts for two main reasons: (1) it is selling new products it did not have before, such as its new e-learning platform and tools; and (2) it is moving beyond the HR and IT departments to sell into different budgets within a corporation by offering a more strategic-value proposition.

- The business model shift toward e-learning gives the company a better opportunity to move into several new markets, including (1) small and medium businesses, (2) extended enterprises, (3) the consumer/OEM market, (4) e-learning infrastructure sales, and (5) emerging international markets (Asia-Pacific and Latin America).

- Management responded to a question from the audience regarding downtime at SMTF's Web site in January 2001. At that time, a 400% increase in customer traffic, due to several new customer rollouts, caused its service to be lower than normal. At present, the company reported that its ASP uptime is in the high 90% range.

- SMTF reiterated previously announced financial guidance, including revenue and EPS estimates for 2001 and 2002. In addition, the company discussed new financial metrics it plans to release, such as the amount of backlog for the upcoming year. The company also continues to endorse high-teen operating margins by the fourth quarter of 2002.

- On the competitive front, SMTF is confident that it can compete for a complete e-learning solution (platform, content, and tools) and noted that it does not see any one competitor more than 10% of the time. For specific products, management noted that SMTF tends to compete against NETg in IT training content, SkillSoft in soft skills training content, and Saba Software in learning management systems.

- SMTF also highlighted its significant customer base of over 2,500 large corporate customers, including Dell, Safeway, Worldcom, Visa, Lucent, Microsoft, IBM, and Compaq.

### Addressing Some Investor Concerns

We believe significant volatility in the stock on March 20, with the shares trading down to $26 at one point during the day, reflected concerns in the investment community about the impact of the economy on SMTF's business trends, CD-ROM segment sales, and valuation. We provide our thoughts on these issues below.

**Contract size**

Some investors may be concerned that as the company's contract value is getting larger, corporations are more likely to walk away from these bigger ticket expenditures in a softer economy. We certainly recognize that average contract values have gone up, providing a solid backwind for SMTF. (The average contract size in the fourth quarter of 2000 was $160,000 versus only $100,000 in the fourth quarter of 1999.) We also believe the SMTF solution is quite comparable with those of other e-learning companies and other training options, but its price is lower. In fact, relative to DigitalThink (average contract size is approximately $350,000) and even SkillSoft (average contract size is about $230,000), the average SMTF contract size is considerably smaller. More important, compared with the option of spending tens of millions of dollars for travel expenditures related to classroom training, the SMTF solution becomes even more persuasive.

A weak economy could have an impact on the future bookings of e-learning companies. However, the economy has been weak for some time now, and corporate purse strings have been tight for two or three quarters. We believe e-learning companies that are presenting solutions as cost-saving initiatives are insulated against an economic downturn to some degree. SkillSoft recently posted strong results, and we expect SMTF to post in-line or better-than-consensus expectations for the first quarter.

**CD-ROM software sales**

There is also some concern that the company's CD-ROM software sales (which represent about 20% of its business) could fall off significantly in a weaker economy. Because revenues in this segment are recognized upon shipment, such a fall-off could have a negative impact on revenues and earnings in the current quarter. However, it is important to remember that this product sells at an even lower price point than SMTF's other solutions, and we believe approximately 50% of this business is retail. As a result, an absolute stop in orders is unlikely. We do expect this business to deteriorate because of a shift to Web delivery, but we have modeled the expected erosion into our forecasts over a four-year horizon. We consider our 2001 revenue forecast for this segment conservative, and note that we are actually $7 million below company guidance.

**Valuation**

While on a relative EBITDA or PEG basis SMTF may appear somewhat expensive, we prefer to value companies using a discounted cash flow (DCF) model. By doing so, we bypass the difficult adjustments needed to address the change in revenue recognition that occurred in 2000. Recall that SMTF's accounting change depresses current revenues but generates a substantial backlog that provides more visibility to the business. The policy change affected revenues and EPS but does not have an impact on cash flow.

We believe our DCF analysis also better incorporates important variables (revenue growth, profitability, capital expenditures, working capital requirements, and the required rate of return demanded by investors) to derive intrinsic value. Our DCF analysis assumes revenue growth of 60.9% and 39.5%, operating margins of 2.4% and 9.6%, and capital expenditures of $19.1 million and $21.3 million in 2001 and 2002, respectively, and a discount rate of 13.7% based on the expected cost of capital. In our opinion, the assumptions that drive our $56 price target are achievable and provide a realistic forecast of SMTF's operations. While we are comfortable with our cash flow assumptions, we also recognize that our calculation for the company's required rate of return is the most subject to fluctuation. We believe our assumption is fair, but we have provided the following sensitivity analysis to show investors how a change in our discount rate affects our price target.

**Exhibit 1**
**Cost of Capital Sensitivity Analysis**
appreciation potential based on March 20, 2001 closing price of $29.81

| Cost of Capital | 9-Month Price Target | Potential Appreciation |
|---|---|---|
| 10.7% | $96 | 230% |
| **13.7%** | **$56** | **88%** |
| 16.7% | $38 | 28% |
| 19.7% | $28 | -6% |

Source: CSFB analysis.

As shown above, our DCF-based price target can fluctuate meaningfully with changes in the cost of capital. A 300-basis-point decrease in the cost of capital moves our price target to $96, while a 300-basis-point increase pushes our target down to $38. A 19.5% discount rate equates to the current market price on our estimates for the company's future discounted cash flows. Nonetheless, we believe that our 13.7% assumption is a fair rate and maintain our $56 price target.

## Conclusion

We acknowledge that the slowdown in the U.S. economy could have a negative impact on e-learning companies, and we intend to monitor this situation closely. However, at this point, our analysis suggests that SMTF remains on track to reach our estimates.

Based on SMTF's upbeat presentation and our analysis, we believe the current price represents a good entry point for investors. We are comfortable with the visibility of the business model at this point, and we continue to project first quarter revenue and EPS estimates of $60 million and $0.03, respectively. In addition, we forecast revenues of $271 million for 2001 and $378 million for 2002. We expect these revenues to generate EPS of $0.30 in 2001, rapidly ramping up to $0.72 in 2002. We reiterate our Buy rating.

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