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Software

E-Business Software Earnings Preview: Preannouncement Parade

- The March quarter was perhaps the most difficult environment we have seen for enterprise software in recent memory. More than 30 prominent software concerns, including Ariba, Commerce One and i2, issued warnings that quarterly results would be worse than originally expected.
- IT spending slowed dramatically across regions, industries and products. Based on anecdotal evidence, the environment grew progressively more difficult in March.
- Expect companies that have not already preannounced to meet expectations with little or no upside to published estimates.
- Discerning company-specific execution difficulties becomes key as each company has an economic excuse to which it can lay claim. Metrics such as deferred revenues and channel productivity should offer insight into relative performance.
- Cost cutting initiatives will rule the day, but deep cuts need to be analyzed in the context of their impact on company growth.

Industry Overview

This quarter distinguished itself as perhaps the most difficult environment for enterprise software spending in recent memory. More than 30 prominent names in software have so far issued warnings that results would be worse than originally expected. In the majority of cases, pipelines remained strong, but closure rates declined precipitously. This has led to a lack of visibility into future sales which we expect to persist into next quarter. We have compiled a list of selected preannouncements in the sector, which we believe underscores the pervasive impact economic conditions have had on sales.

For a complete list, please visit: http://www.epoch.com/research_center/pov/pov_details_sw_note010409.html.

For those companies that have not yet preannounced, we expect little or no upside to published estimates. A handful of companies, including BMC Software and Peregrine Systems, have preannounced results that meet current expectations. Even so, these companies are reporting tougher conditions and many are undertaking cost-cutting measures similar to those of companies that fell short of Street expectations.

We believe all areas of software have been affected by the economy, whether they make their numbers or not. Invariably, slowing sales have occurred across product lines, geographies and verticals. Some segments have held up better than others with supply chain solutions doing relatively well while eCRM companies suffered disproportionately. Companies are reporting that, with the notable exception of Japan, international conditions appear to be weakening as well. Pricing does not appear to be a critical factor on whether or not deals are consummated and we expect to see minimal margin pressure as a result.

A key challenge this quarter will discerning the company- or industry-specific difficulties from those caused by a wider economic malaise. Investors will do well to consider this as companies that continue to execute and build strong pipelines will benefit first and foremost from a rebound in spending that we think may happen as early as the December quarter. Key factors such as shifts in deferred balances, performance of sales channels and days sales outstanding (DSOs) will help distinguish those with stronger prospects.

We expect that cost cutting measures including product rationalization will continue to be a common solution to weaker top-line

prospects. Not all workforce reductions are the same. In some cases, these cuts reflect a reduced long-term business opportunity where companies have endeavored to do too much, too soon. In others, layoffs cull under-performers, preserving cash and the company's ability to grow given a rebound in IT spending. In some instances, we think more reductions may be necessary for companies to achieve sustainable models. Lastly, cash becomes a consideration in an uncertain spending environment. We like companies with strong balance sheets that afford some flexibility in pursuit of long-term business objectives.

When corporations do open the purse strings, software companies will be immediate beneficiaries. Earnings will rebound rapidly because there is no secondary market, few inventory issues and no impediments to delivering product. Therefore, software companies should be purchased at the first indication of improving economic conditions.

Company Discussions

Ariba (NASDAQ: ARBA, $5.06)

On April 2, Ariba reported significantly lower revenues -- $90 million. Our already-lowered estimate was $174 million. Licenses came in particularly weak at $55-$60 million (at 61%-67% of revenues -- well below its historical mix of 75%), less than half of our $130 million estimate. We think the results show Ariba's marketplace opportunity has all but disappeared. In prior quarters licenses represented approximately 40% of the business. Based on this reduced business opportunity, the company plans to cut its workforce by 30%.

Bottom Line: We do not recommend purchase of Ariba shares given difficulties with its product focus, namely those surrounding its marketplace business. With a strong balance sheet of more than $400 million, we believe Ariba has time to restructure, but this will mostly likely take several quarters.

Commerce One (NASDAQ: CMRC, $6.66)

On April 3, Commerce One announced preliminary 1Q results that, despite being below expectations, were respectable given the economic environment. Revenues of $170 million and operating EPS of ($0.11) came in lower than our modestly reduced estimates of $190 million and ($0.08) and original company guidance of $200 million to $210 million and ($0.04). The company noted that licenses, which were $70 million in the quarter (we estimated $87 million), accounted for a majority of the weakness. There was also some slowing in the professional services side of the business. Many metrics to evaluate the company's performance in the quarter are not yet available. The amount of deferred and SAP channel revenue recognized in the quarter will be important metrics to understand.

Bottom Line: Commerce One's leadership in the marketplace business is encouraging, but investors need to review more metrics on its performance in the quarter. If the company has a favorable balance in its customer base and other metrics are in-line with past results, investors should see some lift in the stock.

Corio (NASDAQ: CRIO, $1.78)

As one of the few publicly traded, fully funded ASP businesses in existence, we believe Corio remains well positioned to reach the milestones necessary for success. We believe that continued dot-com fallout will be more than offset by a modest number of new, larger customers. As the shakeout continues for lesser ASPs, Corio will experience a relative competitive benefit. In a slowing spending environment, the economics of hosted applications look more attractive. In the long term, this may drive increased interest in the model. We are comfortable with our applications management services (AMS) revenue estimate of $8.3 million (a conservative increase of $1.5 million over last quarter, down from an increase of $2.5 million in the quarter before that), which represents the recurring hosting fees Corio collects. The company is transitioning the professional services side of its business to integrator partners, and we are accordingly placing less emphasis on our $6.5 million estimate.

Bottom Line: If Corio demonstrates progress towards operating break-even with a modest increase in AMS revenue, we believe the quarter should be viewed a success. So long as its stock price trades below $8, we think the company enjoys a window in which it can build sustainable competitive advantages in the ASP space.

i2 Technologies (NASDAQ: ITWO $18.30)

i2 reported preliminary results for its 1Q on April 2 before the market opened. The company expects licenses to total $210 million, with revenues of $355 million. This exceeded our reduced estimates of $204 million and $343 million, respectively. i2 anticipates EPS of $0.02 Our estimate is $0.03. i2 also announced it will be pursuing a 5%-10% cost structure reduction with an associated 2Q restructuring charge, which will involve layoffs of up to 10% of its 5,100-member workforce spread evenly across departments and geographies. These reductions would effectively reverse the hiring done this quarter (some 500 people). i2 attributed its results to lower-than-expected close rate among customers across almost all geographies. Since many large contracts have been signed

without the receipt of cash, attention should be paid to any detail given on the company's sizeable off-balance sheet backlog.

Bottom Line: i2 appeared to fare better than most this quarter, supporting our view that supply chain spending is resilient but not immune to economic conditions. We believe the company is well positioned for an eventual uptick in IT spending as its pipeline continues to build, but we expect that stock to trade in line with the rest of the market until conditions improve.

MRO Software (NASDAQ: MROI, $7.76)

MRO Software had much less risk in its quarter than most enterprise software companies. We believe the company made its quarter based on continued spending on mission-critical MRO solutions and lowered expectations for the company as it undertakes repositioning initiatives around its traditional Maximo solution and its MRO.com procurement offering. Upside to our license estimate of $15.5 million will indicate the company is gaining traction here faster than anticipated. Traction in key verticals such as energy/utilities and defense could drive upside.

Bottom Line: There is little risk to quarterly results, so we feel investors can purchase the stock ahead of the quarter. That said, the value in the story is long-term and investment horizons should match this outlook.

Pivotal (NASDAQ: PVTL, $10.76)

We think the eCRM side of Pivotal's product line, which is just starting to gain traction, was weak this quarter. However, we think its traditional sales force automation product will continue to do well in the mid-market as companies here are under less pressure to forestall IT efforts. Pivotal, which guided expectations down last quarter, also has a significant international presence for a mid-market vendor, which we believe will help offset delays in North America.

Bottom Line: The company won't disappoint in the quarter, but the eCRM traction it needs to fuel larger ASPs and continued growth will be stunted by the macro climate.

Epoch Partners has been an underwriting manager or co-manager of Corio, Inc. in the last three years. The analyst(s) involved in the preparation of this report has an investment position in the subject security. (CRIO). The analyst(s) involved in the preparation of this report has an investment position in the subject security. (MROI). The analyst(s) involved in the preparation of this report has an investment position in the subject security. (ITWO).

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