

e-learning - Is this the bottom?

by Peter Alternative

As e-learning investors continue to head for the doors, we thought it timely to explore the future of e-learning. To that end, Mirus looked at several baskets of e-learning stocks relative to the NASDAQ and analyzed operating performance relative to several enterprise software peer groups. In addition, we polled numerous buyers that attended the recent e-learning expo in Washington, D.C., and interviewed executives from many of the leading private e-learning infrastructure companies, such as Boston-based Learning Management System (LMS) player, THINQ. What follows is a synopsis of the more comprehensive report that will be released this summer by Mirus' Software Group. The report will assess in greater detail whether the public markets present an accurate picture of the long-term viability of e-learning technology companies.

Through our extensive research, Mirus learned that e-learning **does not** appear to be the next casualty of the Internet bubble. Rather, it is an oversubscribed, yet emerging and increasingly mission-critical, component of an enterprise's infrastructure that is going through the normal growing pains of early adolescence.

MIRUS KNOWLEDGE CHAIN SEGMENTATION

In order to evaluate public market performance, Mirus has segmented the e-learning market in terms of what vendors do. The three categories that make up the Mirus Knowledge Chain include Content, Infrastructure and Collaboration as illustrated below.





CEB
 DigitalThink
 Factset Research Systems
 Healthstream
 Learning Tree Int'l
 New Horizons
 Prosoft
 Provant
 Skillsoft
 Smartforce

DESCRIPTION:

With compelling content (off-the shelf or custom) being the lifeblood of any e-learning initiative, service providers hold key strategic customer relationships that have enabled leaders, such as Skillsoft, to reach profitability and generate more consistent performance.

WILD CARD:

Content providers are facing uncertain times as buyers move away from the content library model, deciding instead to cherry pick content from a variety of vendors. Also, with content interoperability gaining steam, content providers fear losing control of their customer relationship to the infrastructure players and thus have pushed their own proprietary light LMS/portal products.



Click2Learn
 Centra
 iManage
 Saba
 DigitalThink
 Autonomy
 Docent
 Mentergy

DESCRIPTION:

We have started to see tighter integrations between LMS (manage & measure) and LCMS learning content management system (create & deliver) vendors, both through partnering and acquisition. LCMS are used to author, manage, and deliver learning content, while LMS are used to manage the various training, administrative and assessment elements that enable organizations to track learner progress.

WILD CARD:

While the value of the authoring side of the LCMS solution is ringing true as organizations look to include the average business user in the content creation process, the longer-term viability of the content management side of LCMS is questionable at best. Mirus believes that at the enterprise level content management, including learning content, will be handled by the enterprise players such as Documentum and Interwoven, both of which have existing LMS relationships. We also see low survival rates in the oversubscribed LMS space with food for 10% of the approximately 70 + vendors existing today.



ACT Teleconferencing
 Arel Communication
 Ezenia
 First Virtual Comm.
 Latitude Comm.
 Polycom
 Raindance
 RWD Tech
 Webex
 Wire One

DESCRIPTION:

These are the horizontal synchronous and asynchronous communication, collaboration and community players that form a hub of interconnectedness bringing together remote parties to communicate, collaborate, capture, enhance and extend knowledge.

WILD CARD:

Led by players like Webex and Centra, vendors are beginning to create seamless platforms that marry synchronous and asynchronous communication, learning and knowledge management, where otherwise one-time disconnected events are turned into opportunities to automate knowledge capture and reuse. Mirus foresees an integrated communication and collaboration environment where content is captured within the context of the larger collaborative framework and made available to be referenced and mined so that any user can immediately establish what was discussed, decided and, most importantly why.

STOCK MARKET
PERFORMANCE

As illustrated below in Exhibit 1, Mirus looked at the stock performance of our three e-learning stock baskets relative to the NASDAQ Index for a two-year period, ending April 24, 2002. Our primary goal was to assess two things. First, we wanted to establish the percentage of variability (volatility) within each basket and second, we wanted to look at each basket's beta or sensitivity to the market.

Exhibit 1: E-LEARNING PUBLIC MARKET PERFORMANCE



Mirus calculated the correlation coefficient between the NASDAQ and all of our three baskets of securities. All three baskets demonstrated a strong statistical association with the NASDAQ, with coefficients ranging from a low of 80% (content), to a high of 96% (infrastructure). The results suggest that the NASDAQ performance (which is 70% off of its March 10, 2000 high of 5048.2) explained 96% of the variability within our basket of infrastructure stocks. The analysis of the correlation coefficients, paired with the results of the regressions, suggest that much of basket poor performance can be attributed to systemic market factors that do not necessarily reflect company-specific performance.

Another relevant metric we looked at was the sensitivity "beta" of each basket's movements relative to movements in the NASDAQ. We established an average beta of 2.6, with content representing a low of 1.8 and infrastructure representing a high of 4.2. In short, with the industry in its earlier stages, few companies have reached the critical mass generally required to deliver the kind of slow and steady growth associated with lower beta stocks. Rather, our basket results were amplified upward and downward from 1.8 to 4.2., helping to explain our heightened volatility.

From our findings, we analyzed the last several quarters of operating performance of a cross section of e-learning companies to map the sector's volatility and poor stock performance with specific company operating performance.

RECENT
PERFORMANCE

The business performance and balance sheet strength for specific public companies in select enterprise software segments were analyzed and compared to the aggregated data across our focus areas, as illustrated below in Exhibit 2. The Mirus Software Group focuses on relationships within six segments of the enterprise software industry: Platform Value Chain (*Adobe, Borland, Interwoven, BEA, Akamai, etc.*); CRM (*Siebel, PeopleSoft, E.piphany, Kana, etc.*); Design Collaboration (*PTC, Agile, etc.*); Business Process Collaboration (*Manugistics, i2, Ariba, etc.*); e-learning (*Saba, Digital Think, Smartforce, Centra etc.*); and Vertical Market Applications (*Retek, JDA, etc.*). The aggregated results point toward an e-learning space that is nascent relative to its peers, lacking critical revenue mass and experiencing fairly restrained revenue growth. While e-learning's sequential Q/Q growth trailed only the vertical application group, it represented only a third of the aggregate's mean revenue of \$56 million. The group's positive operating cashflow numbers have done little to quell speculation around imminent consolidation due to high costs of capital, deflated currencies and relatively short cash positions. As we continue to see both within the e-learning sector and across enterprise software in general, companies continue to unwind the excess capacity invested in anticipation of demand that never materialized. The broad-based retrenchment from the e-learning sector not only prompted the decision for Smartforce and Centra to walk away from their proposed merger but also led both companies to announce workforce reductions of 20% and 10% respectively. As Leon Navickas explained on Centra's Q1 conference call, "the merger was an attempt to consolidate two industry leaders to reduce the confusion in the market." Unfortunately, buyers have added to the market's confusion by signaling their interest in increased stability through consolidation, while continuing to proactively minimize their exposure to any one vendor.

Exhibit 2: RELATIVE GROWTH & CASH FLOW ANALYSIS

Company	Revenue				Operating CF				Cash
	Q2	Q3	Q4	Q/Q	Q2	Q3	Q4	Q/Q	St. Inv.
	\$c	\$c	\$c	%	\$c	\$c	\$c	%	\$MM
<i>Mirus Select Enterprise Software Groups</i>									
eLearning	\$17.0	\$16.8	\$18.0	7%	(\$7.5)	(\$6.1)	(\$4.3)	-29%	\$46
Vertical Market Apps	\$41.7	\$41.7	\$47.0	13%	\$3.0	\$4.4	\$6.2	41%	\$82
Design Automation	\$112.6	\$107.9	\$111.4	3%	\$2.3	(\$2.3)	(\$1.1)	-54%	\$225
Platform Value Chain	\$93.1	\$84.9	\$79.5	-6%	\$12.8	\$8.9	\$12.1	37%	\$299
Business Collaboration/SCM	\$88.2	\$66.0	\$62.6	-5%	(\$2.4)	(\$15.6)	(\$12.4)	-21%	\$238
CRM	\$18.9	\$15.9	\$16.7	5%	(\$11.5)	(\$8.8)	\$88.1	NM	\$66
Aggregate Mirus Select Software	\$76.7	\$68.9	\$55.5	\$2.6	(\$2.8)	(\$1.8)	(\$4.4)	\$113.4	\$171
Mean:	\$62	\$56	\$56	-10%	-\$1	(\$3.3)	\$15	-5.03%	\$160

1. These numbers are based upon the mean excluding the maximum and minimum values from each group.
2. CRM metrics exclude outlier values from Siebel, PeopleSoft, SAP and Oracle although all three have CRM product offerings.
3. Information based on actual company filings.

When we look at the detail and more specifically Q1 results, we begin to better understand the most recent sell-off. The vast majority of our e-learning sample reported disappointing results, with a mean adjusted decrease in Q/Q revenue performance of 20%. The quarter also saw four e-learning pure plays experience revenue decreases more than 30%, including Centra, Smartforce, Click2Learn and DigitalThink. Contrary to the growing buzz around end-to-end solutions, most of the vendors that came up short referred to a lack of focus, execution and need for a more simplified message as the primary reasons behind its disappointing quarterly results.

PRIVATE VENDORS
CHIME IN

Not surprisingly, the importance of a simplified message and offering was echoed by all of the leading LMS vendors we spoke to, which included THINQ, Plateau Systems and Pathlore. "At the end of the day, corporations are looking to minimize their risk when it comes to a platform deployment," explained Hemang Dave, CEO of THINQ. He added that it was this focus that enabled THINQ to land three-seven figure deals in Q1, asserting that their average deal price has been the highest in the LMS space for Q3, Q4 and Q1. Both Pathlore and Plateau Systems struck the same chord, identifying their laser-like focus on LMS as one of the keys to their respective successes in the market.

Exhibit 3: DETAIL GROWTH & CASH FLOW ANALYSIS

Company	Symbol	Revenue					Operating CF			
		Q2	Q3	Q4	Q1	Q/Q	Q2	Q3	Q4	Q/Q
		\$s	\$s	\$s	\$s	%	\$s	\$s	\$s	%
Centra Software, Inc.	CTRA	\$9.8	\$9.2	\$11.0	\$7.5	-19%	(\$3.4)	(\$5.4)	\$1.3	124.69%
Click2Learn, Inc.	CLKS	\$11.7	\$11.2	\$11.5	\$7.5	-33%	(\$4.4)	(\$2.8)	(\$0.8)	71.13%
Digital Think, Inc.	DTHK	\$15.0	\$15.3	\$13.8	\$9.3	-39%	(\$4.6)	(\$7.1)	(\$9.9)	-39.49%
Docent, Inc.	DCNT	\$8.9	\$6.0	\$7.0	\$8.0	33%	(\$12.6)	(\$11.7)	(\$11.3)	-3.80%
Raindance Communications	RNDC	\$9.1	\$10.1	\$11.2	\$13.9	38%	(\$2.9)	(\$0.5)	\$1.7	470.37%
RWD Technologies, Inc.	RWDT	\$30.4	\$28.9	\$28.3	\$29.2	1%	(\$2.2)	(\$2.0)	\$1.9	195.27%
Saba Software, Inc.	SABA	\$15.5	\$14.5	\$13.5	\$12.9	-11%	(\$8.2)	(\$5.0)	(\$4.2)	14.52%
Skillsoft Corporation	SKIL	\$8.5	\$11.2	\$15.2	NA	NA	(\$2.4)	(\$3.6)	\$1.0	127.78%
SmartForce Plc.	SMTF	\$66.1	\$68.1	\$65.3	\$43.0	-37%	\$5.7	\$1.5	(\$3.1)	-302.11%
Webex	WEBX	\$18.4	\$22.1	\$25.8	\$29.6	34%	(\$6.7)	\$1.1	\$3.9	258.18%
Mean:		\$19.3	\$19.7	\$20.3	\$17.9	-4%	(\$4.2)	(\$3.5)	(\$1.9)	45.13%
Median:		\$13.4	\$12.9	\$13.7	\$12.9	-11%	(\$3.9)	(\$3.2)	\$0.1	102.78%
Mean excl. Max & Min.:		\$17.0	\$16.8	\$18.0	\$17.9	-16%	(\$7.5)	(\$6.1)	(\$4.3)	28.80%

NOTE: Information based on actual company filings.

Both of these vendors have recently announced significant enterprise wins that provide further evidence that their narrow and deep strategy continues to ring true. Plateau recently announced the closing of a multi-year deployment at the Red Cross. From a license perspective, the Red Cross deal is the largest LMS deployment by a factor of 10, according to Plateau's CEO Brian Murphy.

Murphy was also quick to assert that the Company identified their strategy to be a leading Enterprise LMS and have never lost that focus. "The Company has also executed well," he says. In Murphy's words, "executing at large companies is where you become an Enterprise player, nowhere else." Murphy added that, of the 70 LMS players in the market, Plateau consistently sees the same 3-4 players vying for enterprise deployments.

Pathlore's VP of Strategic Development, Brendan Herron Jr., proposed a similar recipe for success. Herron specifically mentioned that product focus, execution, rapid deployment, strong customer references and a clear migration path as Pathlore's critical success factors. Pathlore closed its 2001 fiscal year (9/31) books with \$24 million in bookings and profitability. The company also reported 20% sequential Q/Q growth for its Q2, signing several new enterprise customers, including Delta Airlines. Herron explained that the Delta win was due in part to a strong reference from Southwest Airlines, a longtime Pathlore customer. In support of his claim that rapid deployment has helped the Company secure large wins, he claimed that from the February 1 signing of the contract it only took the Company seven weeks to have all of Delta's 65,000 employees up and running.

WHERE WILL THE GROWTH COME FROM?

To identify likely areas of future growth, we polled prospective e-learning buyers through informal conversations at the recent e-learning magazine conference and expo. While public sector representatives dwarfed those from the private sector, we did connect with a good sample of executives tasked with purchasing decisions for both content and technology budgets which ranged from as little as one million up to \$500M. Our anecdotal evidence consistently suggested that overall budgets were generally flat to slightly lower from their 2001 levels. However, of more interest was the consensus around the plan to reallocate overall training spending away from classroom-based training to e-learning, from approximately 10%-50% over the course of the next 2-3 years. With the training market estimated to be \$100B, we begin to understand where the much needed critical mass will come from over the next several years.

This trend is consistent with the emergence of "blended learning" (mix of instructor led training (ILT) and on-line training) as the methodology of choice for larger corporations that view on-line learning as both a replacement for and a complement to ILT. We compiled several data points that illustrated how on-line training is being used to minimize time spent in the classroom by bringing the class to a baseline of understanding before bringing in an instructor. For instance, EMC was able to turn 40 hours of classroom time into 12 hours, with a 2X improvement in throughput and an annual cost savings of \$1.8 million.

This type of increasing qualitative and quantitative ROI is driving an increasing share of both mind and wallet of C-level executives. While these tactical "low hanging" cost savings will likely drive initial deployments, Mirus believes that e-learning can play a more strategic

role within the enterprise. An example can be found at Pathlore's client Southwest Airlines, one of the only airlines to report a Q1 profit and long considered one of the best companies to work for. The Company has used its LMS to drive improved employee retention and satisfaction: if an employee is unhappy at her current job within the company, she can log onto the LMS and take a series of assessments to identify other potential jobs within the company. Once a new job area is identified, a mentor is assigned to open up a dialogue with the employee to begin the process of placing the employee in the new job area. In just 9 months, Southwest estimates the program has saved \$1.5 million. Another critical take-away from this example is that if e-learning technologies are to realize the lofty goals identified by industry pundits, vendors must work with customers that understand e-learning is about enhancing and strengthening human interactions as opposed to replacing them.

A final thought regarding growth is that we anticipate the application of e-learning technologies to better service a corporation's customers as another significant growth driver going forward. By 2003, Gartner believes that the use of e-learning will be a required process to support B2B and B2E business. This fact is one of the reasons why enterprise ERP players are entering the LMS market. ERP vendors are getting pulled into the e-learning arena because of the growing demand of larger corporations to have one database that compiles all information across the extended enterprise. The recent acquisition of LCMS provider Alvatus by Precision Response, a division of US Networks that provides outsourced CRM services, provides an interesting data point toward the application of customer learning in a call center environment. It also further signals that "outside looking players" will play a significant part in the industry's consolidation, as we saw with Sun Microsystem's acquisition of LMS-provider Isopia. With Gartner projecting that 50% of all current e-learning players will not exist by 2003, Mirus anticipates the noise and confusion in the market will persist for another year. However, as discussed in greater detail in the full report, Mirus believes that consolidation will help rationalize competition and is yet another step towards the maturing of the still adolescent e-learning sector, which is making tangible strides out of the training department and into the Board room.

For more information or a copy of the full report, please contact Peter Alternative at 617.338.1333 or alternative@merger.com.