E-FINANCE

Balance sheets will continue to be a differentiating factor.

By Peter L. Martin

As we mentioned last month, our channel checks and industry barometers are not indicating an improvement in the IT spending environment. For the most part, conditions have declined further since the May-June timeframe. We're finding that the health of a company's balance sheet has, will, and should be a differentiating factor in the sales process going forward. In these difficult times, an increasing number of prospective IT software customers are putting greater emphasis on their financial due diligence and balance sheets to ensure their vendor's long-term viability. We think that's smart of the buyers, but in some cases it will put them in a bind for choosing the best technology or best balance sheet. Here are some key indicators of trouble:

Cash. Cash is king regarding solvency, but customers shouldn't overlook a company's cash-burn rate. In this market, a firm can burn through its cash reserves quickly if it isn't careful. When cash is short, a vendor may quote working capital, which includes accounts receivable. That can be dangerous depending on the quality of the receivables.

Accounts receivable. That can be a red flag. A measure of the quality of the receivables is DSOs or "days sales out-

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standing." If that has been rising for several quarters, a vendor may be financing its sales with extended payment terms or having collection issues. Make sure a vendor's DSOs are within the industry standard range, which varies from industry to industry but shouldn't be over 90 days or concentrated with a small number of customers.

Debt. Debt levels can also be troublesome down the road for a vendor depending on the covenants, or terms, of the loan agreement. A vendor that may look modestly healthy could be put out of business quickly if it isn't in accordance with all covenants of the loan. It's important to understand the terms of the debt to assure that no issues will arise later. Debt covenants often house details that can trigger sudden action by the lender.

Deferred revenue. In some situations, deferred revenue can provide insight into a company's health. Customers should look for increases in deferred revenue as strong visibility to a company's future revenue stream. That's often the case with revenue-recognition methods of subscription and service model business.

Other items to look for in the balance sheet include capital expenditures and revenue recognition policies. They're in the footnotes of a firm's financial statements. We believe capital expenditures on research and development are important to a company's future prospects in terms of new products and continued support of existing products. In tough financial times, capital expenditure is often cut to limit cash burn. Secondly, aggressive revenue-recognition policies also provide insight into a company's integrity and financial health. Think of WorldCom. In many instances, one or several of those items has affected the choice of a vendor.

As this environment continues, it will become even more difficult for companies with weak balance sheets because customers will be making decisions not only on product strength, but also on financial viability.

Performance for the overall corporate knowledge services sector continues to be ugly. In July, the sector as a whole fell 17.2 percent as the market continued to free fall on worries about accounting and the economy. The S&P 500 declined 7.9 percent, and NASDAQ declined 9.2 percent. Corporate segments heaviest hit by the sell-off were staffing (down 21.0 percent); instructor-led training (sliding 20.6 percent); and infrastructure software and services (off 20.2 percent). We think the sell-off is justified as second-quarter results have indicated that the economy continues to affect the sales cycle and signing of purchase orders.

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There were bright spots among individual stocks. The two best-performing were Documentum and Microstrategy, both up 35 percent in July.

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