E-FINANCE

Here we go again?

By Peter L. Martin

On June 10, SmartForce and SkillSoft signed a definitive agreement to merge in a stock-for-stock transaction. That's the second potential marriage Smartforce has entered into in 2002. Its first was to Centra in January 2000, but that deal never made it to the altar as market conditions and shareholder pressure caused the union to dissipate. This new deal is structured as a merger of SkillSoft into a newly formed subsidiary of SmartForce, with SmartForce issuing shares to former SkillSoft shareholders. The key benefit of structuring the merger in that way, in our minds, is the tax benefit that the new entity should receive. The transaction is expected to close in September. Here are the pros and cons.

Pros

SkillSoft management to run day-to-day operations. Due to the recent reduction in expectations, opaqueness of financial statements, absence of a CFO, and informational hype surrounding the Centra deal, SmartForce's management team faces a challenge in renewing its credibility with investors. In contrast, SkillSoft's management has an excellent reputation due to consistent performance and ostensibly straightforward accounting practices. We, therefore, view the announced management structure for the new company as a huge positive for holders of SMTF (SmartForce).

Potential consolidator. Based on the most recently reported numbers (as of press time), the combined entity would have cash and equivalents of more than US$180 million (and very little debt). That war chest enables the combined companies to greatly expand the breadth and scope of offerings. I wouldn't put it past SKIL-SMTF management to revisit the Centra merger in the next six to eight months to expand its market opportunity, product solution set, client base, and competitive position.

Ninety-four percent margins. At the end of April '02, SkillSoft's gross margins were extremely high at 94 percent. We believe that the gross margins of the combined businesses should be higher than SmartForce's historical range of 83 to 84 percent. SkillSoft's operating methodology could provide further leverage going forward.

Elimination of redundancies and poor technologies. Due to some overlap of technologies, this merger gives the companies an opportunity to chose which technologies they'd like to keep, thereby eliminating questions regarding SmartForce's platform. The merged company will have robust development resources, reducing the need for expensive outsourced development work, which both companies have used in the past.

Cons

Why take the discount and dilution? If recent history is any indication, mergers can act as a smokescreen for underlying issues. Some SkillSoft shareholders—based on the effective discount its board and shareholders would be willing to assume due to the exchange rate of the deal—will ask why a discount and the assumption of such dilution. That's the primary negative and the reason the stock sank 30 percent on the announcement. SKIL shareholders showed their disdain for buying the problems associated with SMTF.

Write-off anxiety. We think investors will be watching merger-related write-offs carefully. If the new company's approach to write-offs is aggressive, that could create negative sentiment and negative media coverage.

Complexity of the deal. The complex structure of the deal has weighed down investor enthusiasm. A number of pending questions will need to be answered before investors are comfortable with purchasing shares of SmartForce.

Weak decimation of information. The announcement of the deal and subsequent conference call were rushed, and information wasn't presented in a clear and concise manner to alleviate investors' concerns. Although new management provided guidance, it didn't add up to previous guidance, which prompted rumors of low expectations or a cover-up of future earnings disappointment.

Overall, we view the deal between SMTF and SKIL as extremely positive for SMTF shareholders on two fronts: competitive positioning and investor perception. The merger creates the dominant player in the corporate content space—putting on notice NETG, Element K, KnowledgeNet, and other smaller providers of hard and soft skills content. The scale of the production operations, breadth of content library, cross-selling opportunities, and size of the sales team creates a significant competitive threat for other providers in the space. In addition—and almost as important as the operating synergies of this merger—this deal, if consummated and integrated correctly, will provide a breath of fresh air regarding the perception of SMTF shares by current and prospective shareholders. The stigma surrounding SmartForce's accounting and management credibility may be put to rest sooner than if the company were going forward on its own.

Near term, our enthusiasm for this deal is mitigated by the lack of any indication that a 2H02 corporate spending recovery is imminent. Further, availability and improved ease-of-use of authoring tools has increased the proliferation of internal content development efforts. Looking from the SkillSoft perspective, this deal may have been mistimed and tough to stomach on valuation from a shareholder's perspective. Long-term, it has its merits. But obviously this announcement has been detrimental to shareholder value.

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