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INVESTMENT RESEARCH

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SELL RECOMMENDATION

Cornerstone OnDemand Inc.

March 26, 2014

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SELL RECOMMENDATION

Cornerstone OnDemand (CSOD) Price: $54.28 Fair Value: $27.26

Market Value $2.8 billion

Free Cash Flow (FY2013): ($1.0MM)

Operating Cash Flow (FY 2013): $17.4MM

Operating Cash Flow (FY 2013) Adjusted for Balance Sheet Items: $1.4MM

Balance Sheet Debt (FY 2013): $220MM

Total Debt: $262MM

Q1 Release: May 1

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Summary

Sell side firms are unabashedly bullish on CSOD resulting from a glowingly positive management team not shy regarding future prospects-- in financial presentations and financial filings—supported by strong growth in GAAP revenues and profits, with forecasts of similar growth in upcoming periods. This view was reinforced by the firm's latest report for its FY 2013 in which revenues and billings grew by about 50%, and subsequent 10-K and investor call.

The bullish sell-side scenario is also centered on CSOD being touted as a remaining independent mid-sized high- growth vendor in a large universe of providers, with an ability to attract a growing customer list, as evidenced by a base of over 1600, from less than 600 three years prior.

Yet, despite the glamor, the firm has not been able to turn its growth in revenues, billings, and client base into a firm that is even a modest producer of free cash flows. When considering misclassification error, among other adjustments we make in our cash flow worksheet (Table 5)—such as principal payment on capital lease obligations being reported as a financing activity which we move to an operating activity—free cash flows become even less impressive. Central to the cash flow analysis is large stock based compensation, which during 2013 accounted for over 100% of reported cash flow from operations while reducing the tax bill by about $2MM. I believe it is essential to analyze the firm's cash flows of its basic business and with greater introspection when (a) additional long-term financing will continue to be needed and (b) it is bespoken as a potential takeover with such speculation acting as support under its current valuation.

Analysts' cash flow worksheets are incorrect. They are basing much of their analysis on EBIT which bears little relation to the firm's actual free cash flows. They are also using an incorrect WACC based on a 30% tax rate, when in fact the shield is zero. Although the interest rate on the convertible debt is low, when negotiated, this will not be the case, and in any event does not reflect the actual cost of straight debt. If analysts were to use a more accurate depiction of cost of equity capital in their discount rate models, even under highly optimistic (no room for error) free cash flow projections, such would slice at about 24% off their current valuations.[1]

As to the firm's probability of being acquired that too is quite doubtful, for such an acquisition would be substantially value-destroying (see later section, pp.9, "Case for a Buyout"). It would thus not appeal to either a financial or strategic buyer if the former was concerned with covering cost of capital, as such buyers require a real free cash flow to justify the after-tax cost of investment with leverage, not a free cash created by naïve models in popular use by analysts, such as that shown in Table 10. It is further doubtful a strategic buyer would spend on the order of $3.7 billion, as even the highest credits, like ORCL and IBM, have weighted average cost of capital (assuming 80% equity finance) in the 7% range while CSOD's free cash flow based return on invested capital (for the new owner) would be below 2% given those firms cash tax rates. As CSOD has a 14% cost of capital, based on its predictability of prospective free cash flows, a deal would be hazardous. Given all large firms speak to having a strong

[1] Analysts are using an 11.9% cost of equity capital based on a beta of 1.2. To think CSOD has less risk to cash flows than Disney, EMC, or EBay, among many others is in my opinion, nonsense.

acquisition policy and hurdle rate, a deal becomes a big underdog and **not a real prospect our research indicates any such firm surveyed would consider** for a price close to its deal value, and as similarly reflected by our valuation table.

The company (CSOD) is at a near zero tax rate, only positive due to modest franchise and foreign tax. This too would mitigate the possibility of a buyout as there are no tax savings to be had by a shifting domicile.

Share count creep continues as the firm cannot afford to repurchase shares, yet on the other hand reported cash from operations is benefitting from very generous stock based compensation programs. Over the past 2 years, the actual share count has increased from 49.4MM shares to 52.8MM, with much more share growth to come. The firm is expecting a share count of 53.3MM(weighted average during the year under GAAP) for the current year, but in reality it will be higher, I believe, by about 2 million shares when using actual shares as stated on the cover of the 10-K.

Stock based compensation has been an effectual tool for many firms, and CSOD is no exception as shares are being sold upon vesting. Over 1.3MM shares were sold by insiders over the past year with no insider buys.

The company's July 2018 convertible (at $54.04) notes bear interest of just 1.5%. Obviously, holders are currently somewhat disappointed given the recent fall in the share price. The notes can also convert if the common remains in excess of $70.25, unlikely at this stage. Given the lack of a tax shield and normal rising rates (average historical 10 year treasury of 3.92%, Table 2), interest expense would be greater than the current (2014) projected free cash flow, if current debt needed to be repaid at maturity.

The chief concern is perhaps competitive pressure. If one believes that ORCL, SAP, CRM, and many others with huge market capitalizations (many over $100 billion) who occupy the space are going to sit by and watch a firm with $52MM in equity march their clients out the door, they are mistaken. The software business is by its nature fraught with volatility, and even though CSOD's clients typically sign multi-year contracts, they can leave in a hurry. In fact, I have been told by competition, they could be "crushed "if the largest firms so choose.

If not for conversions, stock issuances, and stock based compensation, the firm would have substantial deficit equity.

CSOD has disappointed investors the past two quarters. I believe another poor quarter or two this year should begin to turn some analysts—all of whom are very bullish—away.

Background

Conerstone OnDemand delivers SaaS (software as a service), providing employers with cloud based solutions in personnel and training. The firm believes its products enable organizations of all sizes to better optimize their workforce resulting in improved business execution and customer integration, including the salesforce. They further believe their software is easier to deploy, less expensive, and easy to configure. Given the growth of firm revenues, such points are difficult to argue.

Their IPO, in March 2011, was priced at $13 with the sale of 10.5MM shares with Goldman and Barclays as joint book-running managers. The $135MM proceeds were primarily used to repay debt, selling shareholders and working capital to finance growth and losses. The initial private equity financing was provided by Bessemer Venture, Meritech and Bay Partners who received preferred shares at $1.60 and stock warrants at $2.40. At the time of the IPO, the company claimed 580 clients. Loans were also provided to senior managers prior to the IPO which were than repaid with the stock sale. All NEO's and venture firm 5% owners (Bessemer, Meritech Capital and Bay) sold shares at the IPO. Subsequently, Bessemer and Bay have sold all their shares and Mertiech, which owned 15% prior to the IPO is now down to about 6.8%, and being pared annually.

Competition

Most large competitors are recognizing the importance of SaaS and are so devoting large resources, both thru expansion of internal budgets and via acquisitions. All are currently expanding into CSOD's space. Last year Success Factors was bought out by SAP ($96 billion market cap) in a $3.4 billion deal, while Salesforce.com purchased Rypple. Oracle bought Taleo for $1.9 billion. While the latest round of acquisitions by larger players has not hurt the company to date, it can't help their position going forward as competitors are substantially stronger and gearing up.

Recruiting and training software is simply not a difficult space to enter, remaining subject to enormous pricing pressures as the field heats up. Clients with global presence are going to demand a firm with the capabilities and infrastructure to fulfill those needs, and already firms like IBM and others are penetrating emerging nations down at the university level.[2]

Yet, I find it quite interesting that in the firm's presentations, management rarely brings up the subject of competition, other than to brush it aside. **CSOD has total R&D spending of just $21MM, compared to over $3billion for SAP and $4.5 billion for ORCL.** Workday Solutions, NetSuite, Accenture (teams with Salesforce), IBM, and literally every large SaaS provider are entering the field, all having substantially greater resources have pricing power in an era of the cost conscious customer.

During its last conference call, CSOD management boasted they were badly beating both ORCL and SAP in landing new customers on "their own turf." I take that as a call to action for the other players, who were certainly listening, even if they need to take on some losses the first years of contracts, and in fact I expect CSOD to lose business as rivals begin to compete more on price and use of less expensive overseas developers and back-office support already in place.

Yet for all the large players in the space, many upstarts are finding their way in, boosted by private equity funds. Firms like *Take Workday* ($15.9 billion) are becoming important entrants and a handful of newer firms are certainly bound to have various levels of success. Other firms in the space all finding good levels of success include NetSuite ($7 billion), Concur Technologies ($4.7 billion), Ultimate Software ($3.7 billion), and Jive Software ($1.2 billion).

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[2] For example, see http://www-01.ibm.com/common/ssi/ShowDoc.wss?docURL=/common/ssi/rep_ca/8/897/ENUS214-068/index.html&request_locale=en

Rypple was started with just $13MM, indicating the ease of penetrating the space, lured by the large potential rewards reflected in the current market values of these firms.

CSOD is fortunate to have been in at the beginning of a trend. **Yet, and almost without exception, investors become fooled by initial success stories the first few years following the birth of new industries. The growth being seen by CSOD never lasts for firms about to face stronger players having substantially greater resources with long-term proven R&D.** The successes seen with the likes of NFLX, AMZN, and PCLN are tied to an advantage that CSOD simply does not have, and such is why we are seeing the large number of upstarts.

Competitive pressure is undefeated in a democracy, as was shown by all too many other fast growth, software and technology firms that were bound to "change the world" but eventually found competition was more than imagined: AOL, Napster, Kozmo, AltaVista, Silicon Graphics, Sega, Sun Microsystems, Blockbuster, Dell, and Yahoo. And there are plenty more you never heard of that enjoyed annual growth rates similar to, or greater than CSOD, also with an impressive list of clients and can't miss attitude. And like CSOD, they did not have the financial muscle (like GOOG), and scope of talent with heavy R&D (like GOOG) to make it long-term. Technology changes all too-quickly.

Need to Raise Additional Equity

CSOD needs to expand its portfolio of products and increase its direct marketing force. Its sparse R&D budget, will, sooner rather than later, present a major obstacle relative to the competition, as its software budget must increase consistent with management and the market's requirement.

Table 1- Balance Sheet	2013	2012	2011	2010	2009
Cash & Equivalents	309.51	76.44	85.41	7.07	8.06
Net Receivables	67.19	47.53	34.11	20.88	12.07
Inventories	0.00	0.00	0.00	0.00	0.00
Prepaid Expenses	0.00	0.00	0.00	0.00	0.00
Total Current Assets	407.45	141.57	126.85	32.14	22.30
Long Term Debt Due One Year	1.42	2.56	1.88	1.38	2.71
Notes Payable	0.00	0.00	0.00	0.00	0.00
Accounts Payable	10.04	4.85	3.83	4.55	1.50
Taxes Payable	0.00	0.00	0.00	0.00	0.00
Total Current Liabilities	173.27	114.04	67.09	46.00	26.63
Long Term Debt	218.57	3.06	1.47	10.23	5.20
Deferred Taxes	0.00	0.00	0.00	0.00	0.00
Minority Interest	0.00	0.00	0.00	0.00	0.00
Other Liabilities	6.61	8.09	4.35	41.81	6.71
Equity:					
Preferred Stock	0.00	0.00	0.00	42.09	33.85
Common Stock	0.00	0.00	0.00	0.00	0.00
Capital Surplus	289.31	242.77	226.92	0.60	0.00
Retained Earnings	(236.42)	(196.12)	(164.46)	(97.83)	(44.92)
Less: Treasury Stock	0.00	0.00	0.00	0.00	0.46
Common Equity	52.90	46.65	62.46	(97.23)	(45.38)
Total Assets	451.36	171.83	135.36	42.89	27.02

CSOD has frequently mentioned the need to expand its offerings, which will again rub square against the significantly larger players, and scores of smaller firms, all of whom are learning from the Facebook model of building the client base and only later monetizing the asset. Development work not only entails larger cash outflows (including marketing budget) but the risks of development delays, product standard and client acceptance. Any slip would dearly cost a firm having a minimal equity base, like CSOD, and must be so recognized in the cost of capital, that rate of return demanded by shareholders. For this and other reasons, the cost of equity used by analysts is faulty, for share price, the basis of beta, is for CSOD more a function of the executives success in selling the story.

The firm does not currently have such needed capital, nor is expected to generate the cash from sales to accomplish this, needing to support its current sales growth with nearly break-even free cash flows. As that problem lingers, the competitive landscape steepens. Admittedly, the firm likely has a few quarters of impressive top line growth, with still insufficient free cash flows coming, but underneath the surface is how this firm must be assessed.

It is doubtful CSOD will be leaning toward debt financing given the lack of a tax shield. Yet, share count will continue to forge ahead as stock compensation grows, For named executives (NEO's), bonus targets are based mainly on growth of revenues, with very low targets for operating cash flows, a mere 15% weighting by the Board in the determination of bonus levels.

CSOD will need to tap the debt market, especially so given the need for greater competitive (capex, R&D and marketing) resources and as its $253MM convertible notes come closer to July 1, 2018. While it will most likely have the cash to redeem the notes, given the cash it receives from stock vesting, upcoming cash from operations, and existing balance sheet cash, use of that small cushion would not be wise given the need to step up the discretionary spending.

I do not believe the firm will be able to continue to solely rely on deferred revenue and stock based compensation as the means to provide long-term financing.

I believe the firm will need to issue higher yield debt as that time draws near, and the rate will be substantially higher than the 1.5% interest rate due to the appeal of the convertible feature. Obviously, holders are somewhat currently disappointed given the current stock price and may be reluctant to again accept a low yield going forward. The notes can also convert if the price of its shares is in excess of $70.25, unlikely at this stage. A conversion of preferred stock series took place in 2011, and the firm would like to see history repeat with the notes, adding to equity without having to recast, although I don't believe they will get their wish this time, adding pressure to the stock if an additional equity raise is needed, which I believe will be the case.

Because taxes are not imposed on the income an enterprise pays as interest to creditors, the income tax system creates a bias in favor of debt financing. This would not benefit OSOD due to its close to zero tax rate. In fact, it is quite likely interest rates will be rising toward the normal historical 3.9% 10 year Treasury rate (Table 2). Given a firm with a 14% cost of capital, a probable pre-tax rate of interest for CSOD would be on the order of 6.5%. On $253MM that would equate to $16.4MM or over 100% of the 2013 free cash flow, and 41% of 2015 an optimistic projected free cash flow forecast. Under our worksheet, including normalizing stock based compensation and other items, cash interest expense would run closer to 85% on 2014 free cash flows, dependent on new signups as reflected in deferred revenue collections. Hence, the urgency to continue to “promote” the firm prior to the onslaught of competition, to raise additional capital.

Table 2- Historic 10 Year Treasury (Risk-Free) Rate:

Mean:	4.64%	
Median:	3.92%	
Min:	1.53%	(Jul 2012)
Max:	15.32%	(Sep 1981)

Source: BankAmerica

Stock Based Compensation and Bonus’

I discuss stock based compensation as it has been used by the firm as a means to save cash and raise equity, while rewarding employees. Executives have been good at “talking the good story” to investors and so providing the liquidity (584,000 shares average volume) for the shares to be sold, and have sold, as vested, with over 1.3MM shares in the past year.

Although most awards do not result in cash being exchanged upon grant, future cash flows are clearly affected, i.e. share buybacks to offset dilution. Yet to date, CSOD has not (of course) been engaged in buybacks, forcing shares outstanding to rise about 1.5MM per year, which may rise as much as 2MM this year. From a cash-flow standpoint, companies gain flexibility to the extent that stock-based grants provide an alternative to cash compensation, improve credit, while their shareholder interests are diluted. Tax credits are shown as an operating item on the cash flow statement under U.S. GAAP only to the extent they relate to the accounting expense; if the tax deduction exceeds the amount attributable to the accounting expense, such excess is a financing item. As necessary, we make reclassification adjustments in our cash flow worksheet, yet because CSOD is in a zero Federal rate, no such adjustment was required.

The employer generally is eligible for a tax deduction equal to the full amount of the stock when the employee vests in the restricted stock or the intrinsic value of the stock when the option is exercised. Firms that trade at higher valuation multiples will be accorded a greater tax savings. Under FASB Statement No. 123(R), for book purposes, a company generally measures the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. Fair value is normally determined using a Black-Scholes option valuation model and is so recorded on CSOD’s income statement. That cost is amortized over the vesting period, as shown in the CSOD footnotes regarding both outstanding warrants and the stock options.

When a restricted stock vests or a nonqualified option is exercised, the amount of the employer's corporate tax deduction is fixed. At that time, it is evident whether the amount deductible on the tax return is greater or less than the cumulative compensation cost amortized over the vesting period. Excess tax benefits, if any, are credited to additional paid-in capital, and of course there are none for CSOD.

Bonus targets for CSOD are extremely generous, with revenues assigned a 75% weighting.

For Mr. Miller, CEO and founder, termination even without cause would cause a $12.4MM payment (he also owns 11.2% of the outstanding shares); Mr. Wallach, the CFO almost $7M; Mr. Seymour, EVP for Strategic Accounts, $5.5MM. Others are almost as generous, but this should paint the picture. All insiders remain very active sellers of the stock, including Mr. Miller.

Under its plans the potential for substantial dilution is apparent as referred to below:

Our 2010 Plan provides that on January 1st of each fiscal year commencing in 2012 and ending on (and including) January 1, 2020, the number of shares authorized for issuance under the 2010 Plan is automatically increased by a number equal to the lesser of (i) 5,550,000 shares of common stock, (ii) four and one half percent (4.5%) of the aggregate number of shares of common stock outstanding on December 31st of the preceding fiscal year, or (iii) a lesser number of shares that may be determined by the our board of directors. Our 2010 ESPP provides that on January 1st of each fiscal year commencing in 2012 and ending on (and including) January 1, 2020, the number of shares authorized for issuance under the 2010 ESPP is automatically increased by a number equal to the lesser of (i) 1,200,000 shares of common stock, (ii) one percent (1.0%) of the aggregate number of shares of common stock outstanding on such date, or (iii) an amount determined by our board of directors or a duly authorized committee of our board of directors.

Source: 2013 Proxy

Given the current share count, one would expect, under the Equity Incentive Plan, total shares eligible for future vesting under plans could grow by 2.37MM (the 4.5% rule) this year. And for the ESPP, total shares to grow by an additional 1% or 528,000 shares. These, of course are Board decisions. It was announced in January, subsequent to the filing of the FY 2013 10-K, shares issued under the ESPP increased by 524,699.

There are currently over 7.4MM shares allowed to be issued under existing plans and RSU's.

Geographic

The firm operates in many overseas countries (using 3rd party marketers), yet as shown, significant growth is resulting basically the US. Yet, it is here, where the competition, both new firms funded by private equity, and old established players, are digging in, and these latter firms are not about to give way in their most important market at a time growth is hard to come by.

Table 3 Sales vs Geography

Geography	2013	2012	2011
US	128,983	81,837	50,874
UK	19,448	12,930	8,612
Other	36,698	23,147	13,536
Total	185,129	117,914	73,022

Source: 2013 10-K

Case for a Buyout

Every buy side analyst makes a case incorporating the belief CSOD is ripe for a buyer to come along and make a bid for the company. Yet, this is not the 1990's. **Simply, given other deals that have taken place, why wasn't CSOD among them?** The answer is simple. Today's CEO needs to make a fundamental case for an acquisition of this size, as the firm has a $2.8 billion market cap not including dilution from the warrants, restricted stock, and other options and incentives that would become due and vested should a buyer come into play, let alone the premium (convert dilution is hedged but not warrants) most larger owners would demand given the current share price. It appears, at present, CSOD is drawing no present interest from obvious players eager to expand their presence in SaaS and cloud-based software.

CSOD paid $49.5MM to hedge the convertible notes and in turn received $23.3MM for the sale of the concurrent warrants (for which it must issue 4.7MM shares above $80.06[3]). A buyer would need consider, including additional warrants to purchase warrants of 133,000 shares held by ADP at $.53 and with whom it had a prior dispute, if the total cost of close to $3.7 billion made sense, to buy a firm that under stretched circumstances, even with the power of a large partner who could take advantage of a large client base, produce no more than $40MM, if that, in annual free cash flows years down the road. Such potential acquirer must consider the many new players coming into the field, many of whom have been funded by "movers and shakers" in private equity who have done this before and are familiar with technology start-ups, as well as **the large dilutive effect on financial metrics** such a deal would entail. All firms we reviewed that could conceivably make a bid speak to an acquisition policy of a candidate (target) earning its cost of capital. Clearly, CSOD would not meet that requirement.

And given CSOD's minimal equity, it would need to draw additional capital from the parent, further increasing an acquirer's cost. This would be needed, as outlined, as the firm does not currently have a positive cash based return on capital. Under the optimistic assumption free cash flows were to rise to $50MM, an unlikely scenario for many years at least (if ever), while return on invested capital would be impressive, likely in the mid 30% range, such would be due to the low capital requirements of the firm, not a reflection to cover cost of purchase based on a logical cost of capital.

When viewed under the microscope of a free cash yield on market value or free cash yield on enterprise value, conclusions are vastly different from ROIC. For instance at a free cash flow of $50MM (minus interest income), free cash flow yield on a $3.7 billion takeout is just 1.4% (at zero tax), way below an ordinary cost of capital, let alone cost of equity for a small tech firm in an industry brewing with

[3] These warrants issued as part of the convertible note financing are included in shareholders' equity.

potential competitors. Thus even for an acquirer with surplus cash, the deal does not make cash sense (value-destroying). If financed with over $1 billion in debt, free cash flows would remain negative, even at the assumed ($50MM pre-interest) rate. It would thus need to be an all-cash/stock deal, and that too, of course would be value-destroying, given the cash return and existing valuation multiples for conceivable public entities which are potential suitors.

Given CSOD's zero "cash" tax rate, free cash flow would further be mitigated as upstream payments were made at the acquirer's tax rate when calculating the division's ROIC. For example ORCL is in a 22% cash rate, IBM about 20%, SAP and ACN both about 24%. Most of the NOL's would be lost in a buyout, and all large countries are currently examining the use of transfer payments in tax avoidance. I believe there are changes coming in this area which will boost the cash tax rate for internationals.

Insiders, including the founder Miller, continue as heavy sellers of stock. Although Mr. Miller reported ownership of 11.2% last April, it is down from 13.3% a year ago, and given reported sales, lower since. One would presume given the continuing sales, he would have preferred a sale of the company at a higher price than was realized in unrelenting open market transactions.

Outstanding dilutions could conceivably add $500 hundred million dollars to any such deal, given existing options and potential dilution, dependent on what contracts were worked out with executives wishing to stay on as continuing consultants with the new firm.

Non-employee directors (5) own options to buy almost 600,000 shares of stock. The Board is staggered with each class serving 3 year terms. Class II until 2016; Class 1 until 2015, Class II which includes the President and Lead director who are up this year.

Credit

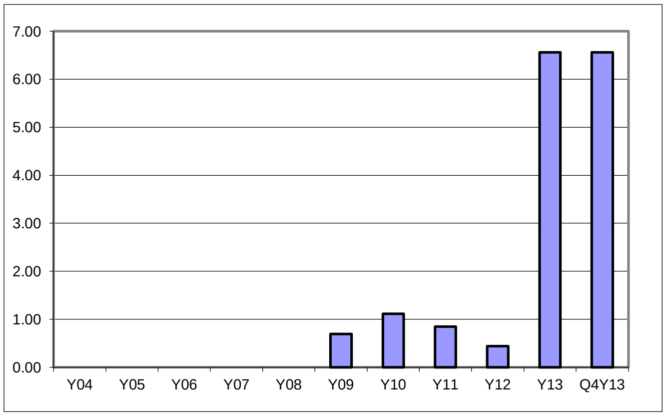
Total obligations are straightforward, consisting of $271MM in long-term debt(including interest) of which most are the convertible notes, $1.1MM in capital leases and $26.8MM in operating leases. They report de-minimus off-balance sheet obligations and commitments (later clarified). I do not view the firm as having a credit issue as a result of the equity conversions (which had been running about 1.5MM shares per year, and may rise about 2MM or more going forward); an acquisition made primarily with stock, and lack of share repurchases. As seen in Figure 1, interest expense is currently of little consequence, yet could easily consume a substantial portion of cash flows if sales growth does not materialize and the Board admits the need for stepped up discretionary spending. After all, while spending 60% of sales on marketing is impressive, $21MM in R&D is not, given the likes of Salesforce spending $624MM.

Goldman, which ran the IPO, should be in a position to raise additional equity, if needed.

As seen, CSOD fancies converts in capital raising alternatives, which has to date, allowed the firm to avoid having negative shareholders' equity at a cheap rate. In 2010, $133MM was converted to common. The same year, $87MM of stock was issued, also helping fund the losses. Stock based compensation and the equity component of the converts added $46.4MM to shareholders equity in FY

2013, almost equal to that of current total equity. Clearly, they have a continuing need to raise long-term capital.

Figure 1-Interest Expense Small Now, but Projected to Rise



Cash Flow Analysis

It is difficult to conceive a software firm with 1600 clients, $185MM in revenues, and modest capital spending and research, cannot generate more than near break-even free cash flows. Yet that remains the circumstance given the large continuing marketing spend. Though our free cash flow analysis and worksheet indicates there is little reason for such optimism, sell-side analysts nevertheless continue to play up the cash flow generating power based on a decade out time horizon.

Popular Method for Computing DCF Analysis Is Incorrect

Goldman Sachs has a $68 price target based on a 10 year DCF model. While I give kudus to any analyst who even attempts to forecast a technology firm's (let alone one which has been in business 12 years with a mere $53MM equity having not "eaten" equity via buybacks, dividends or excessive capex) free cash flows a decade away, to do so when current free cash flows are break-even is little more than a party game with no solid basis.

Sell-side analysts, like the one mentioned, do not make the important adjustments to the statement of cash flows, including over- and under-spending and reclassification error. Even if an investor felt such analysts free cash flow model was accurate, the projected rise from 6 cents per share to 60 cents is still just a 1% yield given probable dilution.

This analyst—and I merely illustrate his work as he seems to represent consensus "Street" thinking, illustrated by a high to low revenues estimate range of less than $3MM-- is forecasting, for 2014, a rise in reported GAAP cash from operations from $17.4MM to $33MM with capital spending of $19.4MM , still making the firm near free cash neutral, due to adjustments. As the firm must continue being generous with expenses related to marketing, it is difficult to see adjusted free cash flows over $25MM

2 years hence[4] given (a) the real need for stepped-up spending on R&D and (2) other issues such as taxes, additional marketing, capex, comp. benefits, etc.

Bear in mind that over 100% of FY 2013 cash from operations resulted from stock based compensation alone. A fall in the share price will put a crimp in this financing tool.

The GS analysis uses a 30% tax rate in his calculation, providing for a lower cost of debt than is really the case, given the actual “cash” tax rate (Table 4) and small likelihood such will change in the coming 4 years given the large and still growing NOL. The use of EBIT instead of actual free cash flow, as shown in Table 5, is incorrect, being based off GAAP income statement components and without regard to capital spending (intensity) and other investment (software and other vendor) requirements, working capital requirements, taxes, payments to minority owners, among other deficiencies, and should not be used as a base in the calculation of return on invested capital. EBIT or EBITA often bears little relation to free cash flows and is evident again here[5]. For the firm in question, return on capital is zero to negative due to the lack of free cash flows. Our models also net out cash interest income and cash on the balance sheet in the calculation of return on invested capital. For a new buyer, the proper price would be the cost of the invested capital, not the current reported GAAP asset values.

What strikes me most regarding our cash flow worksheet is the simplicity of this firm. Typically, we make many adjustments for a firm this size, including cost of sales components, and any unusual items contained therein (supply chain, pension, insurance), as well as factoring out depreciation and moving other components to SG&A or elsewhere; SG&A itself, to taxes and healthcare and litigation.

Because the firm is in a zero Federal tax rate, no substantial tax or other related re-classification was necessary regarding the large stock based compensation, excess benefits shown as a financing activity. Normal adjustments, including reclassification as well as over- and under-spending normally would be in the $15-20MM range for a firm this size and similar growth rate in a competitive sector. The size of the numbers in the statement of cash flows are quite small indeed with the exception of stock based comp and deferred revenue; financial activities relate to capital raises. The current small firm discretionary spend management has earmarked to support *future* growth against major players is highly unusual given CSOD’s growth stage. Sales and marketing runs over 500% of R&D. Aside from the tax account, there is little going on that is difficult to analyze.

Derivatives are not utilized.

Capital spending is low for the firm and may be a result of a decision to preserve cash. While SaaS is typically associated with a low level of capex, in order to grow sales, the $21MM R&D budget must substantially increase if the firm is to effectively compete with the existing players and certain coming onslaught of new competition. As seen with Salesforce.com, capex budget (Figure 3) and its $624MM research budget dwarfs such expenditures for CSOD. For this reason, our cash flow worksheet picks up no excess capital spending or research—every dollar is needed— and in fact should most likely be

[4] That said, we allow for such in our DCF model with smaller than expected increase in the actual share count.
[5] See *Security Valuation and Risk Analysis*, pp. 250-267

considered as under expenditures. **This underspending is a factor in the firm's high cost of capital as future ability to compete must be questioned, and at a minimum will be a considerably larger use of cash going forward. The problem is, of course, the firm equity has been essentially depleted as a result of the operating losses.**

Accruals amounted to just $22MM for FYE 2013 and is immaterial to the cash flow analysis. AOCI is small and requires no adjustments to the cash flow worksheet. Capital lease principal payments are moved to operating cash flows for accuracy and comparability. Capital leases signed during the year were for capital equipment and furniture for the workforce. Operating leases totaled $26.7MM, not an important factor in the analysis.

Tax expense ("Cash" Rate Table 4) would have been even lower if able to recognize other benefits, not possible given the existing rate. As of FY 2013, total NOL's amounted to $146MM, with Federal not beginning expiry until 2019. A takeover would negate most of the NOL benefit, and foreign credits are otherwise small.

Table 4-Cash Taxes and "Cash" Rate

CORNERSTONE ONDEMAND INC
TICKER: CSOD

	Income Taxes Paid	"Cash" Tax Rate
Dec09	0.000	(0.000)
Dec10	0.044	(0.001)
Dec11	0.104	(0.002)
Dec12	0.103	(0.003)
Dec13	0.485	(0.012)

The cash flow worksheet makes no major tax adjustments (some benefit is in fact recognized) or reclassification as a result of the zero tax rate and large NOL with many years to run. GAAP losses continue and should again this year; it (the rate) **does require** a boost in cost of equity capital as seen in that worksheet. Such adjustments to cost of capital are at odds with traditional equity analyst education which continues to rely on the CAPM (as verified by EDGAR filings). Analysts also gravitate toward the effective tax rate instead of the true shield of the cash tax rate in their computation of cost of debt capital. The effective rate for the firm was 32% for FYE2013.

We could have, in fact, penalized the cash flows as an under-expenditure of R&D, yet chose not to as a result of the heretofore large percentage revenue increases. Our cost of capital qualitative adjustment attempts to look "over the mountain" and does slightly penalize the capex spend. Cost of capital should be looked at as a barometer of risk to future free cash flows, the possible return to shareholders for supplying equity based capital. Stock based compensation reduced taxable income by approximately $2MM for FY 2013.

Figure 2-Capital Spending-CornerStone

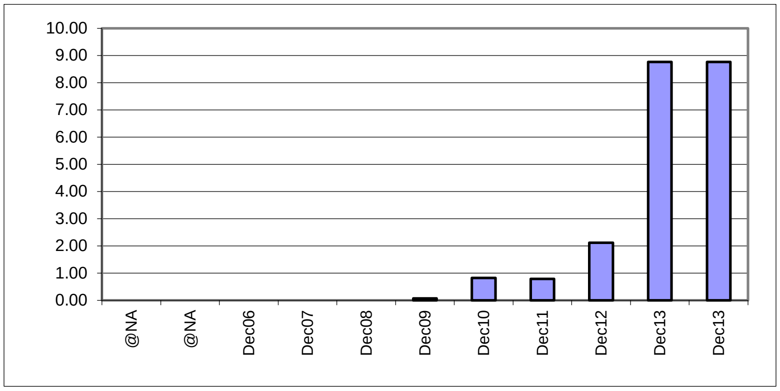


Figure 3-Capital Expenditures Salesforce.com

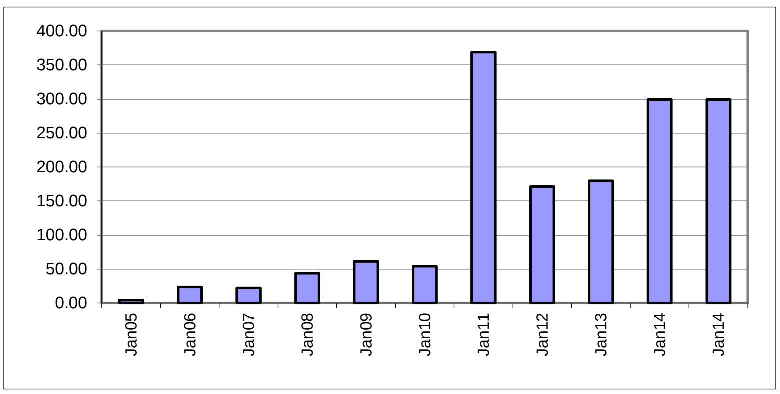


Table 5 Cash Flow Worksheet-CSDO

CT CAPITAL

CT Capital LLC: Cash Flow Analysis

Cornerstone OnDemand (CSOD)

	Adjusted Free Cash Flow (AFCF) ($US, 000)	
	FYE 2013	FYE 2012
Cash Flow From Operating Activities (as reported)	**17.4**	**10.3**
Special Item Adjustments		
Nonrecurring expenses or revenue:	0	0
Paid Claims (excess unusual):	0	0
Legal (excess unusual):	0	3
Tax Holidays	0	0
Other tax benefits	0	0
Non-Recurring costs (acquisition)		
Total benefit from special items:	0	3
Balance Sheet Adjustments:		
Inv	0	0
A/R	3.1	2.1
A/P:	0	0
Deferred Revenue (customer deposits):	-4.6	-2.9
Other assets and liab.:	0	0
Deferred commissions	0.9	0.4
Inc. taxes payable	0	0
Credit Card liabilities	0.0	0.0
Total benefit from balance sheet:	**-1**	**0**
Reclassification Adjustments:		
Taxes:	3.9	4.6
Dividends	0	0
Guarantees:	0	0
Payments to Non-Controlling:	0	0
Interest:	0	0
Repayment of principal on capital leases:	-1.7	-1.9
Other reclassifacations:	0	0
Sales gains classified as operating activity	0	0
Stock Based Compensation-Excess tax benefit-reverse fin activity	-4.6	-1.6
Stock based compensation-normalize	0	0
Capitalized leases (principal reduction)	0	0
Total benefit from reclassification adjustments:	**-2**	**1**
Other Adjustments:		
Pension catch-up contributions vs. normal:	0	0
Derivatives:	0	0
Legal settlement:	0	0
Total benefit from other adjustments:	**0**	**0**
Income statement items:		
Marketing	0	0
C.O.G.S.	0	0
Advertising:	0	0
S.G. & A.	0.4	0
R&D	0	0
Interest	0	
other		
Total benefit from income statement Items:	**0.4**	**0**
Footnote items:		
Pension-funding policy vs. market	0	0
Other Claims:	0	0
Other payments:	0	0
Self-insurance	0	0
Total benefit from footnote items:	**0**	**0**
Investing activities:		
Net capital spending (and trademarks):	-8.8	-2.1
Proceeds from sale of PPE	0	0
Capitalized software	-6.9	-5.0
Capital Expenditures(excess):	0	0
Other capital spending (normalized):	0	0
Other (normalized):	0	0
Total adjusted investing Activities:	**-16**	**-7**
Financing activities:		
Adj proceeds from stock options (normalization, if exl. elsewhere):	0	0
Receivables or payables shown as Fin. Activity (normalized):	0	0
Reversal of other items-ie, prepaid debt fees		
Total benefit from financing activities:	**0**	**0**
Adjusted Free Cash Flow :	**-1**	**7**
Adjusted Free Cash Flow Yield (LTM):	**-0.01%**	**0.07%**

Table 6-Adjustment Summary

Adjustments to Reported Operating Cash Flow	
	FYE 2013
CFO	17
Non-recurring:	0
B/S	-1
Adjustments	-2
Other	0
income statement	0.4
Footnote	0
Financing act.	0
Inv. Act.	-16
Total Adjustments	**-18**
Total Adjustments as % of FCF	**n/a**

Fair Value DCF Sensitivity Model

In recognition of the delineated risks shown next as Tables 8 and 9, associated with holding the equity shares of CSOD, its cost of equity capital, we arrive at a fair value were the firm to generate about $11MM in free cash flow for 2014 (just $2MM lower than "street," due to adjustments) and then allow for 50% growth thru 2018, 20% growth thru 2023, 15% growth thru 2030, then 3%. We allow for no down or even disappointing years. It allows for no large stock dilution, or other negative events, such as increased competition, marketing issues, loss of key personnel, client retention, legal, development and software development issues, recession, or other issues the firm is sure to face.

Displayed in Table 7 are sensitivity fair value estimates based on various cost of equity capital discount rates based on the growth in free cash flows cited in the prior paragraph and discount rates as low as 8.5%, which is only slightly above the 8.1% current cost of capital for the S&P 500, and no higher (although accorded a higher weighting) than 14%, the actual estimated cost of capital our model indicates as correct. The result is a blended fair value of $27.70, very close to our target price.

At an unfairly low 8.5% discount rate, fair value is still some 26% below the share price current value.

Table 7 Fair Value

	Disc Rte.	Probability	FV	
	8.50%	5%	$39.69	
	8.75%	5%	$38.21	
	9.00%	5%	$36.81	
	9.25%	10%	$35.46	
	10.50%	25%	$29.56	
	11.50%	25%	$25.69	
	14.00%	25%	$18.43	
	Fair Value Cash Flow	100%	$27.70	
	Net Cash/Debt*		0	
	Fair Value Per Share		$27.70	
	* Excludes any tax on repatriation			

As footnoted earlier, analysts are basing their DCF cost of equity on a 1.2 beta under the CAPM. Use of the proper value, 14%, based on all known threats to future free cash flows has proven a more reliable and common sense metric. The difference between using a "street" cost of equity of 11.9%, and the 14% our model believes is fair, is a 24% lower fair value target, of $24.31 vs. $18.43. The target gives no credence to a takeover. It purely values the firm as a "going concern."

Cost of Capital

The following two worksheets (quantitative and qualitative factors) are essential in arriving at a reasonable estimate of our 14% cost of equity capital.

Although we are evaluating cost of equity, the cost of debt is a metrics in such analysis. For CSOD, cost of debt is low, the weighting of the composition geared toward low interest rate convertibles. This debt will need to be negotiated in 3-4 years as my premise will not allow for the $54 conversion price at that time.

Our cost of equity capital models are based on estimating the predictability (with related strength) of prospective free cash flows. CSOD's free cash flows have thus far not been sufficient for the firm's needs, and have so offered shareholders no capital return. At this point it remains a risky bet against competitors with nearly unlimited budgets to **forecast large** free cash flows beginning in several years, justifying the current price of the shares, and so forecasted by analysts. Management, to its credit, have been strong marketers (both to new clients and investors), yet, as espoused earlier, the financial history books are full of large GAAP growth projections that never materialized in the ultra-competitive software and tech space. This firm has little fixed assets and software that continually need to be hard-pushed against those competitors over 100 times their size.

We see, under the "Cash Flow heading: several flags for power operating cash flows which are simply reported cash flows from operations adjusted for balance sheet items based on revenue changes. Here we see a large benefit from stock based compensation and less, but still a flag for accounts payable, recognizing the cash flow benefit.

The flag for variability of sales and cost of sales is given due to its large growth rate, as is true for deferred revenue, an important source of financing and risk to valuation multiple. While this may sound at odds with logic (isn't growth good?), the model adds to cost of capital as high growth continues, especially running concurrently with progressively larger dollar volumes. We made the same adjustment with Apple two years ago, as with many small to mid-sized firms which ultimately ran up against the better heeled or superior fast moving technology.

The flags for debt are not serious at this stage and result in a low mark to cost of capital; it results from debt financing (not total debt including leases) rising from $5.6MM to $220MM. Still, the firm could not at present repay such debt within 5 years from the current levels of cash flows, not that such an event is a real issue.

Taxes add 60 basis points to cost of capital. Over time, the "cash" and effective rates, and related stability indexes of both have proven to be a reliable indicator of risk due to likely unpredictable changes, thereby effecting future free cash flows.

The worksheets shown below, with appropriate flags, each adding to cost of capital, form the basis of our cost of equity. Several items, due to level of difficulty, add a negligible markup over the risk free rate. Other flags, of course, would result extremely in severe mark-ups, as would be the case (though not here) if the auditor resigned, the firm lost a large client, or was impacted by sovereign risk (Venezuela). Firms that lost the ability to raise funds in the commercial paper market could also result in a large penalty due to that cheap source of funds. Lack of free cash flow, both last year and historically, as well as the continuing need to raise equity capital, as shown in the "credit" section, added over 350 basis points over the risk free rate.

Table 8-Cost of Capital-Quantitative

A Special Report by CT Capital LLC ™	
CORNERSTONE ONDEMAND INC	**Flags**
Cash Flows:	

Operating cash flow	
Operating cash flow	
Operating Cash Flows over 10 years	
Growing operating cash flows - recent 5 years	
Operating Cash Flow in the most recent quarter	
Power Operating cash flow	**X**
Power Operating Cash Flows over 10 years	**X**
Growing Power Operating Cash Flows - recent 5 years	**X**
Power Operating Cash Flow in the most recent quarter	**X**
Free Cash flow	
Free Cash flow	
4-Year average Free cash Flow	
Free cash flow multiple (P/4-year average FCF)	**X**
Deferred Revenue	**X**
Growing free cash flows - recent 5 years	
Free Cash Flow - most recent quarter	
Accounts receivable flag	**X**
Accounts receivable flag - based on the most recent quarter	
Inventory flag	
Inventory flag - based on the most recent quarter	**NA**
Accounts payable flag	**X**
Accounts payable flag - based on the most recent quarter	
Discretionary capital expenditures	**X**
Discretionary R&D	**X**
Discretionary cost of goods sold	
Discretionary selling, general & administrative	
Discretionary advertising	
Cash burn rate - last fiscal year	
Cash burn rate - most recent quarter	
Undergoing Sig share repurch. with declining OCF	
Capital spending	**X**
Debt:	
Growth in total debt - Recent 10 years	
Growth in total debt - Recent 5 years	**X**
Growth in total debt - most recent quarter	**X**
Debt/(4-year average FCF) multiple	**X**
Debt/(4-year average OCF) multiple	**X**
Able to repay total debt from 4-year average of (OCF-2/3 capital expenditures)	**X**
Able to cover current debt by free cash flow	

Able to cover current and next year's debt from FCF	
Able to cover total debt from FCF in the last 12 months	**X**
Able to cover current debt from net working capital	
Able to cover current and next year's debt from net working capital	
Able to cover current debt from 4-year average OCF	
Able to cover current and next year's debt from 4-year average OCF	
Able to cover total debt from OCF in the last 12 months	**X**
Able to cover current debt from 4-year average OCF + net working capital	
Able to cover current and next year's debt from 4-year average OCF+ net working capital	
Deterioration in net working capital to total debt	**X**
Deterioration in net working capital to total debt current quarter	**X**
Interest coverage from working capital and FCF	
Interest coverage from working capital and FCF current quarter	
Operating leases/total debt	
Pension underfunding/total debt	
S&P Commercial paper rating	
S&P senior debt rating	
Increase in postretirement benefit (healthcare) expense	
Increase in postretirement benefit (healthcare) liability	
Able to cover current and next year's debt from common equity	**NA**
Credit Spreads	
Tax:	
Tax expense / pretax income	
Tax payment / Pretax income	**X**
Stability of tax rate	**x**
Tax expense / pretax income. Most recent quarter.	**X**
Prospective tax rate (holiday, expiration of credits, etc)	**x**
Miscellaneous:	
Country code (non US>0), flagged if non-U.S.	
Qualified audit opinion	
Auditor change	
Growth in F.G Inventory > Growth in Sales	**NA**
Growth in total Inventory > Growth in Sales	
Extraordinary items	
Pension gain	
Interest income	
Significant acquisitions	
Decrease in order backlog	

Reinvestment indicator	**X**
Reinvestment indicator - most recent quarter	
Ability to pay dividends from operating cash flow	
Pension Fund-Assumed Return on Assets increased from the prior year	
Pension Fund-Assumed Rate of Salary Increases deccreased from the prior year	
Increase in the spread between the assumed return on pension assets and salary increases	**NA**
Credit Spreads-Macro	
Inflation Expectations-St Louis Fed	
Reliance on Major Customer	
Litigation, Legal	
Variability of Sales and COGS	**X**
Productivity:	
Sales / Employee Growth - Recent 5 years	
Sales / Net PPE Growth - Recent 5 years	**X**
Disclaimer	

Aside from the quantitative factors seen in Table 8, we also look to qualitative factors (Table 9) which are not captured by the reported financial statements or other statistical databases. Such includes as seen, those risks related to self-insurance, patents, reliance on key customers or suppliers, credit spreads, etc. These are itemized below, and as seen, the firm is fairly clean, yet there are most pressing issues concerning size, competition, industry, shareholders equity, and matters related to the research and capital budgets.

When summing the respective penalties (quantitative and qualitative) for CSOD, we arrive at 11.35% added to the 2.62% risk free rate or a total cost of equity capital of 14%. That is the annual return shareholders should, on average, demand for an investment in this firm given its prospective risks, as delineated. We therefore believe the equity shares to be substantially overvalued, given the use of our cost of equity as the proper discount rate.

Table 9-Cost of Capital Qualitative Factors

	Qualitative Factors Not properly Accounted For In Quant Model	
All rights reserved		
	Company	Ticker
		CSOD
	Country Risk	
	Country risk exposure- US reliance	x
	Currency	
	Supply Chain	
	Government	
	Terrorism	
	Education	
	Hunger	
	Poverty	
	Natural Disasters	
	Elections	
	Unions	
	War	
	% Imported Oil	
	Nationalization	
	Tax Rate	
	Inflation history	
	Commitment to Markets and Biz	
	Corruption	
	Maplecroft	
	CIA Factbook	
	Total Score-Soverign	
	CDS price risk	

	Change to Cost of Equity Capital	
	Heritage Foundation index on business freedom	
	Democracy Index	
	Insurance	
	Self-insurance, incl potential impact	
	Rise in Premiums	
	Effect on Cash Flow	
	Claims	
	Settlements	
	Importance of	
	Underwriting risk (insurance co's)	
	Change to Cost of Equity	
	Key Employee(s)	
	Succession Plan	
	Impact with loss of	
	Insider Ownership	x
	Board of Directors, incl change to	
	Board Structure-independence	
	Other	X
	(not reflected in model)	
	Moral obligations	
	8-K	
	Other Filings	
	Significant Sale (also have consequences)	
	sector	x
	Litigation	
	life cycle	x
	Announcements	x
	Large Acquisition (incl. announcement)	
	Non current debts from M&A-commitments, deferred obligations	
	Changes to Capital Exp	x
	Taxes-holidays, other tax risk	x
	Management Changes	
	Delays in Filing	

	State Issues	
	Derivative risk (counterparty risk)	
	Credit Facilities-Next 2 years	
	Customers-size, other-if not modeled	
	Impact of Change in GDP	
	Restatements	
	Auditor Issues Not Covered Elswwhere	
	Refinancing	x
	Reliability of Supplies	
	Susceptibility to Competition (consumer technology effect)	x
	Patents, tax benefits, other exposures	
	Last 5 Years-ROIC/Costcap	x
	Purchase Agreements	
	Other Contracts or Obligations	
	Commitments/ Contingencies	
	Change to Cost of Equity	
	LIFO Benefit/Reserve	
	% Cash Held Outside US-Impact	
	Workers Comp Issues	
	B/S Assets- Quality incl marketable securities	
	Covenants and changes to	
	Non-recurring items	
	Other post-retirement and other benefits	
	Pension Contributions-Impact on OCF	
	PBGC-ERISA Risk(4062(e))	
	Proxy Review	
	regulatory risk	
	strategic risk	x
	reputational risk	
	inventory risk (excess)	
	Communication-to shareholders, employees, etc	
	Internal controls	
	business strategy	x
	risk culture	
	Prune portfolio as well as add	
	Risk Manager? To whom reports? Board involvment	
	Stock Highly shorted or large increase in short position	
	Share buyback Program	
	Strength of credit facility lenders	
	Commercial Paper risk	
	CDS swap spread=high weighting	

	Concurrence with CRA's (credit rating agencies)	
	Operating lease-terms and % up for renewal	
	Hybrid Securities, shown as equity but s/b debt, or reverse	x
	Securitizations	
	Other retirement plans-SERP, etc	
	operating leases. % reclassified as interest 1/3	

Miscellaneous

401K

The firm's 401K, starting in 2012, with matching contributions up to 50%, $2,400 maximum, and 4 year vesting. Cash contributions normal; no impact to cost of capital or cash flows.

The company reports no pension or post-retirement obligations.

Legal

Aside from one small settled suit ($2.3MM), with no apparent fear of spreading, there are no other apparent issues impacting cost of capital.

Commitments

No adjustments were required due to such, mostly regarding lessors and directors, and commitment related to various third party vendors totaling $15.3MM. As noted PV of operating leases are $26.7MM, although there is a positive drift.

Auditor

Fair opinion. Accounting consistent with industry. PricewaterhouseCoopers LLP.

Catalysts and Conclusion

There comes a time that even firms with a strong top line must produce free cash flows and GAAP profits. To date, that has not occurred for CSOD, and even if such takes place during next two years, free cash flows would most likely be small in relation to its current market value, given needed expenditures. Now, stronger, larger players are entering in force, as well as many worldwide emergent upstarts.

The hoard of analysts who recommend purchase are, in our estimation, using antiquated cash flow models which, in reality, do not measure the real ability of a firm to return cash to the suppliers of equity. **These popular models do not account for unusual changes in the balance sheet, make classification error adjustments, account for over and under-spending, or adjust for market rates, extraordinary activities/events, or other factors which could be reliably used in employment of return on capital or other valuation models, as well as comparisons to cost of capital**. Such a typical worksheet for CSOD is shown below (Table 10), materially differing from our Table 5, despite the simplicity of this firm's accounting.

Table 10- CSOD-Naive Analyst Cash Flow Worksheet

	Dec13		Dec12		Dec11		Dec10		Dec09	
Net Sales	$	185.13	$	117.91	$	73.02	$	43.73	$	29.32
Operating Activities Net Cash Flow	$	17.43	$	10.29	$	1.83	$	0.17	$	(1.63)
- Capital Expenditures	$	8.76	$	2.12	$	0.78	$	0.82	$	0.08
+ Sale of PP&E	$	-	$	-	$	-	$	-	$	-
+ Interest Expense on LTD*	$	6.56	$	0.44	$	0.85	$	1.11	$	0.69
= Free Cash Flow Firm	$	15.23	$	8.61	$	1.90	$	0.46	$	(1.02)

Unfortunately for CSOD, the competition could be expected to narrow its positive product gap. As analysts see such competing and improved products coming on-stream alongside gross margin pressure as price competition enters the picture, the combination should spook at least a few of the many buy side analysts who are currently, without exception, very bullish on the stock. If one such analyst were to turn, which I believe will happen in the coming 12 months, the shares in CSOD, given its ultra-rich valuation, would be brought down closer to our fair valuation. Recall the impact to shares in Apple when just one well-known investor turned away.

Insofar as a potential takeover is concerned, and that sentiment is shared in every buy side report, I doubt that to be a realistic scenario as the numbers are not sensible to a potential investor making large scale decisions on the basis of cost of, and return on, capital, especially considering likely large dilution. CSOD just does not pass the return hurdles.

It is always possible, of course, for a firm with considerable excess cash, by virtue of optimistic projections, aggressive investment bankers, or antsy shareholders looking to deploy said cash currently earning less than 1%, could attempt to make a buyout case by looking at a blue-sky crystal ball 10 years into the future, as the analyst from Goldman attempted. **Our discussions lead us to believe this is not in the current thinking** of several players based on their attitude toward capital efficiency.

Shares in CSOD, like all firms with high cost of equity, are volatile instruments. Small perceptions regarding future prospects, real or perceived, can be expected to result in large swings in the share price. This is not reflected by its 1.2 beta, which is a flawed measure. With a 14% cost of equity, a small event with quite minimal impact on cash flows could consequently propel the stock in either direction.

With that caveat, as well as the "greater fool" caveat, having seen lots of value-destroying acquisitions made for a variety of reasons at the time of announcement, it is hard to place a value on the shares of CSOD in excess of $27.26. And such valuation, I believe a stretch, as shown under our valuation Table 7. I do not believe in the use of "comps" for a firm no greater than cash neutral, or perhaps this year, very slightly free cash positive, and a 14% cost of equity. Intense competition is expected in the year and years ahead which, I believe, they are not adequately prepared to contest.

Kenneth S. Hackel, CFA