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## Summary

### Why investors should be concerned:

- A significant reduction to subscription fees, along with the demise of a key co-marketing partner, raise concerns about whether Investools' subscriber rates are leveling off.
- Greater emphasis on web-based students who pay in installments instead of on live-event students who pay upfront, creating two impacts: lower revenue visibility and a potentially less committed user base.
- Acquisition of options broker is likely to raise margins, but future acquisition costs for new accounts may be higher than anticipated. After an initial uptick in new brokerage accounts following the alliance, account additions may begin tapering-off. Also, new emphasis on web-based education may result in a student base less inclined to "drink the (Investools) Kool-Aid" and open a brokerage account.
- Brokerage business, while more profitable, is also more volatile with lower visibility than Investools' legacy business.

### Additional noteworthy items:

- Higher capitalized software and its impact on earnings once expensing of these assets begins warrants attention.
- Board approved vesting of \$8.5 million in options to CEO even though vesting contingency was not met.

**Valuation:** Investools shares are more expensive than its broker peers by most measures. We believe Investools shares should trade in parity with these peers as the company's education business takes a back seat to the company's new brokerage business.

## Investools Inc. (NASDAQ:SWIM)

Share price:	\$12.55
Market cap:	\$858 M
Enterprise value:	\$949 M
52-week high:	\$17.49
52-week low:	\$9.29
Shares outstanding:	68 M
Float:	53 M
% float short (9/11/07):	12.4%
Revenue (LTM):	\$216
Net income (LTM):	\$(34) M
Cash flow from ops (LTM):	\$28 M
Dividend yield (annualized):	0.00%
Debt to equity:	107%
Debt to capital:	52%
FYE:	Dec 31
Auditors:	KPMG

**Company description:** INVESTools, Inc. provides investor education products and services primarily through correspondence and online in the United States. Its products and services provide learning in various interactive delivery formats, including instructor-led synchronous and asynchronous online courses; in-person workshops; one-on-one and one-to-many online coaching programs; and telephone, live-chat, and email support. Further, INVESTools provides front end trading platforms that allow its customers to trade electronically and provides trading tools and analytics, including tools for implementing options strategies, as well as a range of products, including equities, exchange traded options, futures, mutual funds, and bonds.

## Background

Investools Inc. is undergoing a significant make-over. Through a series of acquisitions in the 1990s, Investools established itself as a solid marketer of investor education services. With its 2005 acquisition of Prophet Financial Systems Inc., the company adopted an on-line strategy to compliment its legacy offerings.

Yet, the company's bread-and-butter has always been its live seminars, which have an almost cult-like following. Its annual meeting of students often draws more than a thousand people, a testament to power of the Investools "Kool-Aid." Historically, Investools' initiation courses have cost thousands of dollars for events lasting several days. These initial courses set the foundation for continuing education that extends the life of the subscriber and increases revenues. The company's 2006 IPO was a strong validation of its services and evolution.

The company has undertaken its most significant shift with its recent acquisition of options broker thinkorswim (TOS). Based in Chicago, TOS focuses on active retail options traders. Its options software is considered by many to be the most advanced application for retail options trading. The acquisition aims to combine Investools motivated subscriber base with TOS' on-line brokerage platform, effectively using Investools' education services to feed new account generation at TOS.

The acquisition raises the question: Is Investools now an education provider that owns a brokerage business or an options broker that provides education services? With its headquarters now in New York City (Investools was previously headquartered in Draper, Utah, population 33,000) and an options brokerage business in Chicago, the company has definitely entered the major leagues. Our report focuses on whether the company is ready to play ball.

## Analysis

### *Change in strategy warrants greater scrutiny*

We are always a tad skeptical when a company puts a positive spin on the closure of a major sales channel, while at the same time cutting its prices in half. Also piquing our interest is the company's dramatic shift in strategy over the last year with its acquisition of retail broker thinkorswim (TOS). Both factors may increase the company's risk profile and merit investor caution.

### **Declining active subscribers points to change**

Historically, Investools has been successful at acquiring new students while up-selling advance courses and recurring subscriptions to its on-line tools. The company's subscriber base increased from 32,500 at year-end 2004 to 96,800 as of July 2007, yet signs of weakness have appeared in subscriber growth rates in the last few quarters as total subscribers have leveled off.

One reason for the slowdown may be the unceremonious closing in August 2007 of the company's largest channel partner, NET Marketing Alliance. Investools partners with NET and other firms to co-market its education services. These partners once generated more than 50% of the company's sales transactions, but their contribution has slowed recently

Surprisingly, Investools put a positive spin on NET's closure. We would think the demise of a significant generator of revenue would be a material event worth mentioning in the prepared comments section of an earnings conference call. And yet, ultimate company cheerleader and CEO, Lee Barba, waited until the earnings call Q&A to drop this tidbit of information saying:

*One other comment and this will probably answer a question that's coming. So one of our partners that we talked about, we're going through a transition here that's also quite positive. One of our partners has had a very difficult time and actually will cease operations this weekend, that's NET...*

Mr. Barba went on to say the demise of the significant partner opens opportunities to find new ways to market Investools' services. Additionally, Mr. Barba said Investools has positioned itself recently to take greater control of its marketing events to boost retention and upsell rates. This is a significant departure from the language used in the company's recent securities filings, which warn that if these relationships were to end, "our ability to distribute our products and services could be impaired."

Moreover, Investools announced this "positive" development in conjunction with a significant reduction in subscription rates for its education services. The company slashed the price of its foundation workshop and home study programs from \$1,999 to \$999. The company also introduced the option of a six-month subscription at \$199 a month instead as an alternative to the \$999 upfront fee. The price reduction is aimed at increasing subscriber rates.

Again, Mr. Barba could see nothing but good news in the 50% cut in rates, saying:

*We understood as we made these pricing and offer changes that we would be reducing the overall sales transaction volume of the investor education group going forward, as well as reducing new deferred revenue each quarter. However, the benefits to our students and shareholders are significant, including ... positive GAAP earnings in EPS.*

Its worth noting that Investools hasn't posted positive GAAP earnings since 1999, raising the question: How will lowering prices increase its odds of generating more consistent positive earnings? The company's deferred revenue trends already illustrate the change in subscription terms (see table below). Deferred revenue appears to be leveling off as a percentage of education revenue due to lower rates and monthly subscription options. So while the reduction in price may spur greater demand, and thus higher overall revenues, it will likely reduce visibility into future revenue.

Table 1: Deferred revenue/collections

<i>(in \$M, FYE Dec. 31)</i>	09/2005	12/2005	03/2006	06/2006	09/2006	12/2006	03/2007	06/2007
Education revenue - LTM	126.7	138.6	150.7	160.0	163.0	170.3	172.6	179.8
Deferred revenue	64.6	77.5	93.1	122.8	139.7	159.6	173.9	181.3
% revenue	50.9%	55.9%	61.8%	76.8%	85.7%	93.7%	100.8%	100.8%
DSO, net - LTM	8.5	7.3	7.6	7.2	9.8	10.0	17.3	20.0

Source: Company reports. Note: The increase in DSO starting the March quarter is due in part to the acquisition of TOS.

### **Brokerage account growth**

In order to generate higher sales and margins while its legacy education division lowers pricing, Investools is banking on its \$340 million acquisition in the first quarter 2007 of thinkorswim (TOS), an on-line brokerage firm that specializes in retail options trading. Investools hopes to convert a significant portion of its 96,000 cult-like subscriber base into TOS account holders, seeing that strategy as a low-cost means of adding higher margin brokerage accounts.

So far, the bet appears to have paid off. Yet, we think challenges lie ahead. First, the good news. Upon the announcement of the TOS acquisition in September 2006, new funded account openings at TOS went through the roof. Before that, TOS averaged approximately 700 new funded accounts per month. After the announcement, this figure reached a high of 3,500 in April 2007. Since then, though, the number of new funded accounts appears to have leveled off, settling at 3,200 as of August 2007.

Table 2: TOS/Investools quarterly metrics

<i>(FYE Dec.31)</i>	03/2006	06/2006	09/2006	12/2006	03/2007	06/2007	QTD Aug
TOS new funded accounts, gross	1,925	2,425	2,475	6,600	8,125	9,725	6,450
Total accounts added since Sept-07	NA	NA	NA	6,600	14,725	24,450	30,900
% Investools subs, 50% est.				3.9%	8.1%	12.9%	16.0%
Investools active subs	73,400	83,700	85,300	85,400	90,800	94,600	96,800
P/P % growth	7.9%	14.0%	1.9%	0.1%	6.3%	4.2%	NA

Source: Company reports. Note: We estimate the number of Investools-sourced TOS account additions by assuming 50% of new accounts are Investools subscribers. The company has stated as high as two-thirds of new accounts may be Investools subscribers.

It's unclear if the leveling off is seasonally driven or a tempering of demand. It is reasonable to assume TOS account growth will decline over time as Investools subscribers convert their existing accounts or open new ones at TOS. However, after the "low-hanging fruit" is picked, TOS' cost of harvesting accounts from the Investools' pool may increase. TOS added approximately 30,000 funded accounts since the Investools merger was announced. Management estimates that anywhere from 30% to more than 65% of new accounts opened are

Investools-sourced. (Management's lack of a more precise figure is slightly unsettling because this information is key to determining whether the merger rationale was sound). Assuming 50% of new TOS account additions are Investools subscribers, then only 16% of Investools' current subscriber base holds a TOS account. This would indicate the potential pool of Investools-sourced TOS accounts remains quite large.

The big question, of course, is whether the remaining 84% of Investools subscribers will be low-cost acquisitions for TOS. Because of regulatory constraints (TOS is a registered broker-dealer; Investools is not), Investools is limited in how it can market TOS' services to its subscribers. Investools, in its courses and collateral, cannot recommend TOS' services or claim it to be superior to other brokers. This creates some barriers to cross-pollination. Additionally, convincing Investools subscribers to convert their existing brokerage accounts may not be easy because of switching costs and general lethargy (remember, Investools subscribers are mostly retail investors who make fewer than 50 trades a year). If these subscribers are happy with their existing brokerage services, they may have little or no incentive to switch.

One way to increase conversion ratios is to capture newly minted Investools subscribers. Investools foundation courses are likely to be the first introduction into active trading for many of these students. Getting these new students onto the TOS platform early in their investing careers both lowers acquisition costs and increases switching costs. Once again, though, Investools faces regulatory limitations on how it can market TOS' services to these students.

Investools' shift to on-line foundation courses, in lieu of the traditional multi-day sessions, may come back to bite the company. The high cost and substantial time investment of the live sessions weeded out students with lower commitment levels. They also were a key contributor to the rabid following of Investools user community. Students using a self-paced, on-line course not only pay less, but don't give the company the opportunity to create a bonding experience among its users. Also, having the ability to market brokerage services to a committed audience over several days certainly seems more effective than doing so indirectly via an on-line medium. In this light, we question the long-term viability of a strategy that lowers education fees to increase demand in order to accelerate TOS account growth.

### **Educator or broker?**

Now that Investools has bought TOS, it's fair to ask: Is Investools an investor education firm with a brokerage business or the other way around? The company will say the two businesses' have a symbiotic relationship, with both sides feeding the other. We don't quite see it that way. To us, it appears the company has looked into the future and seen that its education business will never generate sufficient margins, so it is depending on the brokerage operation to be significantly more profitable (as long as customer acquisition costs remain low).

Yet, the brokerage business, which is highly dependent on trading order flow, is more volatile and has less visibility than the company's legacy education business, with its high deferred

revenue component. It's no surprise that TOS' broker peers trade at lower earnings multiples than Investools given these different operating and financial models. With Investools' growth and profitability becoming more leveraged to its brokerage operation as the education business morphs into an account acquisition channel, it seems to us that Investools should trade in parity with these broker peers.

### *Earnings quality concerns*

#### **Revenue recognition**

Investools continues to struggle with key elements of its financial reporting, even though the company has been working to remedy such problems for some time.

Revenue recognition remains a problem area, with Investools reporting a material weakness related to revenue recognition in each of the last three fiscal years. The company's first restatement for revenue recognition was in fiscal 2004 (for recording revenue prematurely). At the time, Investools disclosed a material weakness with respect to revenue recognition. The weakness persisted in fiscal 2005. In its 2005 10-K, the company disclosed revenue figures in its financial systems "had to be adjusted using spreadsheet-based analyses." For fiscal 2006, the company again restated its revenue recognition (this time, for deferring too much revenue). Not surprisingly, management stated its material weakness had not yet been remedied.

Management is looking to the rollout of a new ERP system by year-end to finally fix this weakness. Even so, recurring restatements and lax controls, especially when related to revenue recognition, always concern us.

#### **Capitalized software**

Investools capitalization rate on software development has increased in recent periods. The deployment of a new CRM/ERP system and the TOS acquisition are driving factors behind the increase. Yet, the company has written off capitalized software assets on more than one occasion in recent years. For example, the company previously applied a 16-year life to certain developed technology acquired from 360 Group at the beginning of 2004. The company subsequently adjusted this estimate to one year at the end of 2005. Premature capitalization (i.e., before feasibility) is always a concern when software asset write-offs take place.

Table 3: Capitalized software

<i>(in \$M, FYE Dec. 31)</i>	FY	FY			YTD
	12/2005	12/2006	03/2007	06/2007	06/2007
Soft. dev. costs - BS	5.1	12.6	16.7	20.6	20.6
Accumulated amortization	0.0	0.3	1.9	1.9	1.9
Capitalized soft. dev. - CFS	5.7	9.2	4.2	4.7	<b>8.9</b>
% revenue*	4.1%	5.4%	7.7%	6.1%	<b>6.7%</b>
Amortization soft. dev. costs	0.0	0.3	0.6	0.6	1.2

Source: Company reports. \*As % of LTM revenue for quarterly figures.

The company's capitalizing rate now exceeds 5% of revenue. We note capitalized software expense as a percentage of revenue at OptionsXpress has averaged 1.6% of revenue over that last three years. The company has recognized limited amortization expense as capitalized software assets have increased from \$5 million at the end of 2005 to more than \$20 million as of the most recent period. A partial reason is that the ERP/CRM system is only now being placed into service. However, according to management, these assets represent approximately 50% of the recent software spend.

Additionally, the company does not explicitly state the useful life assumptions it uses for capitalized software, although we were told three to five years in our conversation with management. If this is the case, the \$1.2 million in year-to-date software amortization appears low if over \$10 million in non-ERP/CRM software assets have been capitalized in the last year and a half.

### **CEO's option vesting**

In the first quarter of 2007, Investools' board paid out a significant performance bonus to CEO Lee Barba, even though the bonus target was not met. According to recent disclosure, in 2002 the board granted Mr. Barba 550,000 options that would vest "upon an event occurring in the future." The grant was set to expire during August 2008. Even though the event didn't occur, the board vested the options anyway. As a result, Mr. Barba was granted the \$0.18 priced options, which at an average price of \$15.45 in February, were now worth \$8.5 million.

It's not clear to us what the vesting contingency is contingent on, as Mr. Barba's previous employment agreements do not explicitly mention the grant (although the grant is disclosed in subsequent annual proxies). Management did address the topic during the company's 2007 first-quarter earnings call, stating the grant would vest in the event Investools was sold for more than \$1.00 per share. Mr. Barba went on to say the compensation committee recommended the shares vest even though the contingency wasn't likely to be met as a reward for completing the TOS merger. When an analyst questioned the rationale behind the vesting, Mr. Barba stated: "There's a merger and the rationale was no more than I've been here eight

years. It's no secret that the board knew that those options had a great deal of value and they would expire. ..."

Nuff said.

## Valuation

Investools shares are more expensive than their peers by most measures. We have used similar sized brokerage firms OptionsXpress and TradeStation as comparables. There are no direct comparable companies for the company's education segment. We believe Investools shares should trade in parity with these peers as the company's education business takes a back seat to the company's new brokerage business.

Table 4: Valuation

	SWIM	Average - Comparables	Premium / (Discount)
Price (current)	\$12.55		
<b><u>Valuation</u></b>			
Price / net income - LTM	NA	6.9x	NA
Price / net income - 2008E	15.9x	15.1x	5.3%
Enterprise value / sales - LTM	4.3x	5.0x	-14.8%
Enterprise value / CFFO - LTM	32.5x	25.2x	28.8%
Enterprise value / EBITDA - LTM	16.7x	11.5x	45.9%
Enterprise value / EBITDA - 2008E	8.9x	8.6x	4.4%
<b><u>Performance</u></b>			
52-week high	\$17.49		
52-week low	\$9.29		
52-week % change	12.6%	-2.1%	

Source: FactSet, Thomppson. Peers include: OXPS, TRAD.

## Appendix

### 1: Selected Financial Data - Annual

<b>Income statement</b>	<b>12/2002</b>	<b>%</b>	<b>12/2003</b>	<b>%</b>	<b>12/2004</b>	<b>%</b>	<b>12/2005</b>	<b>%</b>	<b>12/2006</b>	<b>%</b>
Revenues	53.9	100%	69.8	100%	97.2	100%	138.6	100%	170.3	100%
Gross margin	28.5	53%	27.9	40%	31.5	32%	46.5	34%	49.1	29%
SG & A	28.3	52%	32.6	47%	42.3	44%	61.5	44%	85.6	50%
Operating income	-5.3	-10%	-5.8	-8%	-11.9	-12%	-16.1	-12%	-44.2	-26%
Taxes	-0.2	0%	1.5	2%	0.0	0%	0.1	0%	-0.9	-1%
Net income	-33.6	-62%	-7.3	-10%	-11.7	-12%	-15.7	-11%	-40.7	-24%
Diluted earnings per share	(\$0.80)		(\$0.17)		(\$0.26)		(\$0.35)		(\$0.90)	
<b>Balance sheet</b>										
Cash and cash equivalents	5.2		4.5		10.7		11.5		52.9	
Accounts receivable	3.6		0.3		2.2		3.4		5.9	
PP&E	0.6		0.8		1.6		8.9		5.3	
Goodwill & intangibles	12.4		12.4		16.5		23.3		33.6	
Total assets	25.3		26.6		49.8		72.7		131.6	
Accounts payable	2.9		1.4		5.0		3.2		4.4	
Total debt	0.0		0.0		0.0		0.6		0.7	
Deferred revenues	4.8		14.5		40.4		77.5		159.6	
Total equity	15.2		3.2		(7.2)		(23.7)		(63.7)	
<b>Cash flow statement</b>										
Operating cash flows	1.0		7.4		17.5		24.9		56.2	
Investing cash flows	(0.8)		(8.5)		(7.6)		(19.7)		(18.8)	
Financing cash flows	(1.0)		0.4		(3.7)		(4.5)		4.1	

Source: Company reports, GLC.

## 2: Selected Financial Data - Quarterly

Income statement	09/2006	%	12/2006	%	03/2007	%	06/2007	%
Revenues	40.0	100%	44.2	100%	54.9	100%	77.6	100%
Gross margin	13.8	34%	13.7	31%	22.3	41%	40.3	52%
SG & A	20.5	51%	23.9	54%	41.1	75%	32.3	42%
Operating income	-7.0	-17%	-14.6	-33%	-19.0	-35%	7.2	9%
Taxes	-0.9	-2%	0.0	0%	0.0	0%	1.1	1%
Net income	-5.4	-13%	-13.7	-31%	-19.8	-36%	4.0	5%
Diluted earnings per share	(\$0.12)		(\$0.30)		(\$0.36)		\$0.06	

**Balance sheet**

Cash and cash equivalents	32.7		52.9		20.5		31.1
Accounts receivable	5.2		5.9		15.1		20.8
PP&E	5.8		5.3		7.7		8.1
Goodwill & intangibles	30.9		33.6		369.1		367.2
Total assets	120.2		131.6		471.7		484.3
Accounts payable	6.6		4.4		9.9		12.5
Total debt	0.7		0.7		125.6		123.1
Deferred revenues	139.7		159.6		173.9		181.3
Total equity	(50.5)		(63.7)		109.2		114.5

**Cash flow statement****2007/2006**

Operating cash flows	13.3		11.0		(11.5)		15.7
Investing cash flows	(1.6)		9.2		(146.0)		1.7
Financing cash flows	(0.0)		0.1		125.2		(6.7)

**2006/2005**

Operating cash flows	8.5		11.8		16.5		15.4
Investing cash flows	(2.2)		(9.7)		(7.7)		(18.7)
Financing cash flows	(1.2)		(0.4)		0.4		3.5

Source: Company reports, GLC.

**Disclosure Information**

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