3D ADVISORS

Research Notes

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Research Notes are a brief description of the insider trading, accounting, or governance behaviors that we have been investigating for possible inclusion in standard 3DA reports, and may also include other information of general interest to 3DA subscribers. The ⬆ symbol indicates that we have observed management behavior that suggests a bullish sentiment.

Companies in this Research Notes

- Apollo Group Inc. (NASDAQ: APOL)
- BMC Software Inc. (NYSE: BMC)
- GEO Group, Inc. (NYSE: GEO) ⬆
- Korn/Ferry International (NYSE: KFY)
- Motorola Inc. (NYSE: MOT)
- Time Warner Telecom Inc. (NASDAQ: TWTC)

3DAdvisors Research Notes

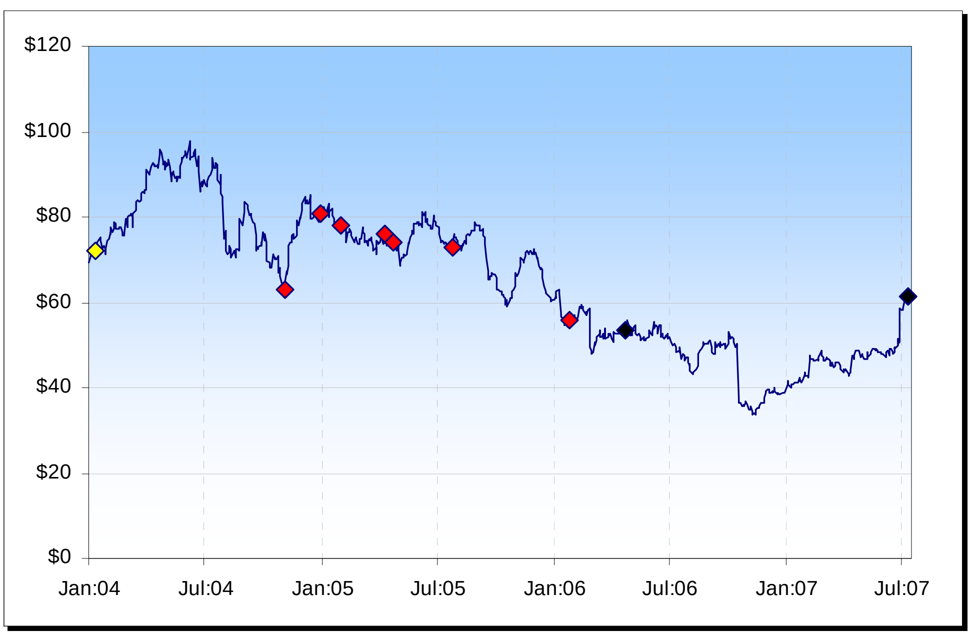
Apollo Group Inc. (NYSE: APOL)

- Investors traded Apollo Group shares 15% higher on June 28th when Q1 earnings beat the consensus despite failing to improve over the prior year. The Company has seemingly worked its way out of Wall Street's doghouse, as evidenced by the issue's 60% gains year to date. Its peer group has been equally as resilient, returning 38% since January. Also contributing to Apollo's recent momentum was the announcement the SEC has concluded its year-long investigation, which already resulted in the "resignations" of four top executives, without recommending any further action. Now, with the shares back to January 2006 levels and a lifting of what we presume to be Company imposed trading restrictions associated with the option investigation (based on a complete cessation of all activity), we are very interested to see how executives, who are historically active traders, respond. Two subtle yet substantial transactions have recently begun to answer that question.

- Apollo is a name we covered extensively back in 2005 and 2006, first in a Special Report dated 02/09/05 and in three subsequent Research Notes reports (01/10/06, 01/23/06, 04/28/06), all primarily highlighting the frequent use of derivative contracts by the Company's founder, Acting Executive Chairman **John Sperling** (86), and his son, Senior V.P., Treasurer, Director **Peter Sperling** (47), to quietly monetize millions of shares. The contracts were initially taken out into the impressive 2003 to early 2004 momentum, but became even more consequential when they continued selling forward their ownership while Apollo suffered through a lengthy period of deteriorating earnings, which resulted in a loss of nearly 60% of the issue's market value by late 2006. The total share count involved in these agreements is mesmerizing. The two collectively delivered 6.2 million shares between November 2003 and January 2007 under now-expired contracts, had another 3.9 million currently pledged through June that will change hands over the next 4 to 21 months, and now, on July 11th, entered into their largest-ever contracts covering 1.5 million shares (John) and 1 million shares (Peter).

- The numbers are definitely large, but comprehensible, as the two own 35 million shares, or 20% of the Company's outstanding stock, in addition to 100% of the Class B voting stock, giving Apollo "controlled company" status. The Sperlings' stock control, along with their inside influence over the Company's operations, makes their trading decisions more significant. The Company has yet to find a replacement for former CEO **Todd Nelson**, who resigned 18 months ago, and Peter Sperling would seem a convenient option to fill the void. But it might be difficult for the board to select a candidate who has 31% of his ownership pledged to third party investors and especially one who has shown little self-discipline monetizing shares at the most inopportune times, including a contract opened just weeks before the option backdating rumors first surfaced.

Figure 1. APOL Daily Closing Price, 01/02/04 through 07/18/07. Yellow diamond is where John Sperling entered into a forward sale contract; Red diamonds are where Peter Sperling entered into forward sale contracts; Black diamonds are where both John and Peter entered into forward sales contracts. Source: Reuters and APOL SEC Filings.



- Recent academic research has shown that forward sale contract initiation precedes periods of both returns and earnings performance declines[1]. The paper goes on to show that "PVFs (read: forward sales) reflect implicit sales by insiders in anticipation of firm performance declines rather than hedges of anticipated uncertainty about performance" and provides evidence that PVFs precede an average 120 trading-day excess industry average return of -12.5%. The ten forward sale contracts taken out by John and Peter Sperling between January 2004 and April 2006 (see Figure 1 above) did not precede the same negative return over a 120-day period following the contract agreement dates (+3% average), however, if we measured the stock movement over a longer timeframe (one year), Apollo shares lost on average -16.3% from the contract date. Needless to say, we feel any Apollo investor needs to pay close attention to the Sperling's recent behavior.

BMC Software Inc. (NYSE: BMC)

- The anomalous trading profile at BMC over the past several quarters, which we covered in detail in our last Insider Research Bulletin on 07/02/07, has led us to investigate several operational, fundamental and accounting-related items. Among the additional findings are: frequent and seemingly ongoing reorganizations of the business which have reduced costs, but have done nothing for top-line growth; the reorganizations and cost-cutting have significantly dropped R&D spending as a percentage of revenue, further reducing the likelihood of any rebound in revenue growth; high turnover in the CFO position and persistent "controls and procedures" deficiencies over several years help underscore several quality of earnings concerns.

- BMC seems to have been almost constantly under some sort of reorganization for the past three years. By the end of the 2007 restructurings, over 2,200 employees will have been terminated since 2004 (the Company now reports 6,000 employees). Perhaps the most glaring area to be affected is R&D which, as a percentage of revenue, has declined significantly since 2004, while the spending by most of its peers has remained relatively stable.

Table 1. R&D Spending as a Percentage of Revenue for Selected Companies. Source: 3DAdvisors, LLC and Company SEC Filings.

Company	2004	2005	2006	2007
BMC	18%	15%	14%	13%
ADBE	19%	19%	21%	21%*
ORCL	13%	13%	13%	12%
CA	21%	20%	19%	18%

* ADBE has a calendar year-end. This figure is for 1Q07.

[1] Jagolinzer A.; S. Matsunaga;, and E. Yeung. "An Analysis of Insiders' Use of Prepaid Variable Forward Transactions." Working Paper, Stanford University. May 2007.

The Company discloses that its restructurings, along with such plans for 2008, are projected to produce savings of $55 to $65 million. Based on the number of employees let go alone, we would have expected larger savings. BMC's restructuring charges are so large and recurring that they almost lose their non-operating nature and become part of the cost of doing business on an ongoing basis. There is not much quantification as to how much of any earnings improvement is due to restructuring. This makes us wonder whether there would be much in the way of earnings without restructuring. Nevertheless, such reductions in R&D and other cost cutting help short-term earnings, but do not auger for well for the future revenue growth. This orientation by management does not surprise us as their compensation is driven by EPS objectives, as we pointed out in our earlier coverage of BMC.

- Over the past six years, the CFO position has been a revolving door, while over the last three years there has been persistent, albeit disclosed, "Controls and Procedures" deficiencies. **William Austin** resigned as CFO in 2001. **John Cox** (an internal hire) took over from 2001 to 2004. Cox was then "demoted" to Chief Accounting Officer and **George Harrington** (from IBM) was hired as CFO in March of 2004. In August of 2005, Harrington resigned. **Stephen Solcher** (an internal hire) stepped in as interim CFO and was officially appointed CFO in December 2005.

  Meanwhile, over the past several years there have been ongoing problems with internal financial controls in several areas. In the Company's 2007 SEC Form 10-K, it is disclosed that management "identified a material weakness in the design and operation of the Company's internal controls over the accounting for income taxes."

  What is interesting is that this material weakness has been in place for some time now. In fact, as mentioned above, the same material weakness was identified and described in 2006 SEC Form 10-K, where a list of efforts being undertaken to correct the weakness in accounting for income taxes was provided. No mention is made whether any of these steps were completed in 2007. We are only reminded that the "material weakness" remains.

  Additionally, several other weaknesses in internal control were identified in the 2005 SEC Form 10-K including vendor specific objective evidence of fair value, monitoring of deferred revenue, and accounting for sales commissions. The question then becomes, does in fact management really want the internal control issues to be remedied?

- In the context of the persistent controls issue, especially the problems with income tax accounting, we found the following quite interesting. BMC discloses that [bolding below is ours]: "The Company can support a large portion of its net deferred tax assets through prudent and feasible tax planning strategies that would result in the realization of deferred tax assets. **The Company's tax planning strategies primarily involve the acceleration of royalty and cost−sharing payments under agreements that are currently in place between the Company and its foreign affiliates. Under these agreements, the acceleration of such payments is at the Company's sole discretion."** [2]

[2] BMC Software Inc. 2007 SEC Form 10-K, page 65.

To this, it is Interesting to note that current deferred tax assets increased 61% in fiscal 2007. One wonders if the company's stressing its ability to employ tax strategies such as acceleration of the royalty payments may be motivated by a desire to distract attention from a large net deferred tax assets account with only a very small valuation allowance. Wish may be father to the thought that the deferred tax assets will be realized.

- The strong cash position of $885 million that the Company reports at year-end (03/31/07) is largely illusory. Over half of it is accounted for by proceeds from a sale leaseback transaction ($292 million) and record proceeds from stock option exercises ($202 million) which basically speak to high volumes of employee selling since most shares acquired through option exercises are subsequently sold. The Company also discloses that its ability to finance receivables at levels it has in the past have been challenged:

  "However, to meet the needs of our customers we have been providing more licensing options, and this increased focus on flexibility may lead to more customer transactions where cash payments will be received over time. This flexibility may also reduce our ability to transfer finance receivables in the future and may reduce our cash flow from operations in the near term." [3]

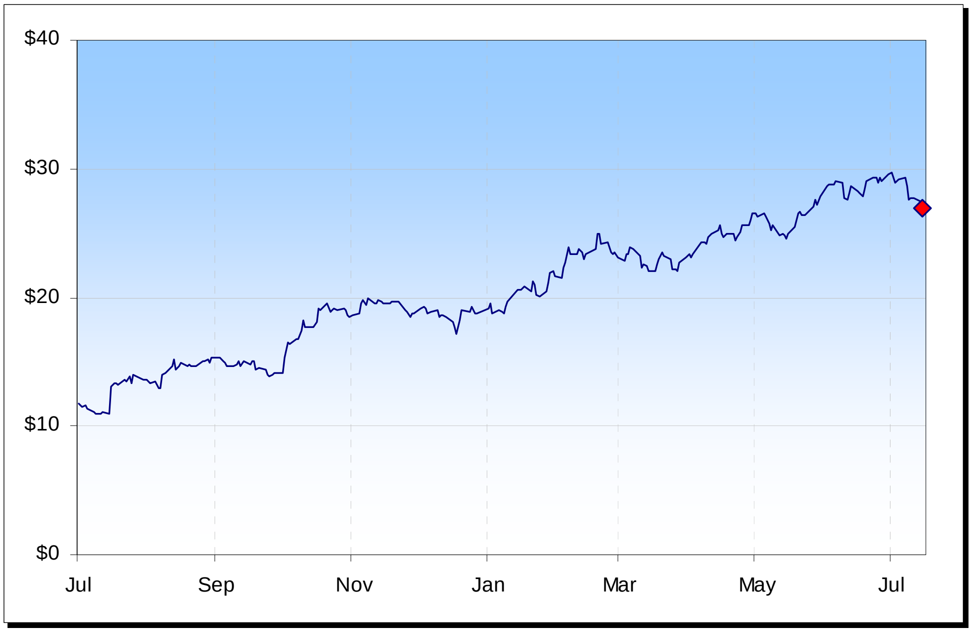
- Upon the adoption of 123R, the Company changed its methodology for computing expected volatility and the expected term. The calculation of expected volatility was changed from being based solely on historical volatility to a combination of both historical volatility and implied volatility derived from traded options on the Company's stock in the marketplace which dropped the volatility assumption on its shares, for option valuation purposes, from 71% in 2005 to 53% in 2006 then down to 34% in 2007. This is not an insignificant change considering the fact that, even after the change, stock option expense cost the Company $0.14 per share in 2006.

<u>GEO Group, Inc. (NYSE: GEO)</u> ⬆

- Shares of correctional and detention facility operator GEO Group, the second largest player in the sector, hit an all-time high on May 1st when the Company reported income and revenue increases of 16% and 28% for the first quarter and raised full-year earnings guidance by 6%. Equally promising was the news GEO is currently developing projects representing more than $148 million in projected annual operating revenue (2006 operating revenue was $860 million), which are expected to be completed by the second half of 2008. In the wake of the earnings report, upon the opening of a trading window, insiders surfaced for the first time this year, including three execs who adopted 10b5-1 sales plans which were commenced one month later (June). Although few of these sales were of much consequence, they proved early as the issue climbed another 13% by July 1st before reversing course. Now, with the shares down 9% this month, we have observed some very unusual insider behavior that suggests near-term upside for the stock.

[3] BMC Software Inc. 2007 SEC Form 10-K, page 35.

Figure 2. GEO Daily Closing Price, 07/03/06 through 07/18/07. Red diamond is the date where President and COO Wayne Calabrese terminated his 10b5-1 trading plan. Source: Reuters and GEO SEC Filings.



- On July 17th the Company filed an SEC Form 8-K disclosing Vice Chairman, President, CEO **Wayne Calabrese** (56), an 18-year GEO veteran, terminated his personal sales plan entered into on May 3rd. Under the terms of the plan, Calabrese was scheduled to sell 540,000 shares over the next 18 months at a rate of 30,000 per month. He had already distributed 30,000 on July 2nd, and because the plan requires a 30-day notice for termination, will sell another 30,000 in August, but the cumulative sales will account for only 10% of his actionable ownership. It is unclear at this time if two other execs who commenced new plan sales, CFO **John O'Rourke** (56) and Senior V.P., International Services **Donald Keens** (63) will continue with their scheduled selling under their respective trading plans.

- To say that corporate disclosures of a terminated plan, not issued in conjunction with a replacement plan, are rare is an understatement. Our search efforts to find additional plan termination examples over the past twelve months at companies with a minimum market capitalization of $500 million produced only six other occurrences (see Table 1 below). The shares of these companies not only showed rather instantaneous momentum swings in the ensuing three months following a plan termination, but maintained or expanded the gains through six months. We performed a similar exercise on terminations between 2004 and 2005, and similarly, the eight examples gained an average of 40% in the ensuing 180 days. This does not guarantee the same result at GEO Group, but judging from the track record of 10b5-1 cancellations at other firms, investors should be encouraged. Please note: the percentage change figures provided in the table are not computed using the highest price during the period, but use the actual closing price either three or six months after the termination date.

Table 2. Three and Six-Month Returns Following Cancellation of 10b5-1 Trading Plans at Selected Companies. Source: 3DAdvisors, LLC and Company SEC Filings.

Company	Insider	Termination Date	% Chg 3 Months	% Chg 6 Months
CIT Group (CIT)	CEO J. Leone VC T. Hallman	07/31/06	15%	30%
GTX (GTXI)	CEO M. Steiner	08/07/06	17%	99%
TALX (TALX)	CEO W. Canfield	08/16/06	36%	49%
Brightpoint (CELL)	Director R. Roedel	02/09/07	25%	24% [1]
Express Scripts (ESRX)	CEO G. Paz	3/14/07	17%	34% [1]
Opsware (OPSW)	CEO B. Horowitz	03/15/07	50%	58% [1]

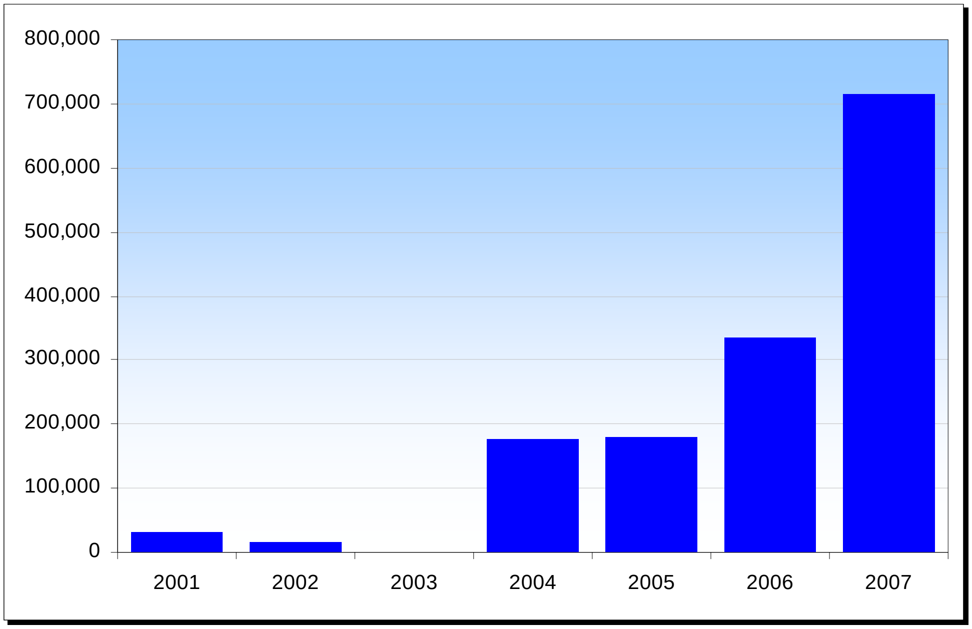
[1] % change computed through July 18, 2007

- There is one angle to this story that makes us a little cautious. The Company did not issue any type of disclosure when the three 10b5-1 plans, including Calabrese's, were entered into in May. Trading plan adoption disclosure is not required by the SEC, but we consider such efforts to be a measure of a company's Section 16 reporting transparency. We do find it a little odd that without initially disclosing the adoption of Calabrese's plan, they now choose to report its termination. This might have been more of a concern if a press release were issued, as it would hint at grandstanding, but we feel the selective disclosure is not enough to invalidate the underlying fact Calabrese halted his diversification intentions and now chooses to retain the equity. Though it may be a touch early, we are monitoring this situation closely should the others choose to cancel their 10b5-1s as Calabrese has.

<u>Korn/Ferry International (NYSE: KFY)</u>

- Executive placement and staffing firm Korn/Ferry disappointed investors on June 6th when it reported a 30% earnings slide in its fiscal fourth quarter, missing Wall Street's consensus by 12%. The news, along with an analyst downgrade from "buy" to "hold", dropped the shares, which were trading at an all-time high, a modest 2%. This brings to question the timing of the April 25th announcement that KFY would be separating the chairman and chief executive roles on July 1st, earning CFO **Gary Burnison** (46) a promotion to the CEO post held by **Paul Reilly** (53) since 2001. Reilly deserves credit for keeping Korn/Ferry afloat through an industry recession five years ago, and at his age, should be poised to continue leading the Company. We wonder if he is taking steps towards a full exit as speculation heats up the Company is entering a "maturing cycle". There is one thing we do know with certainty: Reilly has hedged his position and some of his closest lieutenants have followed his lead.

Figure 3. Annual Shares Sold by KFY Insiders (2007 is through 07/18/07 only). Source: KFY SEC Filings.



- In the wake of the June 6th earnings release, three top insiders, Reilly included, sold 607,000 shares at an average price of $26, just shy of the current median analyst price target of $27. This year's total selling volume of 714,000 has nearly matched the total sold (740,000) between 2001 and 2006. Before turning to the individual sales, we have to address the amendment to Reilly's employment agreement. For the two-month transition period he was given, in addition to his regular base salary, an extra cash payment of $162,500 and 9,420 freely transferable shares. He also agreed to a new contract for his chairman duties (and Burnison mentoring according to the terms), which include a guaranteed base salary and bonus totaling $1.25 million and most importantly, the acceleration of all 200,000 unvested restricted stock and options. This is the first time we can recall this type of arrangement granted an employee not leaving the company and leaves us to question the Compensation Committee's motives. Regardless, with new equity at hand, Reilly sold 500,000 shares, **equal to 50% of his ownership**, on July 2nd at $25.

- Also selling during this timeframe was Executive V.P. **Gary Hourihan** (58), who not only monetized three non-expiring options, but also depleted his common stock holdings. The 47,000 shares sold, his second largest distribution on record, **accounted for nearly 50% of his actionable holdings as well**, leaving his ownership at the lowest level in more than five years. Rounding out the activity was Executive V.P. **Robert McNabb** (60), who cleared out the majority of his vested options in addition to cashing in shares that became unrestricted just days earlier. He has now **shed 80% of his ownership in the past year**, also bringing down his holdings to an unprecedented low. Neither Hourihan nor McNabb, both named executive officers, will see more derivative equity vest for another 11 months.

- We are very interested to see how this story develops. The aggressive monetization of newly-vested options and restricted shares after an earnings shortfall, combined with the management shuffle, gives us the impression there might be more that could unfold. The only key Section 16 filer yet to act is CEO Burnison, who might have abstained because of his aforementioned promotion. It is very possible he could surface in the near future once he settles in to his new role. Should this occur, Korn/Ferry would receive considerably more focus from us.

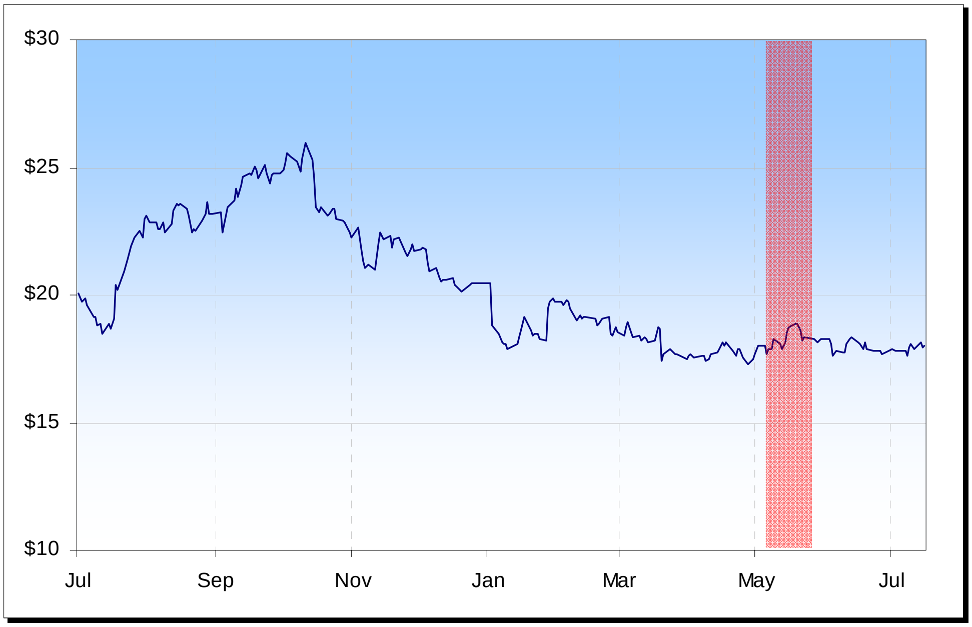
<u>Motorola Inc. (NYSE: MOT)</u>

- We have been keeping close tabs on Motorola since May, when three high-level executives monetized 430,000 non-expiring options at prices marginally above the two-year lows (see Research Notes dated 06/15/07). These untimely sales coincided with not only the uniformly bearish sell-side sentiment, but sweeping layoffs that will eliminate 11% of the Company's global workforce. Little has changed since, with the exception of the successful iPhone launch, a competing product Motorola has no answer for, the July 10th announcement that MOT acquired privately-held communications software developer Leapstone Systems for an undisclosed amount, and of course, a second consecutive unprofitable quarter. With uncertainty hanging over the Company, we are very curious about some recent executive compensation actions taken in recent weeks.

- On June 27th two Form 4s were filed on behalf of **Daniel Moloney**, President of the Home & Networks Mobility Business, and Chief Strategy Officer **Richard Nottenburg**. The filings were very ambiguous, only showing dispositions of 200,000 and 75,000 shares without any accompanying footnote. Upon closer inspection of their past filings, it appeared to us these share totals matched restricted stock grants each officer had been awarded one month earlier (May 8th). Without the benefit of any explanation why they would be turning in newly-granted shares, we contacted the Company and spoke to Senior Director of Investor Relations **Lori Chaitman**, who informed us that the two had in fact forfeited their restricted stock "because they did not agree with certain terms of the [Motorola Omnibus Incentive Plan of 2006] stock plan". When we pressed for an explanation, Chaitman said the Company was not willing to disclose any more information. In a nutshell, Moloney and Nottenburg voluntarily returned shares with a market value of $3.5 million and $1.3 million, respectively.

- It later became apparent that the Company acquiesced to whatever Moloney's protest may have been, as he was granted another 200,000 shares of restricted stock on July 5th. No stock plan was filed for the award, so it is unclear if there was any amendment to the terms. But here is where things get interesting: Along with the restricted stock awarded him in May, he also received, as part of his annual equity compensation, 200,000 stock options which he did not forfeit. He was then handed another 200,000 options in July, making his cumulative 2007 awards the largest in the past seven years. We should also note this is the first instance we can identify of a Motorola executive receiving more than one option award in a calendar year. Nottenburg has not been equally as fortunate, as he is yet to receive any awards to replace his forfeited shares.

Figure 4. MOT Daily Closing Price, 07/03/06 through 07/18/07. Red shaded area is where four insiders sold 429,553 shares. Source: Reuters and MOT SEC Filings.



- The Company also reported on July 10th a pay increase for **Greg Brown** (46), who was promoted to the vacant president/COO positions in March after the Company acquired Symbol Technologies and gave Brown's job to Symbol CEO **Sal Ianuzzi**. Brown, who joined MOT in 2003, was already the second highest paid officer, but still received a 25% base salary increase to nearly $1 million, increased target awards under the Incentive Plan and Long Range Incentive Plan, and was awarded a total of 750,000 options and restricted shares. We find it particularly interesting that, despite the Company's continued problems, none of these options or shares were tied to performance.

- Shareholders have criticized Motorola's Compensation Committee for the generous pay package provided to CEO **Ed Zander** despite his inability to right the ship. With the deteriorating employee morale spreading throughout the ranks, which has been reported by a number of media outlets, it makes us wonder how the Company can justify increasing executive pay while continuing to lay off its employees. It is very possible that Maloney, with 70% of his vested options priced below market or in jeopardy of slipping underwater, threatened to follow other executives and board members who have resigned in the past year unless his equity compensation was increased and the terms of his restricted stock was made more advantageous. If this were the case, and with rumors of the Company actively searching for a new CEO, we can now add management instability to the long list of Motorola's problems.

<u>Time Warner Telecom Inc. (NASDAQ: TWTC)</u>

- Time Warner Telecom Inc. is a Company that has held our attention for the better part of the last year. We have covered TWTC's numerous financial and operating issues in a full report and update this year alone (01/03/07 and 05/01/07), alongside the widespread insider profit taking that consistently contradicts management's inexhaustible professions of bullishness. Since reporting an unspectacular first quarter on May 2nd, the shares have been range bound between $18 and $21. This may be a result of investors and analysts waiting for any meaningful catalyst that will get the Company closer to profitability, which in our opinion is not likely to happen any time soon.

- Such announcement has clearly not materialized in the past 90 days, which can be traced to the absence of any SEC filings not related to insider sales or earnings releases. There has also been a noticeable decline in corporate press releases. After issuing 11 media releases (excluding earnings reports) in 4Q06 and another 11 in 1Q07, there have been only three since April, one of which was a contract (Skybus Airlines) previously alluded to on the last conference call. Even in the absence of any material operational news, we still feel the most relevant information coming from the Company is the insider sales that continue to have our attention.

- Our past reports emphasized the aggressive diversification efforts of nearly every executive in the TWTC hierarchy. The selling, which has been unremitting since the fourth quarter of 2005, has eroded ownership levels between 60% and 99% across the board, largely accomplished through undisclosed 10b5-1 trading plans. What continues to hold our attention is the fact insiders maintain this course of monetizing their derivative equity immediately upon vesting, evidenced by the 100,657 shares sold by five insiders between May 9th and July 18th. The most notable trader is Chief Operating Officer **John Blount** (48), who had two separate option series vest in part on July 1st and July 13th, along with a restricted stock grant, and immediately cleared out all 63,750. He has now **shed more than 70% of his actionable ownership over the past 52 weeks**.

- While Blount might have distributed the most shares recently, the actions of CFO **Mark Peters** (46) and General Counsel **Paul Jones** (60) are just as significant in their own right. Peters, who had previously cashed out all but the 1,500 common shares in his possession, vested in 10,781 options from five separate series between June 30th and July 13th and immediately monetized these. We are constantly intrigued that a corporate head of finance could so blatantly sustain a lack of beneficial ownership for a prolonged period without board intervention, but this seems to be permissible at TWTC. The same applies to Jones, who monetized a total of 6,750 options on May 9th and July 13th, the very dates the options vested. **The two have both sold 99% of their ownership year to date.** Jones' behavior explains the specious trading plan activity exhibited by TWTC execs, as the individual (head counsel) best informed about the spirit of Rule 10b5 clearly sets a poor example for his peers with his own trading practices. The latest sale came from Director **Roscoe Young II** (55), a board member of only two years who shed 72% of his available holdings over the past 52 weeks, including the 12,501 shares sold on July 18th. It is fitting that Young, who should be governing the insider trading policy as Chairman of the Compensation Committee, is an abettor to the excessive profit taking.

- Even with stock options becoming actionable on a quarterly basis and restricted stock vesting periodically throughout the year, the aggressive selling by TWTC's top five executives has shed 65% of their collective ownership in the past year. This clearly does not corroborate the assurances management habitually provides Wall Street that the Company is on the right track. With nothing at the present time to convince us the upcoming earnings report will show decisive operational progress, and more importantly, balance sheet improvement, we are left only with the continued bearish implications of the insider activity. Investors who have been patient with the Company to this point should be concerned that a catalyst for near-term upside might not be in the cards.