| This 3DAdvisors Report Covers: | |
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| ✓ | **Insider Trading**: Insider Trading Behavior |
| | **Accounting**: Quality of Earnings Issues |
| ✓ | **Governance:** Corporate Governance Issues |

# Change in Insider Selling Behavior is Important CDW Corporation (NASDAQ:CDWC) Update

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CDW Corporation, formerly known as CDW Computer Centers, Inc., is a direct marketer of multi-brand computers and related technology products and services in the United States. The Company offers multi-brand computers and related technology products, including hardware and peripherals, software, networking and communication products and accessories, for use with microcomputers based on a variety of operating platforms, including Microsoft, Apple, Linux, Novel, Oracle and others. CDW offers more than 80,000 products that include a range of product types from manufacturers including Cisco, Hewlett-Packard, IBM, Intel, Microsoft, Sony and Toshiba. With this selection of products, the Company can provide its customers with fully integrated, multi-branded technology solutions and the convenience of one-stop shopping. It also offers its customers value-added services; including the ability to custom configure multi-branded solutions and technical support around the clock.

## Summary of 3DAdvisors Findings for CDWC

- **Governance:** Executive compensation behavior is highly unusual
- **Insider Trading:** Change in insider selling behavior is important
- **Governance:** Independence of audit committee member in doubt

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## Discussion of 3DAdvisors Findings

As CDW Corporation works to integrate the Micro Warehouse acquisition, most analysts continue to remain bullish, even though the Company has acknowledged that Micro Warehouse suffered some deceleration of its business in the months leading up to the transaction. The October 22nd Q3 earnings conference call was rife with analyst questions concerning the decrease on the consumer side of Micro Warehouse's business and the lowered run rate for M/W's December quarter.

Surprisingly, CDW would offer no guidance as to when the deal will actually become accretive to earnings, providing instead a list of proactive measures being taken by CDW to correct the problems at Micro Warehouse.

Undaunted, analysts point to *what they have been told by the Company* as the basis for their continued high expectations for CDW shares. Perhaps instead, they should be looking deeper into the actions of certain key CDW insiders. Not only is their stock trading behavior telling, but we also have observed certain governance behavior that we think is noteworthy.

## Governance: Executive compensation behavior highly unusual

Our first look into certain CDW compensation issues (see our report dated 1/15/03) revealed details of a very unusual 2001 severance agreement between the Company and Paul Kozak, V.P. – Purchasing. Kozak had left the Company in September of that year. CDW made no mention of his leaving and the only disclosure was the inclusion of his separation agreement as an exhibit in the 2001 10K. His separation agreement, which was not executed until three months later, revealed what appeared to be quite a contentious situation, detail of which is contained in our two previous CDW reports (1/15/03 and 7/11/03). Succinctly put, after pressuring the Company, Kozak (37) received $722,000 in cash payouts (folded into a non-compete); was reimbursed his $40,000 legal fees; was cashed out of his Country Club membership and received outplacement services for a year. Not bad for an employee who had, prior to his exit, been receiving a salary of $187,000 annually.

Kozak's package seemed over the top for a person in charge of purchasing in an industry where product is fairly generic. There had to be more to the situation. We suspect that the answer may lie in the fact that his responsibilities, according to the Company, included "primary responsibility for our warehousing, distribution and technical service functions."

At the time of our initial reports, we suspected that if CDW was doing anything with inventory and revenue treatment that it didn't want divulged, Kozak might have possessed enough knowledge to make the Company justify such a severance package. We have since uncovered more evidence that points to the fact that, in addition to Kozak, two other key insiders at the time, who continue to be employed at CDW, may have been in similar positions. We say this because, in 1999, all three received very large stock option grants, much larger than had been offered by the Company in either prior or subsequent years. Adjusting for splits, the average option grant to CDW executive officers has been in the 20,000-share/year range since 1996. In 1999, however, three insiders, including Kozak, received options totaling 400,000 shares each.

### Harry Harczak: A CFO Demotion?

It is significant to us that then-CFO Harry Harczak was the recipient of one of those fat option grants. Harczak held the CFO position from 1994 to January 2002. Prior to joining CDW, he had been a partner at PriceWaterhouseCoopers, which was CDW's independent auditor at the time and continues to be today. Unlike Kozak, however, Harczak did not leave the Company. He chose to stay on and now is Executive V.P. – Sales. Upon announcing the apparent "promotion", CDW said that Harczak "will enhance the company's commercial sales strategy and lead an organization of more than 1,100 co-workers. His responsibilities will include management of the company's industry-leading sales force and product category specialist teams, along with sales recruiting, sales training and corporate training."

We have never seen a CFO with an audit background get "promoted" to head of a large sales organization. We also find the fact interesting that Harczak remains the third-highest compensated executive at the Company, with over $1 million paid to him (in salary and bonus) in 2002. Topping off the Harczak discussion is the fact that he is aggressively selling shares at this time (see below), substantially trimming his holdings in the process.

James Shanks: The Third Recipient

Also receiving a fat 400,000-share option grant in 1999 was James Shanks, who was Chief Information Officer at the time. Shanks has since been promoted to President – CDW Government. Shanks ranks just behind Harczak (above) as the fourth highest-compensated executive at the Company and was paid over $876,000 in salary and bonus in 2002. Given his high compensation level, certain components of his recent stock sales are extremely interesting (see below).

<u>Insider Trading: Change in insider selling behavior is important</u>

In our view, the insider activity at CDW has become very significant. In addition to Harczak and Shanks, other officers are letting stock go and are clearing out long-held options in the process. The amounts by which some of the holdings are being reduced suggest that the something significant enough may have shifted at the Company to flush out the shares. These sales occurred on October 23 and 24, the first two days following the Company's October 22nd earnings release.

- **Harry Harczak (46)** – EVP, Sales. The former CDW CFO cleared out of 63% of his actionable position (common stock plus exercisable options) in October by exercising options and selling 89,125 shares for prices in the $59 range. The transaction caused Harczak to clear out the majority of his position of exercisable options from four separate option series. The earliest expiration date for any of these options was 2016. In addition, these are his largest sales of CDW shares in the past five years.

- **James Shanks (38)** – EVP, President of CDW Government Inc. Shank's sales were more aggressive than Harczak's. He trimmed his actionable position by 86% by exercising options and selling 65,425 shares at prices in the $59 range in October. Shanks cleared out most of his exercisable options as well, exercising them across six separate series. Even more telling however, is the fact that he exercised the entire available amount of $55.63 options, selling the underlying 4,400 shares for $59.14 each. These options are not set to expire until 2012. We rarely see such a highly compensated individual cashing in an available option position for such a small profit of just $3.50 per share (about 6%). When this occurs, we feel there is an elevated chance that the options will not remain above water in the intermediate future. The other five option series that he had cashed in were not set to expire until between 2016 and 2021.

- **Douglas Eckrote (38)** - Senior Vice President, Purchasing and Operations. Eckrote reacted in October, along with the others. During the month he exercised options across six separate options series and sold the underlying 59,409 shares in the $59 range. Eckrote's vesting schedules for options exercised are not available as in the cases of Harczak and Shanks. Our estimates however, are that his sale may have trimmed his actionable holdings by about 20% at least. These options were not set to expire until between 2016 and 2021. Eckrote is the fifth-highest compensated company executive with over $780,000 in total compensation in 2002.

- **Arthur Friedson (40)** – Vice President, Coworker Services. Friedson's options exercises and subsequent sale of the underlying 8,750 shares interests us as well. As in the case of the others, his sales occurred during the same two-day period as the others. They are his largest in the past five years and involved options that were not set to expire until 2019 at the earliest.

The option exercise patterns for the above individuals suggest that their behavior has shifted from one where they would retain vested, exercisable options to one where they increasingly exercise their options as soon as they become available, no matter how much time may be left before expiration.

Governance: Independence of audit committee member in doubt

CDW's Audit Committee is composed of directors that appear independent on the surface. There is an interesting connection between CDW Chairman and CEO, John Edwardson, and a current member of the Company's Audit Committee. Edwardson, who joined CDW in 2001, came from Burns International Services where he also served as Chairman and CEO (between 1999 and 2001). Curiously enough, there is another CDW board member who came from Burns International. He is Terry Lengfelder, a former Arthur Andersen partner (retired in '98). Lengfelder's two-year tenure on Burns board overlaps the same two years that Edwardson was at Burns. Lengfelder chaired the Audit Committee at Burns International during Edwardson's tenure there. Three months after Edwardson joined CDW, Lengfelder joined the CDW board where he remains an audit committee member to this day.

Although not illegal, the Edwardson-Lengfelder connection raises the question of whether there is total independence on the part of the Audit Committee. Having someone on the Audit Committee with whom the Chairman and CEO is "comfortable" and with whom the Chairman has worked in the past may not provide the relationship that is going to foster questioning and challenges by the Audit Committee. It would seem that this, at the very least, challenges the spirit of certain Sarbanes-Oxley rules requiring certain board member independence.