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

Section 16 and Rank and File Selling Picks Up
Mercury Interactive Corp. (NASDAQ:MERQ) Update

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Mercury Interactive is a provider of integrated performance management solutions that enable businesses to test and monitor their Internet applications, helping to improve the performance, availability, reliability and scalability of Websites.

Summary of 3DAdvisors Findings for MERQ

- **Insider Trading:** CFO leads round of selling after price drop
- **Insider Trading:** Rank and file follow executives in selling
- **Accounting:** Will tax benefit on option exercises be realized?
- **Accounting:** Interest on employee loans continues to be significant
- **Governance:** Board member behavior again called into question

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Discussion of 3DAdvisors Findings

We began monitoring MERQ in August of 2003 (see our initial report dated 8/5/03) as we had noticed an undisclosed director conflict of interest associated with Kintana, which the Company acquired that same month. Undisclosed was the fact that Mercury director Anthony Zingale, who was also a director of Kintana, held options for 100,000 shares of Kintana prior to the acquisition. Although the number of options involved was not terribly large relative to the size of the Kintana transaction, failure to disclose such interests is behavior that always gets our attention. This fact, combined with certain insider trading behavior, led us to investigate further, revealing several additional noteworthy behaviors: various insider loans booked in a fashion that would imply that repayment was not likely; unusual collateral required for a run-of-the-mill interest rate swap (report dated 8/12/03), and; earnings boosts from swap gains and debt retirement.

MERQ shares were roughed-up after the Company's October 22nd Q3 earnings release, dropping seven points in the two subsequent trading days. Sales difficulties at the newly acquired Kintana provided the initial disappointment as it became evident that certain deceleration in its revenue model in the months prior to its acquisition hurt results. This led to the reorganization of the Kintana sales group, putting it under MERQ management. This news was not very welcome, as just weeks prior to the release the Company had been indicating that things were going smoothly with Kintana.

In a related development, Mercury's DSO's jumped 28 days, to 82 days, as deferred revenues resulting from the Kintana business had their effect on MERQ's overall receivables picture. Contributing to investor unease was the announced departure of COO Kenneth Kline at year-end. Kline is known to be a sales-oriented executive. The loss of his leadership, coming at a time when MERQ is struggling to get Kintana's sales in order, is not the kind of news that calms investor nerves. Bullish analysts reasoned it away by stressing that Kline, at 43 years, is a long way from ascending to the top management spot with current CEO Amnon Landan being just 44. His "retirement", it was figured, must reflect his need to move his career forward. Fair enough, but what about the behavior of insiders since the Kintana deal?

Insider Trading: CFO leads round of selling after price drop

The key insider sale that caught our eye was that of CFO **Doug Smith (51)**, who dropped 100,000 shares on October 27th, the first day MERQ shares rebounded a bit from their post-release drop. Smith got $45.73 for his shares, which had bounced from the $42 to $43 range. Unlike many others at the Company, Smith has yet to file a 10b5-1 trading plan.

Making his sale even more interesting to us is the fact that he had not sold a share since initially becoming a Section 16 filing insider in 2000. After over 20 years of following insider actions we can tell you, with confidence, that selling by insiders into the first bounce from a sell-off has often been a signal that the causes for the drop in stock price have not yet passed and we consider it a classic red flag.

Supporting this notion is the additional fact that a number of other insiders also sold after that earnings release. Unlike Smith, most of these individuals entered into 10b5-1 trading plans during the approximate time of the closing of the Kintana deal:

- **Bryan LeBlanc (36)** – V.P. of Finance. The second financial person to sell after the report, LeBlanc is a new insider having joined the Company in May of 2002. Selling from a new insider is rare, but to see one file a 10b5-1 plan is even rarer. LeBlanc filed his plan and sold for the first time in August. Since then, he has sold 9,000 shares: 5,000 in August for $40 each and another 4,000 after the earnings release in the $47 area.

- **Zohar Gilad (40)** – V.P. of Products. Gilad has been with the Company since 1995. We do not have a record of any selling by him, however, until July of 2003, when he sold 50,000 shares at prices in the $41 range. He then filed a 10b5-1 plan before selling another 12,000 shares, after the release, in the $47 range.

- **Susan Skaer (39)** – General Counsel and Secretary. Skaer had been with MERQ since 2000 but had not sold a share until July of 2003 when she let 15,728 shares go for prices in the $41 range. Like the others above, she filed her 10b5-1 trading plan around the time of the Kintana deal, then let go of another 4,050 between September and November.

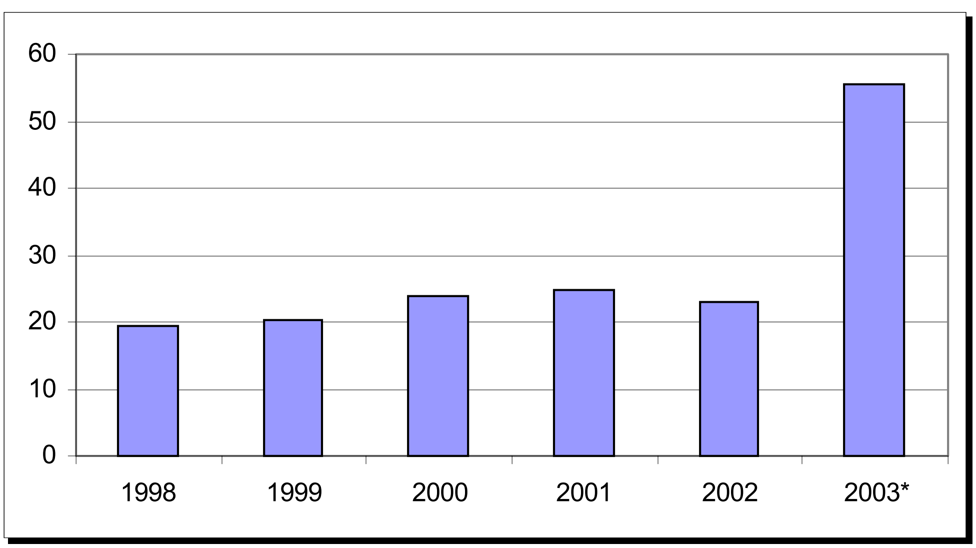
- **Larry Wear (37)** – VP and GM of APM (Applications Performance Management). Wear's profile fits the others. His first-ever sale occurred in July when he dropped 64,583 shares. He followed this up by filing a 10b5-1 plan then sold another 9,375 shares between August and November.

Most Section 16 attorneys will advise their clients to file their 10b5-1 plans first, then wait at least 3 to 6 months before selling. We find it extremely interesting that this group sold their biggest share amounts ever in July, then followed up with 10b5-1 plans somewhere between then and their August sales, all around the time of the Kintana deal.

Insider Trading: Rank and file follow executives in selling

Not only are the Section 16 insiders (read: SEC filing insiders) selling, but non-filing employees are doing so as well, and in record numbers. At the time of our last MERQ reports in August, we could not have made this claim. Things changed dramatically on this front in the past quarter, however. We look not only at Section 16 insider filings but also monitor employee stock option activity through Company financials. The evidence is clear that record amounts of options were exercised in Q3 of 2003. It has been our experience that most employee option exercises, occurring prior to expiration, are accompanied by sales of the underlying securities. MERQ is no exception. Take a look at the activity:

Figure 1: Cash Received From Employee Option Exercises (Mil $). Source: MERQ SEC Filings.



* Through September of 2003

The chart above shows the option exercise activity at MERQ through Q3 of 2003. What it doesn't show is that, in Q3 alone, employee stock option exercise activity totaled $31.9 million or, in other words, far greater than in any other year in the Company's history, and this during a time when the average weighted value of options exercised has remained fairly constant. With a full quarter yet to go in 2003, it is clear that employee selling confirms what we are seeing from Section 16 insider selling, and both are departures from prior behavior. More importantly, the convergence of the two comes at the time of the Kintana acquisition and, since MERQ shares traded at higher levels in 2000 and 2001, cannot be attributed to simple profit taking.

Accounting: Will tax benefit from option exercises be realized?

Our August report covered the fact that, in 2003, MERQ had begun, for the first time, to disclose that it was setting up an allowance related to its recorded tax benefits. In each prior year, the Company has indicated that it intended to be able to utilize such benefits. In 2003 however, the language changed and the Company began indicating that it has **"recorded a valuation allowance for the entire portion of the net operating losses related to the income tax benefits arising from the exercise of employees' stock options that will be credited directly to stockholders' equity in the future."** [The bolding is ours for emphasis.]

Though MERQ discloses it has set up this allowance, it never discloses how much the allowance is. The Company did go on to disclose that additional allowances may be in order: **"In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could materially impact our financial position and results of operations."**

When we first noticed this, we wondered whether the Company might be hedging for the event that intermediate-term profitability may not be sufficient to be able to utilize the tax benefits related to options exercises. It now seems somewhat prescient in light of the fact that Q3 of 2003, with the associated Kintana drag, resulted in the Company reporting a loss for the quarter.

Accounting: Interest on employee loans continues to be significant

Sarbanes Oxley may have put an end to loans to employees for the purchase of company stock in the U.S, but not overseas. We say this because MERQ continues to book plenty of interest from outstanding loans to overseas employees. These loans have been made to MERQ employees to exercise their options to acquire Company stock. In these cases, the shares optioned for are the collateral for the loans. Such loan activity defies the spirit of Sarbanes Oxley.

So far in 2003, MERQ has booked $1.4 million in interest income related to such loans even though it is not clear that actual payments of such interest have been made. This amounts to about 1.6 cents a share in 2003 earnings so through Q3 of this year.

Governance: Board member behavior again called into question

One of the behaviors that originally got our attention at MERQ was the undisclosed interest that director Anthony Zingale had in the Kintana transaction. The size of his interest (100,000 options) relative to the overall size of the transaction ($225 million) was not large, but the fact that such an interest by a board member was not disclosed should be important behavior to investors.

We recently noticed another transaction involving Zingale. This one is even smaller, but again it raises some questions about the behavior of this particular director and why management and the rest of the board would tolerate an apparent conflict of interest.

Zingale is also on the board of Biz360, and MERQ is doing business with this entity as well. In January 2003, MERQ entered in to a 15-month subscription agreement with Biz360 to purchase marketing services for $110,000. By March 14th, MERQ had already paid the $110,000, with 12 months remaining on the contract. We think its odd that the Company would pay a “subscription” fee up front like this. This is a small number, to be sure, but the fact that Zingale is on both boards again gets our attention.