This 3DAdvisors Report Covers:

- ✓ **Insider Trading**: Insider Trading Behavior
- ✓ **Accounting**: Quality of Earnings Issues
- ✓ **Governance:** Corporate Governance Issues

Option Exercises and Other Issues Worth Looking Into CDW Computer Centers, Inc. (NASDAQ:CDWC)

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CDW Corporation, formerly CDW Computer Centers, Inc., is a direct marketer of multi-brand computers and related technology products and services. CDW's extensive offering of products, including hardware, software and accessories, combined with its service offerings, provide comprehensive solutions for its customers' technology needs.

Summary of 3DAdvisors Findings for CDWC

- **Governance:** An unusual severance agreement
- **Insider Trading:** Highly unusual options plan and insider selling
- **Accounting:** Tax benefit from options exercise may be running out

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Discussion of 3DAdvisors Findings

Governance: An unusual severance agreement

If you were only looking at CDWC financials, you wouldn't have a clue that there has been an industry slowdown. Most of their numbers behave - inventory turnover is under control, receivables don't waver, there's no long-term debt, and revenues have been steadily climbing. So have profits. What's not to like? I'm sure you, among others, are wondering how these guys do it.

An industry insider that we know (who is in the same business as CDW) expressed disbelief when we told him of the condition of the Company's financials. The company he owns has been struggling and is no longer listed on NASDAQ. He has been in the industry for quite some time. He says CDW is good, but not that good. With no revenue reductions, indeed growth instead, during the past three year period, and without the aid of acquisitions, one is left to assume that this is a business model that is so fine-tuned that it must be taking market share from competitors. So why all the insider selling?

We may have found a clue in the '01 10K (filed last March). In it, included as an exhibit, is a termination agreement between the Company and an employee. This employee was not on the radar screen as one of the top five or six executives. There was also no mention either by the Company or by the Press, of his Sept. '01 exit. Nevertheless, the Company (or its auditors) deemed the event significant enough to include the individual's termination agreement in the '01 10K.

This person is **Paul Kozak**, who was V.P. Purchasing for CDW. The first two components of the agreement looked normal. Kozak got three months severance on his $187,000 annual salary and received a pro-rated portion of his bonus. The Non-Compete portion of his deal, however, looked suspicious. Kozak received $722,000 in 13 monthly payments totaling $56,000 each. Our industry contact supports our contention that, given this type of company and his position, there should be no proprietary interests sufficient enough to warrant such a payoff. If that wasn't enough, this guy got outplacement services for a period of one year, $8,000 in continuing education expenses and Company assistance in cashing out the equity portion of his Country Club membership. What could it be that caused the Company to acquiesce in such a fashion to this individual?

This makes us wonder whether he may know things about the Company (such as how it treats inventory and revenues) that the Company does not want divulged. It is apparent that this individual would have had some interesting knowledge: According to the Company, he had "primary responsibility for our warehousing, distribution and technical service functions". He is 37 years old. Our industry contact goes on to explain that if the Company is doing something to affect numbers, the first place to look is in inventory. We found this early in our work and it provided us with basis to suspect that there may be dealings going on here that are deeper than what has been disclosed on the surface.

<u>Insider Trading: Unusual options plan and insider selling</u>

We don't think our efforts on this one are wasted, no matter how subtle the clues are. The big blocks of insider stock that have been coming out are classic. If the going is so good, why is the inner circle selling so much stock?

For one, this is a tight inner circle of insiders. The core has been together for about 15 years. Their ages average between 38 and 48. The founder, **Michael Krasny (48)**, is no longer required to sign off on financials as he stepped out of operating responsibility back in '01. He's still on the board and remains, by far, the company's biggest stockholder with 26.4% of the outstanding shares. His holdings are down from 57% in '97 though. Not only has he been cashing in stock through plenty of open market sales but also though a unique arrangement where, through two special stock option plans (which are separate from the Company's broader-based plan), he has contributed his own holdings to provide for options exercised or shares vested. He remains the Plan Administrator for these plans.

These special plans are called the MPK Stock Option Plan and the MPK Restricted Stock Plan. They seem to exist mainly for the benefit of a core group of operating individuals. The Plans were formed, and the related options granted, in '93 when the Company went public. The plans are complex and have plenty of unique detail. For one, options granted under it are guaranteed for the top three officers. If they leave the company, they get immediate vesting of their options. If Krasny sells his own shares, MPK Plan participants can, in turn, exercise and sell proportionately more of their stock than they would be able to if Krasny had done nothing. The Company assists the top MPK Plan participants in registering and selling their shares, even to the extent that it helps with a road show when necessary. Since '01, the Company has been buying back shares. A good portion of repurchased shares have come from those sold out of the MPK Plan.

Accounting: Tax benefit from option plans may be running out

The Plan provides huge tax benefits to the Company. Since the options under this plan were granted long ago (1993), the exercise price of most of the options appears to be about a penny per share. What's truly effective about this is that the options are Non-Qualified and the Company is able to generate huge tax deductions upon their exercise. You may recall that companies are able to deduct, for income tax purposes, the difference between the strike price of Non-Qualified options and the market price of the stock on the day of the exercise. For options to be Non-Qualified, their strike price must equal the market price of the shares on the day of their Grant. The fact that this plan is very old, and the stock price was so low at the time of the initial grants, the spread is huge. The Company is generating very large tax benefits from the exercise of these options, so large in fact that the Company generated $58 million in extra Operating Cash Flow from them in '01 and $71 million in '00. So far this year, through Q3, the Company has received $62 million in extra Cash Flow from these benefits.

This extra cash flow represents the difference between the Company's Income Tax Provisions based on book income and the actual tax paid (to IRS) after these deductions. This is the same game that has allowed Microsoft, Dell and Cisco to pay very few taxes. Indeed, we know that Microsoft paid no taxes in '00 after taking its deductions for its Employee stock option exercises. This strategy provides significant boosts to Operating Cash Flow via tax deductions, which contributes significantly in allowing for CDW to remain long-term debt free.

We all know the pressure that exists in this area, to change the way options are treated. In this reform-minded era, the persuasions of Silicon Valley lobbyists fall on ears that are much deafer than they had been in the pre-Enron days. We are still looking into how the Company is booking some of these option benefits. There are possibly some interesting anomalies with regards to the timing of their recognition. At this time, it is fair to say that CDW will face considerable pressure when the eventual move towards expensing corporate options occurs. On a relative basis, the magnitude of their options programs puts CDW up there in the ranks with Microsoft and Cisco.