

FARMHOUSE EQUITY RESEARCH, LLC

RESEARCH REPORT

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 JANUARY 12, 2004

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 ENTERPRISE SOFTWARE

KANA SOFTWARE, INC.

(KANA – \$4.08)

Initiating at Strong Buy on New Corporate Positioning

EPS (\$)						REVENUES (\$000)			
Fiscal Year:	2002A	2003E	Prev.	2004E	2005E		2003E	2004E	2004 Change
December									
Q1	\$0.02	(\$0.06)A	-	(\$0.03)		Q1	18,109A	16,000	-12%
Q2	(\$0.36)	(\$0.34)A		\$0.00		Q2	12,055A	17,350	44
Q3	(\$0.16)	(\$0.11)A		\$0.02		Q3	13,833A	18,700	35
Q4	(\$0.09)	(\$0.02)E		\$0.05		Q4	16,050E	20,200	26
Year	(\$0.60)	(\$0.32)E		\$0.04	\$0.36	Year	60,047	72,250	20%
P/E	NMN	NMN		102x	11.3x	Mkt Cap/Revs	2.0x	1.2x	

52-Week Range:	\$6.60-2.45	Proj. 3-Year Revenue Growth:	25%
Market Cap. (\$Millions):	\$119.1	Dividend/Yield:	None
Est. Shares Out. (000):	29,200	Tangible Book Value/Share	\$0.08
Estimated Float (000):	27,150	Total Cash and Equivs. (mm)	\$35.0
Est. Insider Holdings:	4.9%	Debt/Equity (9/03)	0%
Est. Institutional Holdings:	40.0%	Gross Margin (TTM):	78.3%
10-Day Average Volume:	528,000	12-Month Price Target:	\$10
Next EPS Report:	January 2004	Rating	Strong Buy

- **We are initiating Kana Software at Strong Buy due to its new corporate re-positioning, valuation, and solid prospects for the next several quarters.** KANA seems to be a forgotten stock in the software sector, but it has a solid balance sheet, good products, and a very favorable risk/reward proposition when accounting for its valuation. With cash of about \$35 million and a market capitalization of \$119 million, it now trades at 1.2x EV/2004 Revs, which we believe is not likely to last as the economy recovers and as investors realize that KANA has new positioning and prospects in the CRM market. It is both extending the depth of its product line and is repositioning its offerings for selected verticals (“verticalization”), a key development that has been a customer-driven response.
- **The Company has several important drivers.** It off-loads virtually all professional services to its main integration partners: IBM, Accenture, and BearingPoint. We spoke with all three of these companies in the past week, and they uniformly suggested that KANA’s has high-ROI products and new corporate prospects. KANA IQ is the first integrated solution combining knowledge management and service resolution in the market, and KANA’s partners have suggested that this is creating a new niche for KANA in its primary business, service resolution (one of the three pillars of CRM, the other two being sales force and marketing). One consulting partner even suggested that Kana Call Center is still winning deals head to head vs. Siebel and PeopleSoft. The Company also has a relatively new management team, brought in after the Broadbase Software acquisition. This team has righted the ship and in our opinion, is making many of the right moves to get revenues growing again.
- **KANA already has a very solid customer base, including 55 of the top 100 global companies.** It pays close attention to customer satisfaction, which has led to high renewal rates. Management stated

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that its renewal rates are 90%+, a very solid number. After speaking with partners, we have no doubt that KANA products are highly functional and provide significant ROI. This leads to high recurring revenues, but even more importantly, should lead to effective up-selling and cross-selling of its recently enhanced CRM platform.

- **By offloading its implementations to partners, it creates a business model with very high margins and significant leverage.** Up until recently, KANA was winning deals and then passing them to the partners. Management states that just recently, the partners are doing much more co-marketing, especially IBM, and we believe this is likely to lead to upside.
- **Our initial estimates for Q4 are \$16.1 million in revenues and EPS of (\$0.02).** In speaking with KANA's partners, we derived comfort with Q4 numbers, as they stated that their KANA channel was strong in Q4. Our initial estimates for 2004 are \$72.5 million and EPS of \$0.04. Again, with a low base of consulting revenues in the total (the business is about 50% license and 40% to 45% maintenance), the EPS leverage is enormous. KANA has already scheduled its 4Q earnings call, which suggests that they have made their quarter.
- **Valuation on these projections is very attractive and is a strong driver to our investment thesis.** Its current valuation stands at a 2005 PE of 11.8x and a 2004 EV/Revs of 1.2x. We believe KANA is a low risk play on:
 1. Growth in the recovering CRM market, which should have higher-than-average growth than other software segments,
 2. The global IT recovery, and
 3. The proliferation of complexity in customer service interaction. From camera phones to home wireless routers to financial services, customer interaction is becoming more complex with the proliferation of many different gadgets. Customer service is not simple anymore. Even in financial services, the many different investment products/retirement vehicles and investing options are driving complexity – KANA's enterprise clients are looking for ways to minimize their customer interaction in the new gadget era, which is inexorably creating service difficulties. Kana's solutions provide efficient cost-cutting measures to help enterprises address this growing complexity.

Investment Thesis

Investors familiar with our strategy know that we look primarily for four factors in a potential software investment. We believe KANA meets all four of these, hence our Strong Buy rating:

1. *A company approaching an inflection point:* Kana has downsized over the past several years to become a very streamlined organization. We believe the CRM market is picking up, and KANA has a chance to be a very important player in the service resolution segment of CRM. **The ROI on Kana's product is clear.** Approximately 80% of customer service costs are in "problem resolution", which today is mostly non-automated. CRM has previously been able to automate sales, route calls to the correct person, and to answer simple email questions (i.e. "When will my book get here?"). But anything more complex or dynamic has been difficult to automate. KANA is smartly re-focusing its business on vertical industries, including financial services, retail, telco, and high-tech.
2. *An untapped, underpenetrated market:* To restate our thesis, partners have told us that Kana's new product positioning is unique – KANA's new IQ product is the first integrated, automated solution for service resolution in the CRM market. The market for CRM and service resolution is also reaching inflection points: the proliferation of devices (PDA, laptops, etc.) and channels of services (Web, phone, e-commerce, etc.) have caused customer service costs to skyrocket. The Christmas season of 2003 suggests that e-commerce will be a major driver for customer service needs, and KANA has multi-channel solutions that lower costs in every customer channel. Anything new that causes customer confusion is a driver for

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- KANA: home networking creates phone calls when customers are trying to hook up new wireless routers, new camera phones have customers confused about how to print the resulting pictures, new IRA regulations cause banking customers to have more questions. These all create new markets and potential customers for KANA.
3. *Strong Positioning:* It comforts us that KANA is not a start-up. It has been around since 1996 and has 1,300 customers, *including 55 of the top 100 global companies*. It is very strong in financial services, high tech, and telco. Its customers include eBay, Dell, Sprint, and Wal-Mart.com. Another strong metric that supports its positioning is the fact that telco customers, even in their downturn, continued spending on KANA solutions, suggesting that in an era of rampant cost-cutting, they still believed in the ROI to find space in their limited budgets for KANA purchases.
 4. *Valuation:* Considering the many positives that we have uncovered in performing our due diligence, we believe KANA remains forgotten. At the current valuation, it is a low-risk play. At the least, we believe KANA is an attractive buy-out candidate for a larger CRM player looking to extend its solutions. Its strong customer base cements our belief in the risk/reward aspect of the thesis.

Background

Kana was founded in 1996, and its original product was what we define “simple” CRM (i.e. simple customer service, such as “When will my book arrive?”). About 25% of its revenues still come from this product line. It merged with Broadbase Software approximately 2.5 years ago, and has made at least 10 other acquisitions. It has downsized from over 500 employees to approximately 200, and has developed (and kept) a significant customer base that includes many Telco, financial service, and high-tech customers. It has developed multi-platform support and is not homogenous to any single platform (i.e. Windows, Unix, etc.). Today, we believe Kana IQ, its complex resolution solution, will be able to automate answers to questions such as “How do I connect my Windows XP to Cisco’s LinkSys wireless router?” The mark of a potentially successful software company is the ability to “automate what has not been automated before”, and Kana has this opportunity in service resolution.

Competition

In general, Siebel and PeopleSoft are considered the “heavyweights” of CRM. SAP and Oracle are lesser players. We believe that KANA is increasing its competitive positioning through its new product line-up, its “verticalization” strategy, and its increasing reputation due to its high ROI products. Kana mainly competes with these four in Call Center deals, which is a more mature piece of CRM. There is much less competition in the service resolution segment.

Kana Primarily Plays in the Service Resolution Segment of CRM

CRM can be generally divided into three separate areas: sales automation, marketing, and service resolution. In each of the three segments there are different pure-plays. Siebel and PeopleSoft dominate the first segment, sales automation. In marketing, there are competitors such as E.piphany and Chordiant. Service resolution is Kana’s primary niche in CRM. In this segment, KANA competes with Primus Knowledge Solutions, in-house solutions, and private companies such as Kanisa, Inc.

Financials

After a recent secondary, the Company now has approximately \$35 million in cash and no debt. It recently purchased a small CRM company, Hipbone, for about \$1 million, issuing 250,000 shares.

Trailing 12-month revenues are \$62.9 million, and we project 2004 revenues of \$72.3 million. In 2005, we project revenues of \$91.9 million, growth of 27%. By offloading implementations to

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integrators, one positive is that KANA has high leverage on the EPS. We project a loss per share of (\$0.02) in 4Q03, but rapid growth in 2004 and 2005, when our estimates are \$0.04 and \$0.36.

Currently, 45% of revenues are derived from licenses, while 46% and 9% come from maintenance and services respectively. In the latest quarter, the largest verticals were telco, financial, and high-tech, representing 34%, 20%, and 9%, respectively (travel, services, and manufacturing was 12% but is really a hodge-podge of verticals). Hipbone was in the financial services sector, and will add to its expertise there. Wells Fargo was Hipbone's premier blue-chip client. KANA is also a good play on the recovery in telco. In recent days, we have received fairly solid earnings reports from several telco-related companies.

In summary, we believe Kana is a largely undiscovered leader in the CRM space. The new management team has been wily in its turnaround, and has righted the ship, in our opinion (and in the opinion of the partners we have spoken with). We believe that as 2004 unfolds, its progress will become evident in the financials, and will result in significantly higher valuations. Hence, we rate Kana Software a Strong Buy.

INVESTMENT RISKS

Among the risks of purchasing shares of Kana Software are:

1. **Competition is almost always the largest risk to any software story.** In Kana's niche, service resolution, we believe Siebel and PeopleSoft do not have the functionality that Kana does. However, SEBL and PSFT's market presence can give them a competitive edge with customers looking for single-vendor solutions. They can also discount, leading to pricing pressure.
2. **KANA needs to increase its industry exposure.** Partners we spoke with suggested that Kana really needs to cater to the Gartners, MetaGroups, etc, because these analysts are influential in enterprise software purchasing decisions. They have recently hired Brian Kelly (a former employee of Broadbase Software, where much of the management team came from) as VP – Marketing, so it will be interesting to see how rapidly they can increase their market exposure.
3. **We are not totally out of the IT depression yet.** Even though Kana has put together several solid quarters now, we are still unsure if the IT recovery will be as fast as the market is projecting. Our estimates have a macro-recovery built in.

Publicly trade companies mentioned in this report:

Accenture (NYSE: ACN, \$25.22, Not Rated)

IBM (NYSE: IBM, \$91.21, Not Rated)

PeopleSoft (NASDAQ: PSFT, \$22.67, Not Rated)

Primus Knowledge Solutions (NASDAQ: PKSI, \$6.81, Not Rated)

SeeBeyond (NASDAQ: SBYN, \$5.06, Not Rated)

Siebel (NASDAQ: SEBM, \$15.25, Not Rated)

Wells Fargo (NYSE: WFC, \$57.38, Not Rated)

Unless otherwise noted, prices are as of the close, January 9, 2004.

The Farmhouse Equity Research, LLC Rating System:

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Strong Buy: We believe that shares of this stock are significantly undervalued and should be acquired immediately. Over the next 12 months, we believe that the share price will increase more than 50% on a sustained basis. As of 10/16/03, of the 15 companies we have under coverage, 6 are rated as Strong Buy.

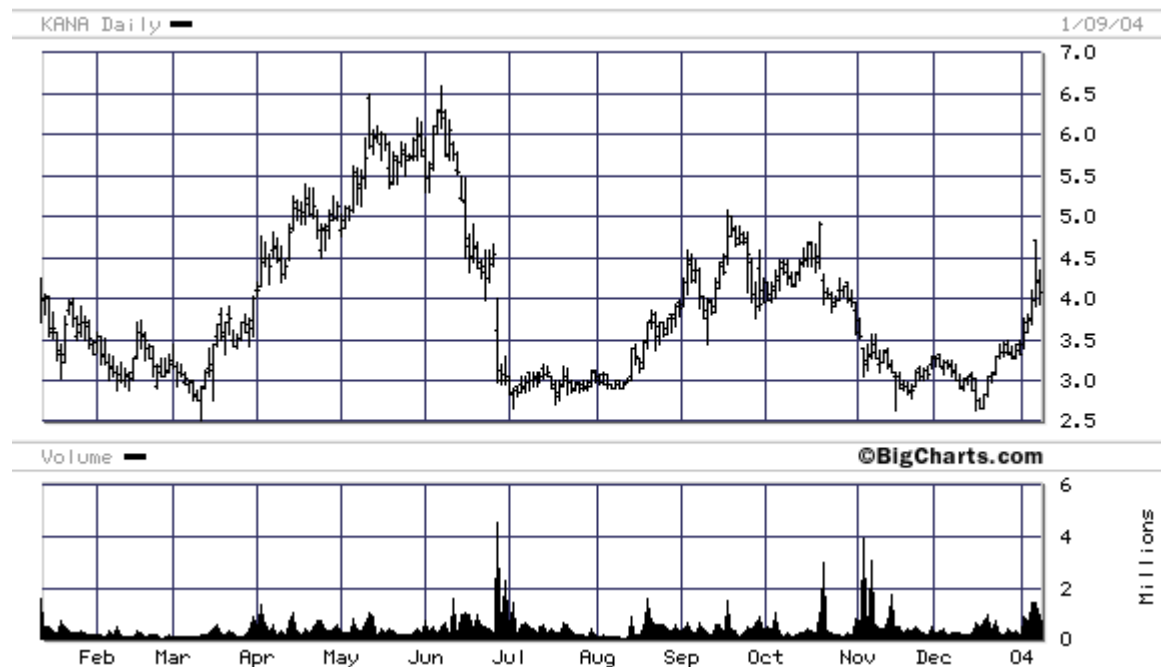
Buy: We believe that shares of this stock are relatively undervalued and should be acquired on an opportunistic basis. Over the next 12 months, we believe that the share price will increase more than 25% on a sustained basis. As of 10/16/03, of the 15 companies we have under coverage, 5 are rated as Buy.

Market Perform: We believe that shares of this stock are fully and fairly valued. Over the next 12 months, we believe that the share price will track with the overall market. As of 10/16/03, of the 15 companies we have under coverage, 3 are rated as Market Perform.

Market Underperform: We believe that shares of this stock are relatively overvalued and should be sold on an opportunistic basis. Over the next 12 months, we believe that the share price will decrease more than 25% on a sustained basis. As of 10/16/03, of the 15 companies we have under coverage, 2 are rated as Market Underperform.

Sell: We believe that shares of this stock are significantly overvalued and should be sold or sold short immediately. Over the next 12 months, we believe that the share price will decrease more than 50% on a sustained basis.

For the complete version of this report, please contact your CAPIS salesperson at 800.247.6729 or 214.720.0055 or Farmhouse Equity Research, LLC at 972.562.0429.



Source: Bigcharts.com

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Fiscal Year End: 12/31	1Q02A	2Q02A	3Q02A	4Q02A	2002A	1Q03A	2Q03A	3Q03A	4Q03E	2003E	1Q04E	2Q04E	3Q04E	4Q04E	2004E	2005E
	Mar-00	30-Jun	Sep-00	Dec-00		Mar-03	30-Jun	Sep-03	Dec-03		Mar-04	Jun-04	Sep-04	Dec-04		
Composition of Revenues																
Product Licenses	15,129	8,309	8,784	9,308	41,530	9,351	3,183	5,083	7,250	24,867	7,000	7,900	8,900	10,000	33,800	47,900
% Total Revenues	60.2%	48.3%	48.7%	49.7%	52.5%	51.6%	26.4%	36.7%	45.2%	41.4%	43.8%	45.5%	47.6%	49.5%	46.8%	52.1%
Services	10,014	8,881	9,243	9,422	37,560	8,758	8,872	8,750	8,800	35,180	9,000	9,450	9,800	10,200	38,450	44,000
% Total Revenues	39.8%	51.7%	51.3%	50.3%	47.5%	48.4%	73.6%	63.3%	54.8%	58.6%	56.3%	54.5%	52.4%	50.5%	53.2%	47.9%
Total Revenues	25,143	17,190	18,027	18,730	79,090	18,109	12,055	13,833	16,050	60,047	16,000	17,350	18,700	20,200	72,250	91,900
Cost of Product Licenses	965	1,056	548	833	3,402	918	507	578	650	2,653	690	760	880	970	3,300	4,100
% Product Licenses	6.4%	12.7%	6.2%	8.9%	8.2%	9.8%	15.9%	11.4%	9.0%	10.7%	9.9%	9.6%	9.9%	9.7%	9.8%	8.6%
Cost of Services	3,907	4,291	2,762	2,690	13,650	2,362	2,708	2,381	2,420	9,871	2,500	2,600	2,700	2,800	10,600	11,700
% Services	39.0%	48.3%	29.9%	28.6%	36.3%	27.0%	30.5%	27.2%	27.5%	28.1%	27.8%	27.5%	27.6%	27.5%	27.6%	26.6%
Cost of Revenues	4,872	5,347	3,310	3,523	17,052	3,280	3,215	2,959	3,070	12,524	3,190	3,360	3,580	3,770	13,900	15,800
Gross Profit	20,271	11,843	14,717	15,207	62,038	14,829	8,840	10,874	12,980	47,523	12,810	13,990	15,120	16,430	58,350	76,100
Gross Margin	80.6%	68.9%	81.6%	81.2%	78.4%	81.9%	73.3%	78.6%	80.9%	79.1%	80.1%	80.6%	80.9%	81.3%	80.8%	82.8%
Sales & Marketing	10,305	10,395	8,732	7,991	37,423	7,437	7,887	6,854	6,900	29,078	7,000	7,200	7,400	7,600	29,200	33,000
% Total Revenue	41.0%	60.5%	48.4%	42.7%	47.3%	41.1%	65.4%	49.5%	43.0%	48.4%	43.8%	41.5%	39.6%	37.6%	40.4%	35.9%
Product Development	6,638	6,512	6,389	6,394	25,933	6,080	5,943	4,718	4,700	21,442	4,760	4,860	4,900	4,930	19,450	21,400
% Total Revenue	26.4%	37.9%	35.4%	34.1%	32.8%	33.6%	49.3%	34.1%	29.3%	35.7%	29.8%	28.0%	26.2%	24.4%	26.9%	23.3%
General & Admin	3,220	3,383	3,458	2,992	13,053	2,680	2,990	1,981	2,020	9,671	2,020	2,100	2,170	2,320	8,610	9,980
% Total Revenue	12.8%	19.7%	19.2%	16.0%	16.5%	14.8%	24.8%	14.3%	12.6%	16.1%	12.6%	12.1%	11.6%	11.5%	11.9%	10.9%
Total Op. Expenses	20,163	20,290	18,579	17,377	76,409	16,197	16,820	13,553	13,620	60,191	13,780	14,160	14,470	14,850	57,260	64,380
Operating Income	108	(8,447)	(3,862)	(2,170)	(14,371)	(1,368)	(7,980)	(2,679)	(640)	(12,668)	(970)	(170)	650	1,580	1,090	11,720
Operating Margin	0.4%	-49.1%	-21.4%	-11.6%	-18.2%	-7.6%	-66.2%	-19.4%	-4.0%	-21.1%	-6.1%	-1.0%	3.5%	7.8%	1.5%	12.8%
Net Other Income	298	297	175	143	913	90	17	5	20	132	25	30	35	40	130	250
Pretax income	406	(8,150)	(3,687)	(2,027)	(13,458)	(1,278)	(7,963)	(2,674)	(620)	(12,536)	(945)	(140)	685	1,620	1,220	11,970
Pretax Margin	1.6%	-47.4%	-20.5%	-10.8%	-17.0%	-7.1%	-66.1%	-19.3%	-3.9%	-20.9%	-5.9%	-0.8%	3.7%	8.0%	1.7%	13.0%
Income Taxes	0	0	0	0	0	0	0	0	0	(4,701)	0	0	0	0	0	0
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	37.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Income	406	(8,150)	(3,687)	(2,027)	(13,458)	(1,278)	(7,963)	(2,674)	(620)	(7,835)	(945)	(140)	685	1,620	1,220	11,970
Shares Outstanding	21,071	22,762	22,851	22,898	22,396	22,958	23,201	23,396	27,500	24,264	29,800	30,300	30,900	31,450	30,613	33,000
OPERATING EPS	0.02	(0.36)	(0.16)	(0.09)	(0.60)	(0.06)	(0.34)	(0.11)	(0.02)	(0.32)	(0.03)	(0.00)	0.02	0.05	0.04	0.36
Y-O-Y Change	1Q00A	2Q00A	3Q00E	Yr-Yr	Yr-Yr	1Q01E	2Q01A	3Q01E	4Q01E	Yr-Yr	1Q02E	2Q02E	3Q02E	4Q02E	Yr-Yr	Yr-Yr
Product Licenses	29.8%	-46.9%	-37.6%	103.5%	-9.6%	-38.2%	-61.7%	-42.1%	-22.1%	-40.1%	-25.1%	148.2%	75.1%	37.9%	35.9%	41.7%
Services	100.7%	64.9%	54.3%	38.0%	61.9%	-12.5%	-0.1%	-5.3%	-6.6%	-6.3%	2.8%	6.5%	12.0%	15.9%	9.3%	14.4%
Total Revenues	51.0%	-18.3%	-10.2%	64.3%	14.4%	-28.0%	-29.9%	-23.3%	-14.3%	-24.1%	-11.6%	43.9%	35.2%	25.9%	20.3%	27.2%
Cost of Revenues	13.6%	-16.9%	-33.8%	-51.5%	#DIV/0!	-32.7%	-39.9%	-10.6%	-12.9%	-26.6%	-2.7%	4.5%	21.0%	22.8%	11.0%	13.7%
Gross Profit	64.0%	-19.0%	-2.3%	267.5%	-10.3%	-26.8%	-25.4%	-26.1%	-14.6%	-23.4%	-13.6%	58.3%	39.0%	26.6%	22.8%	30.4%
Operating Income	NMN	NMN	NMN	NM	NMN	NM	NMN	NMN	-70.5%	NMN	NM	-97.9%	-124.3%	-346.9%	-108.6%	975.2%
Pre-Tax Income	NMN	NMN	NMN	NM	NMN	NM	NMN	NMN	-69.4%	NMN	-26.1%	-98.2%	-125.6%	-361.3%	-109.7%	881.1%
Net Income	NMN	NMN	NMN	-73.5%	NMN	-414.8%	NMN	NMN	-69.4%	NMN	-26.1%	-98.2%	-125.6%	-361.3%	-115.6%	881.1%
Earnings Per Share	NMN	NMN	NMN	-50.1%	NMN	-388.9%	NMN	NMN	-74.5%	NMN	-43.0%	-98.7%	-119.4%	-328.5%	-112.3%	810.2%

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