

FARMHOUSE EQUITY RESEARCH, LLC

RESEARCH REPORT

C. GREGG SPEICHER, CFA, SENIOR ANALYST
 GSPEICHER@FEQR.COM
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(972) 562-0429
 ENTERPRISE SOFTWARE

EPICOR SOFTWARE CORP. (EPIC – \$13.14)

Initiating at Buy after User Conference and Acquisition

EPS (\$)					REVENUES (\$000)			
Fiscal Year: December	2003	2004E ¹		2005E		2003	2004E ¹	YOY Chg. ¹
Q1	\$0.08	\$0.15		\$0.19		34,332A	54,450	59%
Q2	\$0.10	\$0.17		0.20		36,692A	60,700	65%
Q3	\$0.09	\$0.18		0.21		40,336A	63,650	58%
Q4	\$0.14	\$0.21		0.23		42,400	68,320	61%
Year	\$0.41	\$0.71		\$0.84		153,760	247,120	61%
P/E	32.1x	18.5x		15.6x		Mkt Cap/Revs	4.3x	2.7x

52-Week Range:	\$13.25-1.23	Proj. 3-Year Revenue Growth:	18%
Market Cap. (\$Millions):	\$666.8	Dividend/Yield:	None
Est. Shares Out. (000):	50,747	EV/ FY04 Revs:	2.6x
Estimated Float (000):	44,200	Cash/Share (9/03)	\$0.67
Est. Insider Holdings:	12.4%	Debt/Equity (9/03)	0%
Est. Institutional Holdings:	54%	2005 PE, Excluding Cash	14.7x
10-Day Average Volume:	430,000	12-Month Price Target:	\$20
Next EPS Report:	January, 2004	Rating	Buy

¹ Includes impacts of Scala Business Solutions acquisition, which should be completed in January, 2004

- **We are initiating Epicor with a Buy rating and \$20 price target after recently attending its User Conference and also due to its recently announced acquisition of Scala Business Solutions.**
 Management has turned this Company around and has just made a potentially synergistic acquisition, that of Scala Business Solutions (after having acquired the smaller ROI Systems earlier this year). Management has developed a strong product vision (something lacking before its turnaround), which includes a recent major product introduction, Epicor for Service Enterprises. It is also re-writing its entire manufacturing product suite to .NET (code-name: Sonoma), in which both users and consultants alike showed high interest. As a result, we believe Epicor has a solid operating model with high earnings potential over the next several years.
- **Our initial 2004 revenue and EPS estimates are \$247.1 million and \$0.71 per share, respectively.**
 Due to the feedback we received at the conference, we believe that both Sonoma and Scala could make a significant contribution to Epicor's results in 2004. We are also optimistic due to the reception that the ROI Systems acquisition received. The Company also has a healthy balance sheet, with \$34.0 million in cash and no debt.
- Epicor, based in Irvine, CA, has a long history in the manufacturing sector, with over 15,000 customers and a very healthy balance sheet. After the Scala acquisition, it will be globally strong and have over 20,000 customers. The Scala acquisition is projected to be highly accretive, and should add about

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\$0.15 to previous EPS guidance. Even more importantly, it will be the largest Microsoft ERP business partner, and should receive many benefits from this relationship.

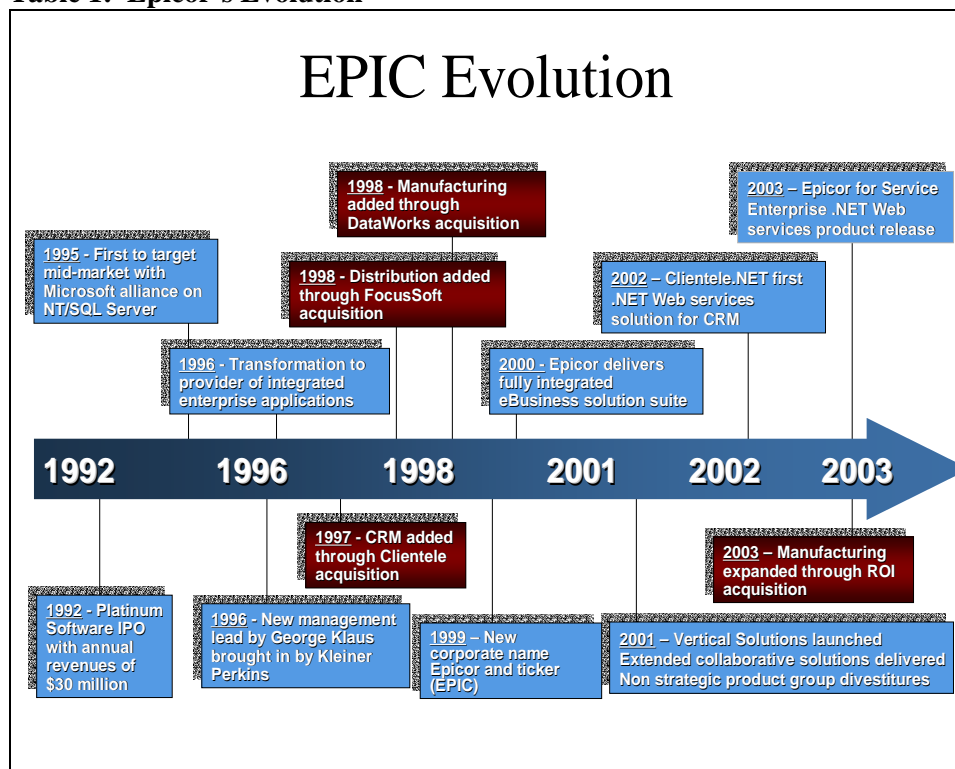
- **Our enthusiasm also comes from our expectations that the mid-market is the “hot spot” for enterprise applications over the next several years.** It is a largely untapped market with over 6.4 million target customers (revenues between \$10 and \$500 million), and even though there is competition, Epicor has brand recognition and a solid presence in its niches. We also believe that EPIC’s goal of “marrying” itself to the Windows platform is a good strategy due to its large presence in this market. Finally, Epicor is also an inexpensive play on a manufacturing recovery because over 50% of its revenue come from this sector.

Background

Epicor was founded in 1984 and offered only an accounting package until 1992 when it ported its solutions to the client/server environment, and was first-to-market in 1995 with an NT/SQL based platform. It has long been a Gold-certified Microsoft partner, and is in the process of rewriting its entire platform to .Net, which is where much of our enthusiasm rests. It now has a twenty year operating history, and went public in 1992. It ran into trouble after Y2K subsided and went into several years of turmoil, but it now turning around.

Table 1 shows the evolution of the Company as it has pursued the mid-market. It now has three operating units, as described in Table 2. Most of its revenues come from its manufacturing operations.

Table 1: Epicor’s Evolution



Source: The Company

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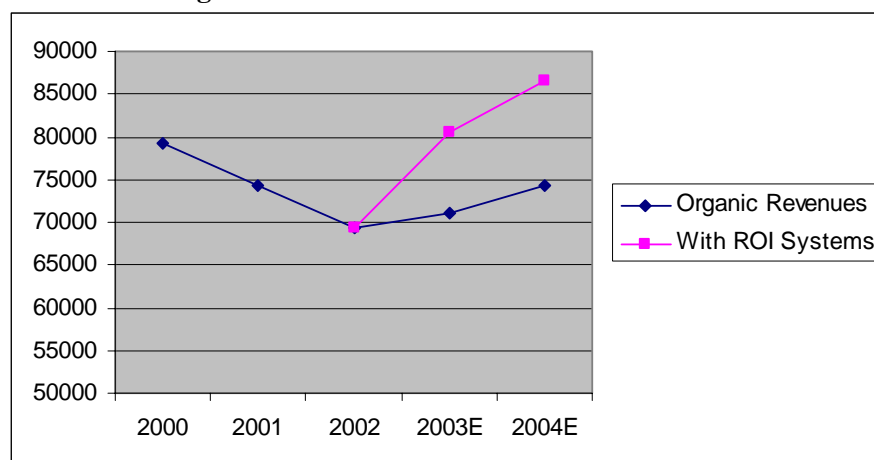
Table 2: Epicor's Three Business Focuses

	CRM	Solutions for Services (ESA)	Manufacturing
Products:	Clientele		Avante DataFlo Vantage Vista Supply Chain Business Intel.
Segments:	Sales Force Automation Marketing Customer Support	Financials Budgeting/Reporting Business Intel. WMS, CRM, SRM	Large Mid-Sized Entry-level
Percent of Customer Base:	10%	35%	55%
Platform:	.NET	.NET	1H04: .NET + Progress OpenEdge (Sonoma)

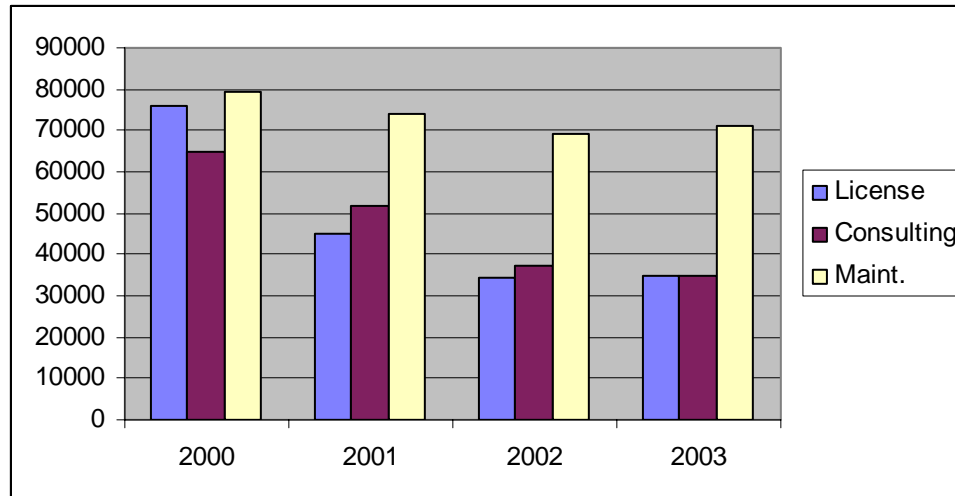
Epicor's Turnaround

As recently as 2001 and 2002 Epicor was down to less than \$10 million in cash, the stock was at \$0.65, and the Company lost \$7.2 million in 2002. However, the Company has several strong drivers, in our opinion, that are causing its turnaround.

One sign of EPIC's turnaround is its maintenance revenues. In a downturn, it is our opinion that it is not just license revenue that distinguishes a Company's positioning – maintenance is just as important. Maintenance revenues have shown an organic turnaround (not just from ROI Systems maintenance – ROI's revenues were comprised of just under 50% maintenance for the first six months of 2003). Table 1 documents EPIC's maintenance revenue turnaround.

Table 1: One Sign of EPIC's Turnaround: Maintenance Stabilization

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Table 2: EPIC's Organic Revenue Line Items

The next stage of the turnaround is revenue growth. With 50+ new product releases in 2003, and many more planned for 2004, the Company has re-invigorated its morale and the customers, who were at the Conference to learn about the Company's newfound product strategies. Epicor for Service Enterprises, aimed at service, hospitality, and distribution customers, was released in June, 2003 and has gained traction. It already has 7 customers live, 20 have bought the product, and we believe this a strong catalyst for the short-term. Scala provides new functionality, new vertical opportunities, and a strengthening of the Company's relationship with Microsoft.

The Acquisition of Scala Business Solutions

This acquisition creates the 11th-largest ERP provider, according to AMR Research's data. Scala's \$75 million revenue run rate adds to Epicor's global and vertical opportunities, and accelerates EPIC's move to offshore R&D due to Scala's existing operations in Russia. This will be a large part of the \$8 million in cost savings that EPIC plans to receive from this merger. The terms of the agreement include an \$87 million purchase price, with \$41.7 million in cash and 4.1 million shares issued to Scala shareholders. There is an unusual equity protection clause in the agreement, in which if EPIC trades below \$10.21, there is an adjustment to the cash payment to offset the weakness. This occurs if the stock of EPIC trades below \$10.21 and \$8.17. Below \$8.17, EPIC is not liable. We are slightly uncomfortable with this risk, but the attractive purchase price and many other merger benefits mitigate much of our concern.

Other thoughts on Scala:

- 1) Scala was even closer to MSFT than EPIC in terms of platform support, which will be a good thing as the combined entity further begins to push its .Net product platform.
- 2) Scala sells to remote sites of large customers. In fact, the marketing slogan in Europe is often "SAP and Scala". SAP wins the enterprise business and Scala wins the remote sites.
- 3) Scala's existing outsourcing business in Russia will enable EPIC to move even more rapidly in its efforts to outsource its R&D offshore.
- 4) If one were to place both EPIC's and Scala's operations by country on a map, there would only be a couple of countries where there is overlap. This makes the acquisition very additive. Additionally, Scala's product has been translated into 50+ languages, whereas Epicor only has about 30.
- 5) Scala was selling to the small division and sites of large enterprises – but it had no US presence. This will add to its potential market.

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- 6) Scala's business model had a higher mix of license revenues than EPIC's. This means licenses as a percentage of total revenues could increase from about 24% in 2003 to 28% in 2004.
- 7) We also did some channel checks verifying Scala's reputation. One of our trusted sources suggested that he knew many satisfied Scala customers and that the EPIC/Scala combination should be very successful.

Competition

Being the 11th largest ERP provider globally, it is obvious that there are still many larger providers. The obvious large competitors are SAP, PeopleSoft, Oracle, etc. One competitor is the Great Plains division of Microsoft, who EPIC sees somewhat often, even though Epicor and Microsoft really exist in "co-opetition". Mapics, who recently acquired FrontStep is a competitor in some situations, as is Lawson. JD Edwards, who was acquired by PeopleSoft, is also seen periodically.

Financials

The under-appreciated EPS potential of Epicor, especially after the combination with Scala, is partly what increased our interest in EPIC. Before the acquisition, management guidance was for 2004 EPS of about \$0.53 to \$0.55 (even in the \$10 - \$12 range, it was trading inexpensively). After the merger was announced, they suggested that it could add about \$0.15 to this. While there is always integration risk, the two seem to have very synergistic characteristics, so we believe that our 2004 EPS estimate of \$0.71 on total revenues of \$247.1 million is achievable.

We have previously mentioned the revenue solidification that the Company has experienced this year, and the Company is now trading at 18.5x next year's EPS estimate. Our price target represents a multiple of 25x our 2005 EPS estimate.

Summary

Purchasing Epicor's stock right now is an interesting play on a manufacturing recovery, a company turnaround, continuing growth of mid-market application sales, and synergies driven by two recent acquisitions. At the Customer Conference, we are impressed with the customer's improving satisfaction with Epicor. The ROI Systems acquisition is proof of EPIC's acquisition competence, and we believe Scala will result in concrete benefits beginning in 2004.

Risks

Among the risks of buying shares of Epicor are:

1. **Competition is almost always the largest risk in a software story.** The ERP market is not a rapidly-growing market, and there are several vendors who could move into Epicor's niches. There large vendors do not typically compete down here, but Microsoft could become more of a competitor than partner down the road. Scala gives EPIC stronger international presence, which adds to its competitive positioning.
2. **Integration risk (product and people).** With the acquisition of ROI Systems and the much-larger Scala, EPIC has its hands full in trying to integrate these operations into a unified business base. We hope that EPIC management will not lose its grip on its other prospects, such as Sonoma, while trying to integrate these acquisitions. One positive is that Scala is very MSFT-oriented, so this is not a clash of platform on the product integration side.
3. **Extra Dilution risk:** As we stated, EPIC placed downside protection to Scala shareholders. As long as the stock remains above \$10.21, there is no fear of dilution. We understand that the deal was attractive, and this was a "sweetener", but it could hit EPIC's balance sheet if the stock declines.

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Publicly trade companies mentioned in this report:

Lawson (NASD: LWSN, \$8.65, Not Rated)

Mapics (NASD: MAPX, \$12.43, Not Rated)

Microsoft (NASD: MSFT, \$25.84, Not Rated)

PeopleSoft (NASD: PSFT, \$21.34, Not Rated)

Progress Software (NASD: PRGS, \$22.41, Not Rated)

SAP (NYSE: SAP, \$39.60, Not Rated)

Unless otherwise noted, prices are as of the close December 1, 2003.

The Farmhouse Equity Research, LLC Rating System:

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 12/2/03, of the 16 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 12/2/03, of the 16 companies we have under coverage, 6 are rated as Buy.

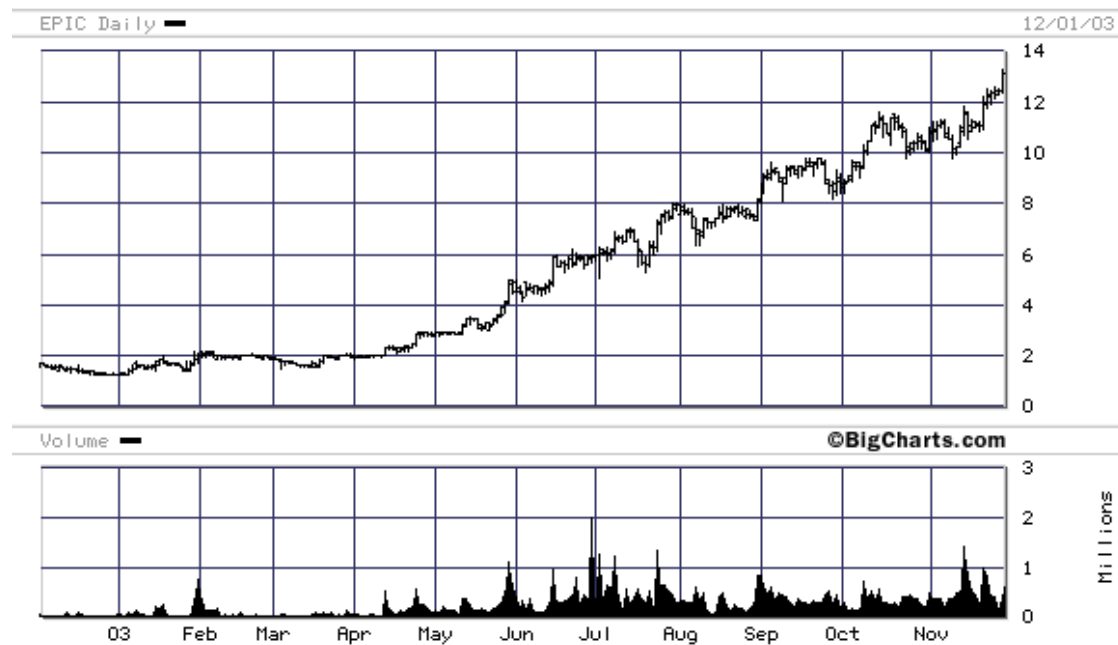
Market Perform: We believe that shares of this stock are fully and fairly valued. Over the next 12 months, we believe that the share price will track with the overall market. As of 12/2/03, of the 16 companies we have under coverage, 3 are rated as Market Perform.

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 12/2/03, of the 16 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.

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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	1Q05E	2Q05E	3Q05E	4Q05E	2005E
Composition of Revenues																				
Software	8,406	9,250	6,772	9,788	34,216	7,805	9,517	9,352	10,700	37,374	15,000	16,700	17,600	19,200	68,500	16,700	18,000	19,340	21,000	75,040
% Total Revenues	23.4%	25.1%	19.9%	26.7%	23.8%	22.7%	25.9%	23.2%	25.2%	24.3%	27.5%	27.5%	27.7%	28.1%	27.7%	25.3%	26.1%	27.1%	28.1%	26.7%
Consulting	9,792	9,731	9,115	8,721	37,359	8,379	8,736	10,637	10,900	38,652	12,450	15,000	15,650	16,120	59,220	16,000	16,700	17,340	18,090	68,130
% Total Revenues	27.2%	26.4%	26.8%	23.7%	26.0%	24.4%	23.8%	26.4%	25.7%	25.1%	22.9%	24.7%	24.6%	23.6%	24.0%	24.2%	24.3%	24.3%	24.2%	24.2%
Maintenance & Other	17,786	17,826	18,066	18,213	71,891	18,148	18,439	20,347	20,800	77,734	27,000	29,000	30,400	33,000	119,400	33,400	34,135	34,800	35,600	137,935
% Total Revenues	49.4%	48.4%	53.2%	49.6%	50.1%	52.9%	50.3%	50.4%	49.1%	50.6%	49.6%	47.8%	47.8%	48.3%	48.3%	50.5%	49.6%	48.7%	47.7%	49.1%
Total Revenues	35,984	36,807	33,953	36,722	143,466	34,332	36,692	40,336	42,400	153,760	54,450	60,700	63,650	68,320	247,120	66,100	68,835	71,480	74,690	281,105
Cost of Revenues	15,476	14,663	13,868	13,312	57,319	13,142	13,730	15,349	15,780	58,001	20,500	22,700	23,700	25,000	91,900	24,500	25,400	26,340	27,230	103,470
Gross Profit	20,508	22,144	20,085	23,410	86,147	21,190	22,962	24,987	26,620	95,759	33,950	38,000	39,950	43,320	155,220	41,600	43,435	45,140	47,460	177,635
Gross Margin	57.0%	60.2%	59.2%	63.7%	60.0%	61.7%	62.6%	61.9%	62.8%	62.3%	62.4%	62.6%	62.8%	63.4%	62.8%	62.9%	63.1%	63.2%	63.5%	63.2%
Sales & Marketing	10,722	11,273	10,732	9,276	42,003	8,159	8,810	10,080	9,800	36,849	11,800	12,700	13,600	14,400	52,500	13,700	14,250	14,890	15,340	58,180
% Revenue	29.8%	30.6%	31.6%	25.3%	29.3%	23.8%	24.0%	25.0%	23.1%	24.0%	21.7%	20.9%	21.4%	21.1%	21.2%	20.7%	20.7%	20.8%	20.5%	20.7%
Product Development	4,806	4,543	4,540	4,407	18,296	4,767	4,692	5,459	5,200	20,118	7,000	7,600	7,800	8,090	30,490	8,100	8,200	8,340	8,800	33,440
% Revenue	13.4%	12.3%	13.4%	12.0%	12.8%	13.9%	12.8%	13.5%	12.3%	13.1%	12.9%	12.5%	12.3%	11.8%	12.3%	12.3%	11.9%	11.7%	11.8%	11.9%
G & A	5,745	5,001	4,459	3,169	18,374	4,674	4,523	4,785	4,600	18,582	5,800	6,500	6,800	7,200	26,300	7,000	7,270	7,400	7,600	29,270
% Revenue	16.0%	13.6%	13.1%	8.6%	12.8%	13.6%	12.3%	11.9%	10.8%	12.1%	10.7%	10.7%	10.7%	10.5%	10.6%	10.6%	10.6%	10.4%	10.2%	10.4%
Total Op. Exp.	21,273	20,817	19,731	16,852	78,673	17,600	18,025	20,324	19,600	75,549	24,600	26,800	28,200	29,690	109,290	28,800	29,720	30,630	31,740	120,890
Operating Income	(765)	1,327	354	6,558	7,474	3,590	4,937	4,663	7,020	20,210	9,350	11,200	11,750	13,630	45,930	12,800	13,715	14,510	15,720	56,745
Operating Margin	-2.1%	3.6%	1.0%	17.9%	5.2%	10.5%	13.5%	11.6%	16.6%	13.1%	17.2%	18.5%	18.5%	20.0%	18.6%	19.4%	19.9%	20.3%	21.0%	20.2%
Net Other Income	218	(280)	218	-14	142	(64)	197	112	120	365	110	130	130	165	535	170	175	180	185	710
Pretax income	(547)	1,047	572	6,544	7,616	3,526	5,134	4,775	7,140	20,575	9,460	11,330	11,880	13,795	46,465	12,970	13,890	14,690	15,905	57,455
Pretax Margin	-1.5%	2.8%	1.7%	17.8%	5.3%	10.3%	14.0%	11.8%	16.8%	13.4%	17.4%	18.7%	18.7%	20.2%	18.8%	19.6%	20.2%	20.6%	21.3%	20.4%
Income Taxes	0	0	0	0	0	0	90	118	120	328	1,419	1,700	1,782	2,069	6,970	1,946	2,084	2,204	2,386	8,618
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2%	2%	1.7%	1.6%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%
Net Income	(547)	1,047	572	6,544	7,616	3,526	5,044	4,657	7,020	20,247	8,041	9,631	10,098	11,726	39,495	11,025	11,807	12,487	13,519	48,837
Shares Outstanding	43,180	43,781	44,071	45,180	44,053	46,025	48,367	50,748	51,000	49,035	53,000	56,000	56,500	57,000	55,625	57,500	58,000	58,500	59,000	58,250
EARNINGS PER SHARE	(0.01)	0.02	0.01	0.14	0.17	0.08	0.10	0.09	0.14	0.41	0.15	0.17	0.18	0.21	0.71	0.19	0.20	0.21	0.23	0.84
Amort of Intangibles	1,780	1,776	1,786	1,714	7,056	1,712	1,517	1,986	2,000	7,215	2,300	2,300	2,300	2,300	9,200	2,300	2,300	2,300	2,300	9,200
Stock Based Comp	227	207	204	0	638	276	815	1,125	1,180	3,396	1,400	1,500	1,600	1,700	6,200	1,600	1,700	1,800	1,900	7,000
Restructuring	0	0	0	3,891	3,891		1,230	(292)	100	1,038										
Prov. For doubtful	173	51		(1,200)	(976)	(1,080)	191													
Un. FCTA	98	(681)	0	0	(583)	136	(749)	0	0	(613)	0	0	0	0	0	0	0	0	0	0
GAAP Net Inc.	(2,825)	(306)	(1,418)	2,139	(3,386)	2,482	2,040	1,838	3,740	9,211	4,341	5,831	6,198	7,726	24,095	7,125	7,807	8,387	9,319	32,637
GAAP EPS	(0.07)	(0.01)	(0.03)	0.05	(0.08)	0.05	0.04	0.04	0.07	0.19	0.08	0.10	0.11	0.14	0.43	0.12	0.13	0.14	0.16	0.56
Year-Over-Year %					Yr-Yr	Yr-Yr					Yr-Yr					Yr-Yr				
Product Licenses					-24.1%	-7.1%	2.9%	38.1%	9.3%	9.2%	92.2%	75.5%	88.2%	79.4%	83.3%	11.3%	7.8%	9.9%	9.4%	9.5%
Services					-28.1%	-14.4%	-10.2%	16.7%	25.0%	3.5%	48.6%	71.7%	47.1%	47.9%	53.2%	28.5%	11.3%	10.8%	12.2%	15.0%
Total Revenues					-17.8%	-4.6%	-0.3%	18.8%	15.5%	7.2%	58.6%	65.4%	57.8%	61.1%	60.7%	21.4%	13.4%	12.3%	9.3%	13.8%
Cost of Revenues					-23.4%	-15.1%	-6.4%	10.7%	18.5%	1.2%	56.0%	65.3%	54.4%	58.4%	58.4%	19.5%	11.9%	11.1%	8.9%	12.6%
Gross Profit					-13.5%	3.3%	3.7%	24.4%	13.7%	11.2%	60.2%	65.5%	59.9%	62.7%	62.1%	22.5%	14.3%	13.0%	9.6%	14.4%
Operating Income					-133.2%	NM	272.0%	1217%	7.0%	170.4%	160.4%	126.9%	152.0%	94.2%	127.3%	36.9%	22.5%	23.5%	15.3%	23.5%
Pre-Tax Income					-134.1%	NM	390.4%	734.8%	9.1%	170.2%	168.3%	120.7%	148.8%	93.2%	125.8%	37.1%	22.6%	23.7%	15.3%	23.7%
Net Income					-134.1%	NM	381.8%	714.2%	7.3%	165.8%	128.0%	90.9%	116.8%	67.0%	95.1%	37.1%	22.6%	23.7%	15.3%	23.7%
Earnings Per Share					-132.5%	NM	336.1%	607.0%	-5.0%	138.8%	98.0%	64.9%	94.8%	49.5%	72.0%	26.4%	18.4%	19.4%	11.4%	18.1%

Source: Company Financial Documents and Farmhouse Equity Research, LLC Estimates

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