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New Rec: Exult, Inc.	(EXLT-\$11.99)	January 27, 2002
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Position: Sell Target: \$6 Timing: 2 (1=aggressive; 5=cautious)

\$MM	Q1 02e	Q2 02e	Q3 02e	Q4 02e	F2001a	F2002e	F2003e
REVS	96.1	103.3	111.1	119.4	272.5	429.9	584.8
EPS\$	(0.07)	(0.04)	(0.03)	(0.03)	(0.58)	(0.17)	(0.07)
Y/Y Gro					n/a	n/a	n/a
PE					n/a	n/a	n/a
PSR					4.55	2.88	2.12
Consnsus	(0.06)	(0.01)	0.03	0.08	(0.58)	0.04	0.32

Shares Out: 103MM

Market cap: \$1.2B

FYE: Dec.

Summary: Exult states that its business mission "is to be the leading provider of outsourced human resources (HR) services to Global 500 corporations.."

Basically, Exult proposes to take over all the usual HR functions of various major corporations. It defines the business opportunity in the U.S. as follows:

"The market opportunity for multi-process HR outsourcing is new and is

projected to grow from \$2.5 billion in 2000 to over \$21 billion by 2005 for United States companies", according to EXLT's recent S-3.

Exult's business model is considered to be the first of its kind in the HR business because of its comprehensive nature. Other companies provide outsourced individual functions, but none has offered comprehensive HR solutions to large corporations until Exult.

Exult's business model has been viewed with enthusiasm by many analysts and investors. Others have adopted a more cautious attitude toward the model, citing concerns mainly about the length of time and the volume of business that will be necessary before Exult delivers on its promise of profitability. Currently, expectations are that Exult will turn a profit in Q3 2002.

Large corporations' HR departments basically have two cost centers. One is the HR personnel and functions that are provided by the company itself to its employees (direct costs). The other is the functions that it already outsources to others (third party costs). Examples of these outsourced functions are the likes of payroll processing and benefit plans, such as health plan, insurance and administration. Our sources say that these cost centers are roughly equal in total dollar outlay.

Exult proposes to large corporations that it will take over both these cost centers. Its value proposition to give incentive to companies to let Exult take over is that Exult will both guarantee savings and will provide guaranteed service levels as well. On the direct cost side, Exult guarantees that it will save the client between 10% and 20% of its baseline current costs. On the third party cost side, Exult agrees to share in any savings that it can achieve over the client's baseline current costs.

This deal appears to be a pretty good one, for the client. But, does it work for EXLT? We think the answer is that it does not. In our view, the math goes as follows: Direct costs and third party costs are each about 50% of the total of the client's costs. Exult guarantees on average a total reduction of 15% in direct costs to the client, and it agrees to split any savings it might achieve on third party costs. We think that the best that Exult can do on reducing the client's third party costs is about 10%. Half, or 5% goes to the client. The combined 15% reduction in direct costs plus the 5% rebate on the third party costs means that the client has reduced its bill by 10%. By the same token, Exult's revenue is 90% of the client's former cost.

Now look at it from Exult's point of view. In our opinion, the best that Exult could actually achieve in cost savings on direct costs on the customer's base historical costs is 25%. Even this will be very difficult to achieve. Our

research also tells is that the best it can do on third party costs is 10%. Therefore, EXLT's cost basis is the combined 25% savings on direct costs and the 10% cost savings on third party costs. The combined total of these costs is 82.5% of the original client base cost.

So, EXLT's revenue is 90% of the client costs, and its operating expense is 82.5% of the original client costs. The difference is what EXLT has left to pay its own corporate overhead, plus make a profit.

The problem is obvious. The difference is only 750 basis points. This is the equivalent of a 8.3% operating profit on Exult's revenues. ($7.5/90=8.3\%$).

Exult's operating expense is projected to be no less than 10% of its revenue. Therefore, under this business model scenario, EXLT can not make money. Break even for EXLT is operating expense of 8.3% of its revenue, or the equivalent of 7.5% of the client's original cost.

In addition, Exult is supposed to deliver a 15% pre-tax profit to investors some day. But if it can not break even, how can it ever make a profit?

This report will detail the extensive research into the subject that we have done, and which has led us to the conclusion that, in our opinion, Exult's business model simply does not work. The conditions that would allow it to work would necessitate that EXLT be able to achieve cost savings relative to the client's original costs that we do not think are achievable.

Some analysts have been more skeptical than others of EXLT's business model. That is probably the reason that the shares are trading at just \$11.99, and they traded as high as \$18 previously. While we regret not being able to get an \$18 price for EXLT shares at this point, the shares could decline to well below \$6, if our analysis is correct. It is difficult to put a share value on a company that you do not estimate can make a profit. EXLT's market capitalization is \$1.2 billion.

Background:

Exult, Inc. (EXLT) is the first company to provide an outsourcing solution for the entire human resources function to Global 500 companies. The company commenced operations in 1998 and acquired Gunn Partners, Inc. in late 1999. Gunn Partners was a business process improvement consulting company with operations in the United States and Europe. This acquisition allowed the company to gain access to the elite clientele it would ultimately pursue.

EXLT shares began trading June, 7, 2000. Immediately after the offering,

there were 85.0MM shares outstanding. Of the 85.0MM shares, only 6.0MM were sold by the company. 78.5MM shares were subject to a 180 day lock-up, but this has since expired. However, these shares must be registered prior to their release into the open market. Also, of these 78.5MM shares, 53.0MM shares were owned by General Atlantic Partners. In August 2001, the company conducted a secondary offering consisting of 8.0MM new shares and 4.0MM shares held by existing owners at a price of \$13.34 each. As of September 2001, General Atlantic Partners owned 49.0MM shares. Currently, the float is 94.0MM shares.

EXLT's value proposition to Global 500 companies is that it can run the HR department cheaper than they can. In turn, EXLT will provide outsourcing services for a guaranteed fee that is lower than the client has historically paid for its HR department.

There are two components to HR cost, direct costs and third party vendor costs. Typically, according to the company, these costs share a 50/50 split in regards to the total cost of a company's HR department. EXLT provides a discount of between 10%-20% on the direct costs. The third party costs are assumed by EXLT, any savings achieved by EXLT are split 50/50 with the client.

EXLT has two types of clients, brownfield and greenfield. A brownfield client is one for which EXLT assumes the client's service center. A greenfield is when the client is transitioned to existing EXLT service centers.

In December 1999, EXLT inked a deal with its first major client, BP Amoco. The relationship was a five year Framework agreement for which EXLT was to provide a comprehensive eHR services organization as well as a broad range of human resource services to BP and its affiliates. Prior to EXLT beginning its outsourcing work for BP, BP took an equity stake in EXLT. Currently, it owns about 8% of EXLT.

EXLT gained recognition again in late 2000 with the addition of Bank of America (BofA) to its book of business. The agreement was for 10 years and worth an estimated \$1.1B. Bank of America also took an equity stake in EXLT. BofA purchased 5.0MM shares at \$11 each and also received warrants granting them the option to purchase an additional 5.0MM at the same price. For the 5.0MM shares purchased, Bank of America paid only \$11MM in cash. The remaining \$44MM in consideration took the form of the transfer of a prepaid lease from BofA to EXLT for a 96K square foot facility in Charlotte, NC as well as its related assets. The prepaid lease is being expensed over the life of the contract. Currently, BofA owns about 7% of EXLT.

Other blue chip companies in EXLT's client portfolio are Unisys, International Paper, and Prudential. The Unisys contract does not generate a significant amount of revenue, only \$6MM through the first six months of 2001. International Paper and Prudential will generate revenue of about \$60.0MM and \$25.0MM respectively in 2002.

EXLT justifies its existence and its business model by referencing a research study by the Hunter Group. That study states that by using the functionality of the internet to move HR delivery to a self-service mode, organizations can achieve annual cost reductions of 25%-30%. We will discuss this notion later.

EXLT expenses the start-up costs of its client contracts as incurred, rather than capitalizing them and amortizing them over the life of the contract. This is costly initially, but the policy benefits EXLT's reported earnings going forward as the majority of its clients have been transitioned.

EXLT has never generated a US GAAP gross profit, let alone an operating profit. However, in Q401, EXLT generated a gross profit on a pro forma basis. EXLT reports its pro forma figures net of "business optimization" costs. According to the company, business optimization costs represent nonrecurring expenses taken to improve the future profitability of company's business. Other than the reported Q401 pro forma gross profit, revenues have never exceeded the cost of revenues.

"Street" analysts have high hopes for the large scale HR outsourcing concept. To them, the market is huge and the possibilities endless. The "street" is projecting EXLT to turn its first quarterly profit in Q302. In fact, analysts are forecasting EPS of \$0.04 for 2002 and \$0.32 in 2003. This represents a remarkable turnaround for a company that lost (\$0.58) per share from operations in 2001.

Discussion:

1. Types of Human Resource Costs

EXLT puts HR costs into two components, direct and third party. The direct costs consist of a company's internal costs, such as salaries, facilities cost, and other overhead items. Third party costs consist of fees paid to vendors for their services. Such vendors include ADP for payroll, Watson and Wyatt for actuarial services, and SmartForce for corporate training. According to the company, the cost of an HR department is split evenly between direct costs and third party vendor costs. However, the fees associated with third party vendors do not include the cost of benefits, just their administration. Basically, EXLT does not

provide benefits such as health insurance as a PEO does. This remains a cost to the client.

2. EXLT's fee structure

a. EXLT generates its fees by providing direct HR services and by managing third party vendors. The 10-K states a client's fee for these services is typically equal to, or less than the client's historical cost of providing the services itself. We know, from our research, the "equal to" qualification only applies to the initial term of contracts with two of EXLT's large clients. All other clients received an initial discount.

b. The two clients who did not receive initial, up front savings for the direct costs of their HR departments are BP Amoco and Bank of America. According to their contracts, they were charged their historical cost of operating their HR departments for the first 14 months (BP) and 12 months (BofA) of their individual contracts. After these periods lapsed, they were charged discounted rates for direct costs. These initial periods lapsed by the end of 2001. Now that the initial periods are over, EXLT is obligated to provide the services related to HR direct costs at a discount for all clients.

c. The fee structure is broken down into the two cost components described above, direct and third party. For direct costs, EXLT provides the services at a 10%-20% discount to the client's historical cost. For the management of third party vendors, EXLT charges a fee equal to the client's cost for these vendors. However, if EXLT can achieve a cost reduction through the management of these vendors, the savings are split 50/50 between EXLT and the client.

3. The business model.

a. The EXLT business model is unique. We know EXLT generates revenue by charging front-end discounted fees for direct HR costs and fees equal to the cost of third party vendors. It hopes to generate profits by providing these direct services for less than it historically cost the client and by attaining cost savings through the management of third party vendors. However, when it achieves cost savings from third party vendors, 50% of these savings must be shared with the client. Given the sharing of these cost savings, it is more difficult for EXLT to increase Y/Y profit dollars because to increase the gain, it must cut the cost of the services that have already been cut. This becomes increasingly difficult year after year.

Conceptually, the mechanics of the business model are simple. However, in reality, the goals are difficult to achieve. To demonstrate this, we begin with "street" expectations for gross margin, which are below.

“Street” model

	Q102E	Q202E	Q302E	Q402E	Q103E	Q202E	Q303E	Q403E
Revenue	96,110	103,310	111,060	119,390	131,330	141,180	151,770	163,150
COS	91,300	91,950	94,400	97,900	107,690	114,360	121,410	128,890
GP	4,810	11,360	16,660	21,490	23,640	26,820	30,360	34,260

We broke the above model down into direct and third party costs. This is possible by making an initial assumption of what percentage discount EXLT is giving its clients. According to the company, HR department cost is about equally distributed between direct and third party. We also know EXLT discounts direct HR costs 10%-20% and assumes third party vendor contracts at cost. Given that, we have assumed clients receive an initial total HR cost discount of 7.5%. This percentage is calculated by assuming all clients receive a 15% discount on their direct HR costs, the mean between the 10%-20%. Given that HR department costs are split evenly between direct and third party, we know this translates into a 7.5% cost savings on the entire department. Our results using this assumption are below.

	Q102E	Q202E	Q302E	Q402E	Q103E	Q203E	Q303E	Q403E
Historical cost	103,902	111,686	120,064	129,070	141,980	152,628	164,076	176,380
3rd party	51,951	55,843	60,032	64,535	70,989	76,314	82,038	88,189
Direct cost	51,951	55,843	60,032	64,535	70,989	76,314	82,038	88,189
3rd party COS	49,354	53,051	57,031	61,308	65,665	70,590	75,885	81,575
Direct COS	41,946	38,899	37,369	36,592	42,025	43,770	45,525	47,315
% direct better than client	19%	30%	38%	43%	41%	43%	45%	46%

The first row, “Historical cost,” is our estimate of the clients’ cost to run their entire HR department. This was obtained by dividing “street” revenue (previous table) by 92.5%, the discount rate assuming the clients receive a 7.5% discount on the total HR cost discussed above. The next two lines represent “third party” and “direct cost”, evenly distributed based on “historical cost.”

Now that we know the historical cost of running the HR department and its cost composition, we get into the mechanics of the model. The last three rows of the table represent our calculation of the composition of EXLT’s “street” forecasted cost of revenue. We obtain these figures by making one more assumption. This assumption is that EXLT can achieve a 10% reduction in third party cost by managing vendors. Only 5% goes to EXLT because savings from third party costs are split 50/50 with the client. Given that, we discount “third party” by 5% to obtain “third party COS.”. Now, the difference between cost of revenue from the “street” model (previous table) and “third party COS” equals “direct COS.”

“Direct COS” represents EXLT’s cost of providing the direct costs associated with its clients’ HR departments. When we divide the difference between “direct cost” and “direct COS” by “direct cost,” we obtain “% direct better than client.” This represents how much more efficiently the “street” thinks EXLT can provide direct HR costs than its clients can.

The “street” appears to think EXLT can operate the HR departments of its clients for as much as 46% less than the client was able to operate the same function. According to our research, this amount of savings would be amazing, and indeed seems unachievable.

EXLT thinks it can leverage technology to operate the client’s HR department for significantly less than the client can do it itself. However, we do

not think it has been, nor will it ever be as easy as EXLT management and the “street” would like. This is because there appears to be a fundamental flaw in the business model.

b. In our opinion, the “street” is expecting too much from EXLT. Below are the components of the EXLT business model the way we see them.

Client HR Costs			Assumptions
Direct	50		
Third party	50		
Total	100		
Client direct costs with EXLT		42.5	15%*50
Client third party costs with EXLT		47.5	5%*50
Client cost with EXLT	90		
New Client Cost	90		
New Client Cost equals EXLT Revenue			
EXLT Revenue	90		
EXLT direct costs		37.5	25%*50
EXLT costs		45	10%*50
Cost of revenue	82.5		
Gross margin	7.5	8.3%	Breakeven = 7.5/90
EXLT opex at 10%	9		
deficit	-1.5		
Break even for EXLT 8.3%			
Street ultimately expects 15% pretax for EXLT			

The above table represents EXLT's business model and its proposition to clients. If a client’s HR department costs \$100, we know it is split evenly between direct costs (\$50) and third party costs (\$50). In order to obtain the new business, EXLT offers to operate the HR department for less than it cost the client. It gives the client, on average, 15% off its direct costs, resulting in the \$42.5 above. Next it obtains a 10% savings through the management of third party vendors, of which \$2.5 or 5% is given back to the client. This results in the \$47.5 above. Therefore, in the model, the client is paying \$90 to EXLT for its services.

EXLT’s revenue is \$90. We know from our research that 25% cost savings is as much as it can save on the direct costs related to the HR department. We know the direct costs were originally \$50. Therefore, if EXLT

saves 25% on the direct costs, its cost or revenue from direct costs is \$37.5. The other component of cost of revenue is third party costs. If EXLT saves 10% on the management of third party vendors, its cost of revenue from this component is 45.

Total cost of revenue is \$82.5: \$37.5 for direct costs at a 25% savings and \$45 for third party costs at a 10% savings. Given revenue of \$90 and cost of revenue of \$82.5, gross margin is \$7.5.

In order to break even, EXLT’s operating expenses must be equal to gross margin, which is \$7.5, or 8.3% of revenue. However, the “street” is projecting operating expenses of 10% of revenue. This is the \$9 above. Given this, EXLT can’t make money.

To further compound the problem, the “street” is ultimately expecting pre-tax operating margins of 15%. Therefore, gross margins would have to increase to 25%. According to our research, only 25% savings can be achieved from direct costs and 10% from third party vendors, of which 5% must be given back to the client. If these assumptions, which are the result of our research, are indeed correct, then EXLT can not make money unless it gets its operating expense below 8.3% of sales and only then would it begin to have some pre-tax profit. Pre-tax operating margins of 15% seem impossible to achieve.

4. The flaws in the model.

a. The business model seems flawed because clients pay EXLT “only” to run the HR department. They do not pay a premium to cover the cost of EXLT’s own management and corporate overhead. That, coupled with the fact that the direct costs of the client are discounted, increases the difficulty of turning a profit. In layman’s terms, EXLT must cut historical direct costs by 10%-20% to breakeven on a “gross” basis and must cut costs by significantly more than 10%-20% to break even on an “operating” basis. Based on the amount of income the “street” is expecting from operations in 2002, and using the "street" revenue assumptions, our calculations estimate EXLT would have to manage HR department direct costs up to 43% better than its clients could themselves, while also reducing third party vendor fees by 10%. In 2003, direct cost reductions needed increase to 46% while third party reductions remain the same at 10% . The cost reductions in each of these years seem rather too high to us.

To date, EXLT has never broken even on a GAAP “gross” basis, let alone an operating basis. Below we detail quarterly results since the initial IPO:

	Q300	Q400	Q101	Q201	Q301	Q401
Revenue	\$20,878	\$32,034	\$43,464	64,318	\$75,332	\$89,420

Cost of revenue	30,119	\$44,933	54,855	72,761	77,684	84,120
Gross loss	-9,241	-12,899	-11,391	-8,443	-2,352	5,300
Operating Expense	9,874	11,264*	11,993	9,725**	10,574	10,827***
Operating Margin	-19,115	-24,163	-23,384	-18,168	-12,926	-5,527

*Excludes a \$29.9MM warrant charge in connection with Bank of America's equity stake.

**Excludes \$7.3MM of business "optimization" costs.

***Excludes \$11.1MM in business "optimization costs.

Since Q300 (for 6 quarters), EXLT's cost of revenue has exceeded its revenue by a massive \$39MM. On an operating basis, the total loss increases to \$103MM, excluding nonrecurring costs of about \$48MM. The "street" justifies these massive losses as an investment, the building of infrastructure. Apparently, however, it is only a "virtual" infrastructure, as the company has spent only \$32.1MM on capital expenditures during the same period. Regardless of the poor past record, EXLT's future is hinged on its ability to generate profits going forward.

b. Exult seems to have justified its business model based on the Hunter Group study we mentioned in our introduction. The study states that by using the functionality of the internet to move HR delivery to a self-service mode, organizations can achieve annual cost reductions of direct costs of 25%-30%. Ironically, according to our calculations, EXLT actually needs to go far and above the already optimistic percentages quoted in this study to achieve both 2002 and 2003 "street" expectations.

c. We conducted our own research on the cost savings achievable from overhauling an HR department. We contacted numerous people, including HR consultants, benefits directors, industry authors, and HR department heads. The potential HR direct cost savings, according to our sources, was generally in the range of 9% to 25%. We also contacted the Hunter Group itself. A representative told us that the study referenced by EXLT did not include salaries higher than staff level and did not include facilities cost when calculating the base historical cost from which savings could be achieved. This is important, because EXLT does assume facility costs. We noted those two costs are significant, and Hunter agreed. Given that, we estimate that a more correct characterization of the cost savings that even Hunter would envision including facilities would be 15% to 25% at best.

d. We note the facilities costs are especially important in the case of EXLT. This is because it has been required in many of its deals, to assume responsibility for an on-site service center. For instance, EXLT initially bought a center in Texas and leased a facility in Glasgow in order to manage BP, and it

was required to lease spaces in both the Bank of America and International Paper contracts.

e. We note one of the individuals we contacted believed 40% cost savings were attainable, given the right situation. However, he noted that percentage cost savings depend on where a company starts out, and we agree completely. Basically, it is easier to achieve cost savings with companies that are behind the times from a technological perspective. But who are EXLT's clients? Through Q301, most of its clientele consisted of BP, BofA, and Unisys. Since then, it has signed up International Paper (IP) and Prudential. These aren't the type of companies that completely miss the boat when it comes to technology and cost cutting. We are not claiming these companies cannot attain more efficiencies, but we think their human resources systems are starting at the point where 40% reductions are not achievable. For instance, BofA overhauled its HR delivery model three years before EXLT walked in the door, resulting in significant cost savings, according to a source at the bank. Also, this source said BofA was 10 years ahead of most companies from a technological perspective. International Paper overhauled its system last year, resulting in a modern HR delivery system. We think, at least anecdotally, this is evidence these companies are not candidates for 40% cost reductions within the HR department, and are also probably not candidates for any direct cost reduction over 25%.

5. Anecdotal evidence of EXLT's problems with its core business

a. In order to achieve efficiencies sufficient enough to attain a 40+% direct cost reduction over what the client would spend to operate its HR department, the EXLT delivery model needs to operate as an exceptionally, almost impossibly, well tuned machine. However, there is evidence suggesting EXLT is having problems with its core HR delivery operations.

From conversations with people who worked on EXLT contracts, we noticed a recurring theme. That theme is that EXLT does not have a standardized delivery model. We were told EXLT sells a lot of promises, and figures out how to deliver on them later.

The problem with not having a standardized delivery model is that each new job is repeatedly marred by inefficiency. This inefficiency shows up on the job, in front of the client. Not surprisingly, the client gets upset. We will provide detailed cases of this problem momentarily.

b. EXLT has two types of clients, brownfield and greenfield. A brownfield is a client for which EXLT assumes the client's service center and assets. A greenfield is a client that is serviced from existing EXLT service centers. From conversations with people with experience with both of these,

brownfields are much easier than greenfields because with a brownfield EXLT merely walks in and changes the nameplate. A greenfield requires more strategy and execution as all obligations under the contract are transitioned to EXLT's existing service centers. Although greenfields are more difficult, they should also be where the real profits would lie. This is because the greenfields come with no service centers of their own, which is additional overhead, and should allow EXLT to get economies of scale in its own service centers.

c. To date, brownfield clients include Bank of America and International Paper. Greenfield clients include BP, Unisys, and most recently Prudential (Prudential will not produce significant revenue until 2003). We discussed each of these contracts with sources familiar with them. From these discussions, we heard something that surprised us. These sources say that they think that EXLT has never had a successful greenfield client. . In our opinion, this doesn't bode well for EXLT, especially since greenfields contain more profit. We discuss each of EXLT's greenfield clients, BP and Unisys, below.

d. From what we were told, EXLT experienced numerous scheduled milestone delays in its BP Amoco conversion. One person told us EXLT was late on every delivery date. Regardless of the quantity of schedule misses, we do know there were several problems with the conversion, and BP ultimately put the project on hold for a short time. One source tells us the problems occurred with EXLT's inability to handle client requests at its service centers. We heard the service model at these centers was not "modern" enough to handle a sophisticated client such as BP.

A British industry journal summed it up best with a Q401 article titled, "BP turns its back on HR outsourcing." The article was based on a presentation made by a BP vice-president who noted HR delivery costs were actually higher after EXLT took over responsibility for the HR department. Being numbers people, we know that can't be good for EXLT shareholders. We also heard EXLT was having problems negotiating with third party vendors, the other portion of its profit potential. We heard the larger vendors negotiated with BP, instead of with EXLT, whom BP was paying to handle these negotiations. This, coupled with the fact revenues have never exceeded the cost of revenue on a GAAP basis, causes us to think the BP contract has never generated any profits over its first two years. As a result, we see this relationship as a loss for EXLT. This is because the contract doesn't generate a profit and the client is unhappy. A source in England summed it up best when she said, "Officially, the project is moving forward, but unofficially, it's a disaster."

e. We also heard horror stories about another EXLT client, Unisys. When this contract was announced, EXLT informed investors the deal could be worth up to \$200MM over seven years. Then, it announced an add on agreement that

could be worth another \$100MM. That's \$300MM, a nice chunk of change. What EXLT didn't tell investors was the contract went "south," and the potential contract value was reduced by such an amount that Unisys revenue is not material to its financials anymore. Per the announcements, this contract should generate about \$40MM-\$50MM per year. Through the first six months of 2001, it generated only \$6MM. From our discussions with people close to this contract, we heard it was EXLT's inability to maintain service levels. The situation between Unisys and EXLT became so strained, the current amount of the contract is about 20% of its origination.

f. To date, EXLT is responsible for a single client's international operations, even though it has a large service center in Glasgow. We also note it has always had an international sales office in London, which we heard was very nice. However, since it signed BP, no other client with international operations has turned over its international employees to EXLT, and no other international client has been signed up. We found this odd, especially since there is a real nice sales office in London. We asked our sources why there were not other international clients. They told us it was because EXLT cannot provide references outside of the United States. Basically, the only two international clients it has are BP and Unisys, neither of which are especially satisfied.

The history of EXLT's greenfield clients to date may or may not be the harbinger of what is to come, but it does not appear to be a good start.

positive gross margins. In our opinion, EXLT is merely taking expenses related to the cost of revenue and reclassifying them to operating expense. This in turn improves gross margins.

The charges appear to be legitimate, and we are not questioning their propriety. However, we disagree with how EXLT portrays them. Basically, EXLT claims these expenses are extraordinary, which allows them to report EPS as pro forma without the charges. We disagree with this treatment. All EXLT is doing is reducing total expenses, which is what it is supposed to do. We do not deem this as extraordinary. In the future, we think EXLT should be held accountable for these expenses.

EXLT argues these are one time costs and the events associated with each charge are final, and nonrecurring. We do not agree. Primarily, we take issue with the Q201 severance charges and the Q401 workforce rationalization charge, which is a fancy name for severance. Basically, our research reveals that these charges were for corporate EXLT employees, and not for employees assumed from a client. These EXLT employees were responsible for transitioning clients to EXLT. Basically, they were the on-site intellectual capital. The elimination of their jobs is not an improvement in EXLT's core business of HR. It is the reduction of overhead in EXLT's corporate cost structure due to the fact that there are no longer as many transitional Exult employees required. Severance to these employees is a regular cost of doing business because many may need to be rehired, or new employees will need to be hired when the transition team employees are again needed.

In our opinion, the charges related to severance are not actually nonrecurring. This is because these employees were let go as a result of no new projects in the pipeline. When new projects ramp up again, EXLT will have to hire these people again or find others to take their place. Given this, we think these are temporarily nonrecurring charges, and should be reported as a component of operations. The way to think about this work force reduction is similar to an auto plant. Workers are laid off and are paid benefits when work slows down, and they are rehired when work picks up again. The money spent on these workers even when they are not working is not a non-recurring charge.

Former employees themselves told us they were let go because there were no new projects in the pipeline. We heard this was the case after EXLT lost a bid to e-peopleserve, an Accenture/British Telecom venture, for Cable and Wireless. Given these comments, we found it interesting when management announced a potential \$2billion in the pipeline during the Q401 conference call. If EXLT really has such a pipeline, why is it laying off transitional employees?

Below is the sequential reported gross margin improvement.

Gross Margins

	Q300A	Q400A	Q101A	Q201A	Q301A	Q401A
Revenue	\$20,878	\$32,034	\$43,464	64,318	\$75,332	89,420
Cost of sales	30,119	\$44,933	54,855	72,761	77,684	84,120
Gross margin	-9,241	-12,899	-11,391	-8,443	-2,352	5,300
Revenue chg.	\$12,706	\$11,156	\$11,430	\$20,854	\$11,014	\$14,088
COS chg.	17,726	14,814	9,922	17,906	4,923	6,436
Gross Margin chg.	-5,020	-3,658	1,508	2,948	6,091	7,652
Absent salary					5,200	5,200
Incremental chg.					891	2,452

The improvement in gross margins from Q2 to Q4 is the result of the absence of salary costs of employees who are ordinarily employed when Exult is transitioning a new client to its services. The absence of these expenses is only due to the fact that there is no new client being taken on. It is not a permanent reduction in COS due to efficiencies gained in operating the client's HR department.

We estimate that the quarterly salary costs of the transition employees who were let go is about \$5.2MM. This expense will in all likelihood return if EXLT is to grow its business. We calculated this as follows:

In Q201, EXLT took its first business optimization charge in the amount of \$7.3MM. This charge included severance charges of \$3.4MM, of which \$1.2MM was cash. We researched this charge and discovered these were corporate EXLT employees responsible for transitioning clients. Per the company, the average severance package is 3 weeks salary. The \$1.2MM just mentioned represents three weeks pay for these employees. If we convert that into 13 weeks, one quarter, it equals \$5.2MM.

As a result, we think that if EXLT takes on new clients, it will increase its quarterly COS by \$5.2MM again to cover the cost of the transition employees.

7. OWS Projections

The "street" is forecasting EPS of \$0.04 in 2002 and \$0.32 in 2003. We evaluated the "street's" assumptions and in our opinion they are unrealistic. We are projecting EXLT to generate EPS of (\$0.17) in 2002 and (\$0.07) in 2003.

Our revenue and operating expense figures are in line with "street" estimates. However, our gross margins vary considerably. The "street" is assuming EXLT can manage direct HR costs up to 43% better than its clients in

2002 and 46% better than its clients in 2003. As we indicated above, our research indicated direct cost savings of only up to 25%. Therefore, we optimistically assumed EXLT can achieve direct cost efficiencies of 25%. For the third party management of vendors, we assumed EXLT can attain 10% cost savings in 2002 and 2003. We project that EXLT can reduce all overhead expense to 10% of revenue in 2003, but that it will be unable to achieve greater efficiencies. We think that the 10% total in 2003 may be difficult to achieve. Total expenses were 19% in 2001. Our projections are as follows.

OWS Projections

	2000A	2001A	2002E	2003E
Revenue	66,661	272,534	429,870	584,830
Cost of revenue	93,195	289,420	397,998	537,411
Gross Margin	(26,534)	(16,886)	31,872	47,419
Product dev	6,674	4,630	3,550	3,850
SG&A	28,207	25,983	33,560	36,150
Dep/Amort.	8,811	12,472	14,820	16,820
Total expenses	73,592	50,419	51,930	56,820
Loss from operations	(100,126)	(67,305)	(20,058)	(9,401)
Interest income, net	5,306	3,794	2,500	1,800
Taxes	0	0	0	0
Net Income	(94,820)	(63,511)	(17,558)	(7,601)
EPS	(1.74)	(0.58)	(0.17)	(0.07)
Shares outstanding	54,491	96,577	105,000	105,000
Y/Y CHG.	2000A	2001A	2002E	2003E
Revenue	1272%	309%	58%	36%
Cost of revenue	1972%	211%	38%	35%
Gross Margin	-7491%	-36%	-289%	49%
Product dev	1714%	-31%	-23%	8%
SG&A	183%	-8%	29%	8%
Dep/Amort.	834%	42%	19%	13%
Total expenses	365%	-31%	3%	9%
Loss from operations	547%	-33%	-70%	-53%
Interest income, net	1917%	-28%	-34%	-28%
Taxes	0%	0%	100%	#DIV/0!
Net Income	523%	-33%	-72%	-57%

% of Revenue	2000A	2001A	2002E	2003E
Revenue	100%	100%	100%	100%
Cost of revenue	140%	106%	93%	92%
Gross Margin	-40%	-6%	7%	8%
Product dev	10%	2%	1%	1%
SG&A	42%	10%	8%	6%
Dep/Amort.	13%	5%	3%	3%
Total expenses	110%	19%	12%	10%
Loss from operations	-150%	-25%	-5%	-2%
Interest income, net	8%	1%	1%	0%
Taxes	0%	0%	0%	0%
Net Income	-142%	-23%	-4%	-1%

	Q101A	Q201A	Q301A	Q401A	Q102E	Q202E
Revenue	43,464	64,318	75,332	89,420	96,110	103,310
Cost of revenue	54,855	72,761	77,684	84,120	91,300	94,934
Gross Margin	(11,391)	(8,443)	(2,352)	5,300	4,810	8,376
Product development	2,169	817	822	822	850	875
SG&A	6,262	6,308	6,861	6,552	8,270	8,370
Dep/Amort.	3,562	2,566	2,891	3,453	3,520	3,640
Total expenses	11,993	17,025	10,574	10,827	12,640	12,885
Loss from operations	(23,384)	(25,468)	(12,926)	(5,527)	(7,830)	(4,509)
Interest income, net	1,077	667	1,055	995	800	700
Taxes	0	0	0	0	0	0
Net Income	(22,307)	(24,801)	(11,871)	(4,532)	(7,030)	(3,809)
EPS	(0.24)	(0.27)	(0.12)	(0.04)	(0.07)	(0.04)
Shares outstanding	91,186	92,194	99,497	103,432	105,000	105,000

Y/Y CHG.	Q101A	Q201A	Q301A	Q401A	Q102E	Q202E
Revenue	679%	687%	261%	179%	121%	61%
Cost of revenue	854%	487%	158%	87%	66%	30%
Gross Margin	-6484%	-100%	75%	141%	142%	199%
Product development	170%	-48%	-57%	-66%	-61%	7%
SG&A	-31%	-17%	21%	11%	32%	33%
Dep/Amort.	111%	37%	25%	18%	-1%	42%
Total expenses	4%	54%	7%	-4%	5%	-24%
Loss from operations	100%	67%	-32%	-77%	-67%	-82%
Interest income, net	36%	-54%	-28%	-37%	-26%	5%
Taxes	0%	0%	0%	0%	0%	0%
Net Income	105%	80%	-33%	-80%	-68%	-85%

% of Revenue	Q101A	Q201A	Q301A	Q401A	Q102E	Q202E
Revenue	100%	100%	100%	100%	100%	100%
Cost of revenue	126%	113%	103%	94%	95%	92%
Gross Margin	-26%	-13%	-3%	6%	5%	8%
Product development	5%	1%	1%	1%	1%	1%
SG&A	14%	10%	9%	7%	9%	8%
Dep/Amort.	8%	4%	4%	4%	4%	4%
Total expenses	28%	26%	14%	12%	13%	12%
Loss from operations	-54%	-40%	-17%	-6%	-8%	-4%
Interest income, net	2%	1%	1%	1%	1%	1%
Taxes	0%	0%	0%	0%	0%	0%
Net Income	-51%	-39%	-16%	-5%	-7%	-4%

	Q302E	Q402E	Q103E	Q203E	Q303E	Q403E
Revenue	111,060	119,390	131,330	139,000	152,500	162,000
Cost of revenue	102,055	109,710	120,682	127,730	140,135	148,865
Gross Margin	9,005	9,680	10,648	11,270	12,365	13,135
Product dev	900	925	940	955	970	985
SG&A	8,440	8,480	8,700	8,925	9,150	9,375
Dep/Amort.	3,770	3,890	4,020	4,140	4,270	4,390
Total expenses	13,110	13,295	13,660	14,020	14,390	14,750
Loss from operations	(4,105)	(3,615)	(3,012)	(2,750)	(2,025)	(1,615)
Interest income, net	500	500	600	500	400	300
Taxes	0	0	0	0	0	0
Net Income	(3,605)	(3,115)	(2,412)	(2,250)	(1,625)	(1,315)
EPS	(0.03)	(0.03)	(0.02)	(0.02)	(0.02)	(0.01)
Shares outstanding	105,000	105,000	105,000	105,000	105,000	105,000

Y/Y CHG.	Q302E	Q402E	Q103E	Q203E	Q303E	Q403E
Revenue	47%	34%	37%	35%	37%	36%
Cost of revenue	31%	30%	32%	35%	37%	36%
Gross Margin	483%	83%	121%	35%	37%	36%
Product dev	9%	13%	11%	9%	8%	6%
SG&A	23%	29%	5%	7%	8%	11%
Dep/Amort.	30%	13%	14%	14%	13%	13%
Total expenses	24%	23%	8%	9%	10%	11%
Loss from operations	-68%	-35%	-62%	-39%	-51%	-55%
Interest income, net	-53%	-50%	-25%	-29%	-20%	-40%
Taxes	0%	100%	100%	100%	100%	#DIV/0!
Net Income	-70%	-31%	-66%	-41%	-55%	-58%

% of Revenue	Q302E	Q402E	Q103E	Q203E	Q303E	Q403E
Revenue	100%	100%	100%	100%	100%	100%
Cost of revenue	92%	92%	92%	92%	92%	92%
Gross Margin	8%	8%	8%	8%	8%	8%
Product dev	1%	1%	1%	1%	1%	1%
SG&A	8%	7%	7%	6%	6%	6%
Dep/Amort.	3%	3%	3%	3%	3%	3%
Total expenses	12%	11%	10%	10%	9%	9%
Loss from operations	-4%	-3%	-2%	-2%	-1%	-1%
Interest income, net	0%	0%	0%	0%	0%	0%
Taxes	0%	0%	0%	0%	0%	0%
Net Income	-3%	-3%	-2%	-2%	-1%	-1%