

New Rules, New Schools, New Market



K12 Education

Industry Outlook 2005

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Please see the end of this report for important disclosures.

INTRODUCTION

We believe the U.S. K12 school system is undergoing structural changes that have the potential to redefine and expand the role of business in the \$500+ billion market over the next decade. In the next two to three years, an improving spending environment and top down legislative changes should provide compelling pockets of opportunity for investors. In the next decade, we believe even wider and deeper opportunities for savvy investors exist. Today, private enterprise already actively supports and supplements K12 education in multiple capacities. Through technology, innovation, and strategy the business world has the potential to increase access, reduce the cost and improve the quality of education for students across the country and the world. We estimate that domestic business opportunity in the K12 market amounts to \$75 billion, or 15% of all U.S. K12 expenditures. We estimate this opportunity will expand in the next 10 years to 20% of the market, or \$163 billion, as the K12 market moves into an age of data, efficiency, technology and globalization.

Companies selling into the K12 school system differ greatly in products and services offered, market needs being targeted and fundamental business models. Major categories of service include: Infrastructure and Hardware (\$6.6 billion), Instructional Content (\$8 billion), Assessment (\$2.2 billion), Professional Development (\$2.5 billion), Curriculum and Data Management (\$500 million), Tutoring (\$4 billion), Alternative or Special Education (\$9.3 billion), Childcare (\$43 billion), and Supplies (\$6 billion). We believe each of these segments has tremendous opportunity for growth in the next 10 years and that leverage opportunities between the sub-sectors should also increase. As a consequence, strategically pulling these services together into integrated education hubs may be THE opportunity in K12 education.

EDUCATION SPEND GREATER THAN SOCIAL SECURITY AND DEFENSE COMBINED

<i>\$ millions</i>	TOTAL U.S. Spend	% of GDP	
GDP	\$11,800,000		
Social Security	\$496,000	4.2%	
Healthcare	\$1,897,000	16.1%	
Defense	\$456,000	3.9%	
			<u>Spend per student</u>
Education Total	\$1,017,100	8.6%	
Post Secondary	\$356,508	3.0%	\$21,032
Post Secondary for-profit	\$14,260	0.1%	\$895
Post Secondary online learning	\$18,462	0.2%	\$6,000
Post Secondary textbook sales	\$3,391	0.0%	\$213
K12	\$501,300	4.2%	\$9,179
K12 technology	\$8,865	0.1%	\$162
K12 software	\$2,300	0.0%	\$44
K12 instructional software	\$1,800	0.0%	\$35
K12 hardware/infrastructure	\$6,565	0.1%	\$126
K12 textbook sales	\$4,290	0.0%	\$83
K12 supplemental content	\$3,700	0.0%	\$71
K12 Instructional content	\$7,990	0.1%	\$154
K12 assessment	\$2,200	0.0%	\$42
K12 professional development	\$2,500	0.0%	\$48
K12 curriculum and data mgmt	\$500	0.0%	\$10
K12 tutoring	\$4,000	0.0%	\$77
K12 alternative/special education	\$9,300	0.1%	\$179
K12 supplies	\$6,000	0.1%	\$115
K12 construction	\$19,700	0.2%	\$379
Pre-K childcare	\$43,000	0.5%	\$7,620
Corporate Training	\$110,000	0.9%	\$833

Source: Source: NCES, Department of Labor, Association of American Publishers, ThinkEquity Partners

The Problem

Nearly 20 years have past since a Nation at Risk, the landmark study which focused the public's attention on critical inadequacies in the U.S. school system, was first published. However, the problematic student performance data of American's students has remained remarkably stagnant since that time. More money flushed into the system throughout the 80s and 90s resulted in lower class size ratios and more specialized instructors, but the central problem of inadequate student outcomes remained. Meanwhile, the world's economy continued to globalize and the threat of outsourcing and the ability of U.S. corporations to compete on a flattening economic playing field became heightened national concerns. The consequences of not improving America's students' (and future workforce) ability to compete in a knowledge economy appeared to escalate every year. Business leaders, politicians and the general public became focused on what the economic future and social stability of the United States would be if K12 education did not finally enter the 21st century. Important social forces added to the mounting economic pressures to change. With the knowledge economy gradually eradicating a tier of occupations that don't require advanced (or sufficient) education, the wage gap between workers of different levels of education obtainment began to gape open. Consequently, the achievement gap among U.S. public school K12 students that falls along racial and socioeconomic lines became a critical civil rights issue. Access to education is no longer enough, public education must be equitable as well. As a result of these converging forces the roots of more structural changes began to take hold in the late 1990s and early 2000s. States and localities began increasing the use of high-stakes assessment and school accountability measures throughout the country. As public support for these efforts grew, the stage was set for a major, top-down, sweeping reform package. The Bush Administration took the opportunity in 2001, when the federal government's Elementary and Secondary Education Act (ESEA), first passed in 1965, came up for renewal. In January 2002, the ESEA act was officially renewed under the name No Child Left Behind (NCLB). NCLB vastly expanded the role of the federal government in the public school system through increasing K12 funding allocations (up more than 40% since 2001) and tying the funds to requirements and accountability measures, including regular assessment, disaggregated outcome data, school transparency (i.e. "school report cards"), teacher quality and school choice. Although the legislation promises to seed radical change in the system, we believe the effect it has had on the market has been muted over the past three years as states, districts and schools struggled under major budget deficits while attempting to both interpret and become compliant with the new legislation. With funding problems alleviating and most states compliant with NCLB on the major issues, we believe significant change is afoot in the K12 market that will ultimately expand opportunities for private enterprise.

Business and Technology to the Rescue?

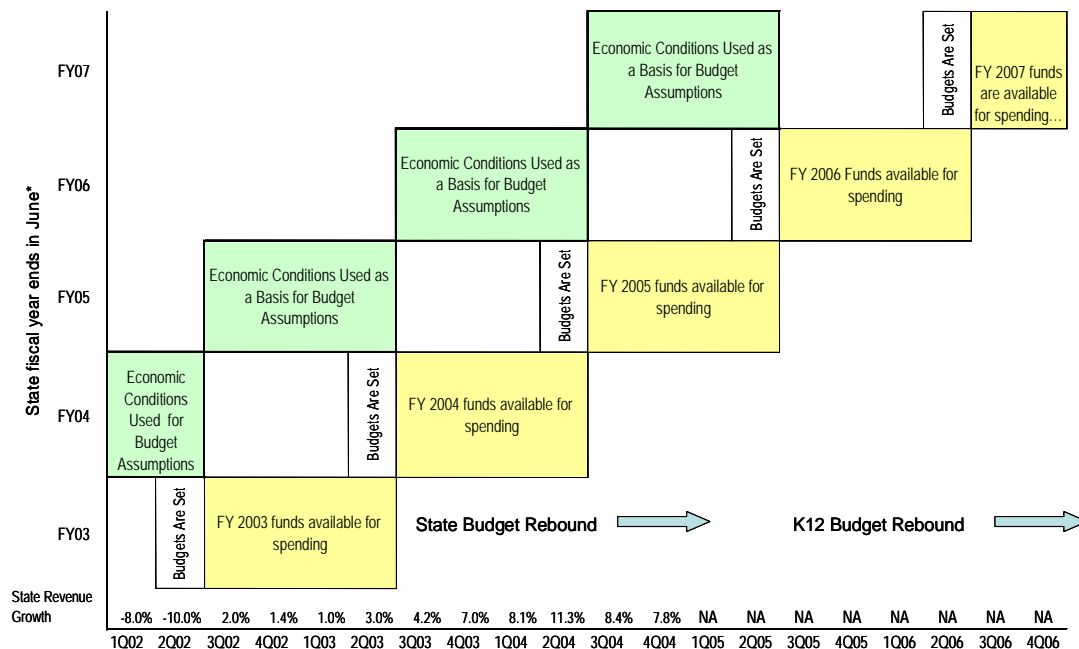
The K12 system has historically had a push-pull relationship with the business world. While Corporate America is deeply integrated with our public school system in many ways (providing incentive, consequence and assistance), there remains a pervasive stigma against the concept of a profit-motive playing a hand in the publicly funded education of America's youth. In addition, change and innovation (including technology) is generally difficult to implement in the large, fragmented, unionized and bureaucratic K12 system. As a result, schools pull business in with one hand and push it out with another. We believe this balance is shifting toward deeper acceptance and integration of education and business as an evolving school leadership base becomes more business and technology friendly and as the immediacy of The Problem grows. Specifically, as the reality of accountability sets in, the system is (for better or worse) becoming more "results oriented," thereby enabling focus to shift from the means of change (e.g. pedagogical debates) to the end: student outcome data. If a product or service improves test scores effectively, then it has a chance to find a place in the market, despite feuding theorists and/or anti-for-profit sentiment. Meanwhile the immediate value of the efficiency, distribution and innovation that businesses can offer is growing as the market becomes more data oriented. A trend towards transparency (school "report cards") is galvanizing the public and politicians alike to also focus on the outcomes. The consequences of unfavorable reports can be considerable. They can affect local real estate markets, local economies and the success or failure of current government policies (and the politicians which enact them). A byproduct of this trend toward the

bottom line is that schools are focusing more narrowly on improving the middle ground (i.e. students just below or at proficiency). As a result, we believe the opportunities for consumer education and for schools outsourcing ancillary services will expand in the next decade. In addition, we believe the true value of technology (beyond improved communication and data collection) has yet to be realized in schools. Ongoing formative assessment and summative assessment with quick turnaround times is still not uniformly available in schools. In addition, demand for individualized instruction, a possibility made more viable with technology and school outsourcing, should increase as our population grows and becomes more diverse. We believe businesses can and will offer solutions to these issues as historical barriers to change are lowered.

Short-Term Outlook (the next two to three years): Playing the Rebound in K12

As K12 districts and schools gear up for the 2005-2006 school year, we believe buyers will have more targeted spending priorities and larger budgets at their disposal. Both of these factors bode well for private enterprise. Following three years of budget difficulties, our analysis of federal, state and local funding sources has provided us with an optimistic view of the near-term direction of K12 budgets. Relief will by no means be a windfall. Many states are recovering from deficit years that exhausted short-term fixes, such as borrowing on future tobacco revenue, and federal money has been slow to trickle down to schools. However, we believe the current school year (2004-2005) showed improvement over the difficult 2003-2004 school year and we are seeing signs of even greater improvement as 2005-2006 school budgets begin to take form and spending decisions are made. We estimate that funding from local sources (43% of K12 revenue) will continue to vary depending on local real estate markets and legislation. However we believe strength in state (49% of K12 revenue) and federal funding (8% of K12 revenue) will provide enough of a boost to create a more-permissive spending environment overall. We estimate that state FY06 K12 funding allocations, which will be mainly set in June 2005, should be based on state revenue in the FY04 period (see chart below). In FY04 (June 2003 to June 2004), state revenue increased an average of 7.7% vs. an average of 1.8% and (1.4%) in the prior two fiscal years.

K12 BUDGETS OPERATE AT A LAG TO THE GENERAL ECONOMY

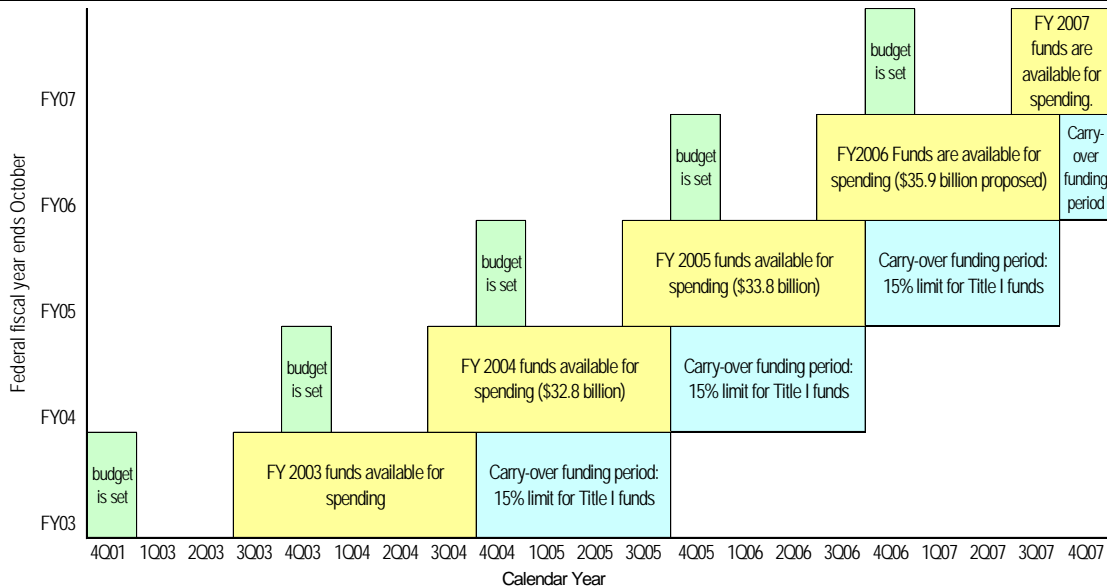


*48 states fiscal years end June 30. The four exceptions (out of the 48) are New York (March 31), Texas (August 31), Alabama (September 30) and Michigan (September 30)

Source: *The Nelson A. Rockefeller Institute of Government*

In addition to more robust funding from states we believe schools' access to federal funds, which have always taken a long time to flow through into the hands of district buyers, should improve in the next school year. Federal dollars are increasing as a percentage of total K12 spend and account for one-third of technology funding, making them of increasing importance to companies selling into the K12 market. Federal DOE budget allocations are typically set in the October-November time frame and then made available for states for a 15-month period beginning on July 1 (the start of most state fiscal years). This means that schools/districts theoretically spent FY03 federal money (this first year of substantial increase to federal K12 allocations) from July 1, 2003 through September 2004. States can also carry over 15% of their Title 1 funds for another 12 months beyond the initial deadline, so a percentage of the FY03 allocation is still available and will be until September 2005. Clearly, investors can see that the overlap of increasing federal allocations has a delayed and compounded effect. In the first half of 2005 districts will have access to the tail end of FY03 dollars and the bulk of FY04 dollars – both of which were very healthy budget allocation years. In the second half of 2005 federal money available for district spending will receive another boost as two full years of increased budgets are available for school spending in the same time period.

Availability of Federal Funds



Source: U.S. Department of Education

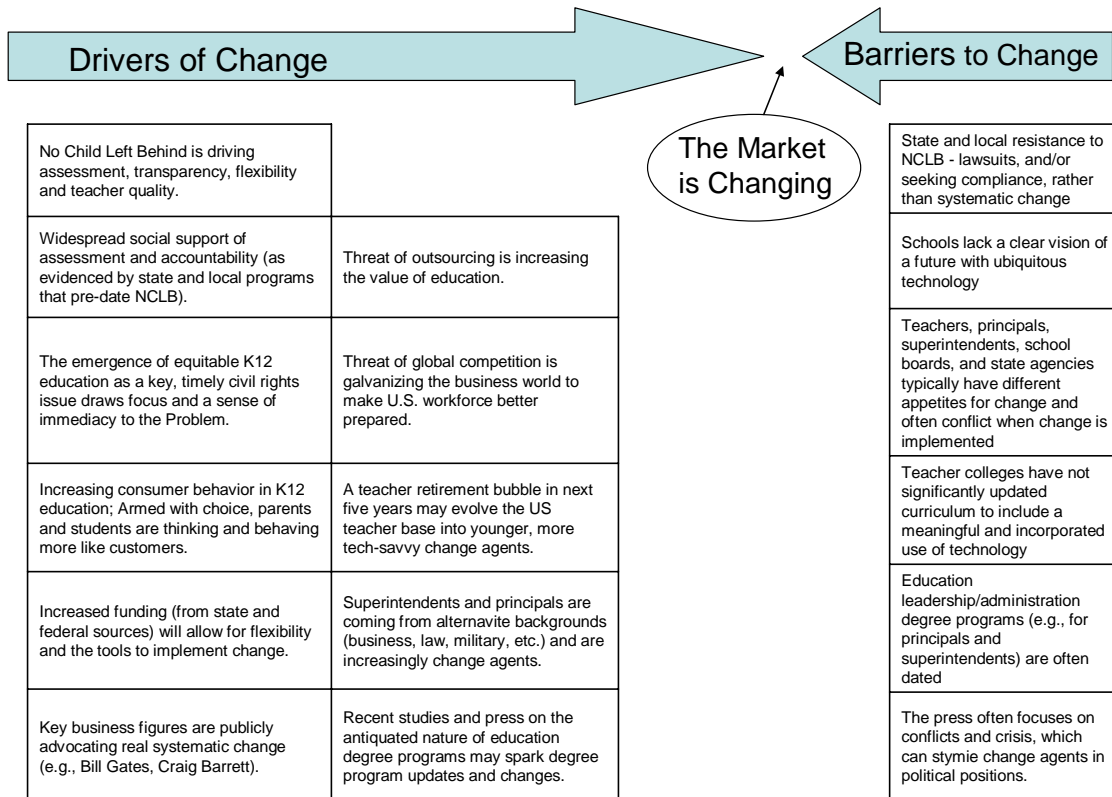
There are a multitude of factors pushing budgets in the opposite direction (increased healthcare costs, etc) however K12 is more than ever a key public concern. It is the most frequently used platform in gubernatorial races and is generally considered to rank fourth in federal attention (behind defense, social security and Medicare).

Although K12 budgets seemed to have turned a corner over a year ago, the performance of the private sector selling into K12 schools remained disappointing for many in 2004 as sales cycles lengthened and buyers balked at major purchases. As a result, with budgets moving more firmly into the black in the 2005-2006 fiscal year and buyers more clear with spending priorities and funding paths we believe there is upside to the market. Meanwhile, the significant barriers to entry in this market remain strong. These include the entrenched nature of most sales relationships, the need for delicate business management in tandem with choppy sales cycles and an understanding of ever-evolving funding issues. **These barriers emphasize the need to carefully handpick investments in the industry, despite what appears to be a rising tide of market dynamics.** In addition to increased opportunity in school sales, we believe companies capitalizing

on the strong consumer demand for supplementing K12 public education (tutoring, childcare, toys, etc) should continue to benefit from robust demand and healthier consumer spending. With market conditions improving, we believe the most pertinent question today is how to play the rebound in K12.

Long-Term Outlook (the next 10 years): Investing in a Market Evolution

Change is notoriously difficult to implement in the tradition bound U.S. K12 market. As mentioned previously, the system is enormous, bureaucratic and highly politicized. Despite this, we believe several powerful drivers of change are gaining steam and are fueling the system's normally sluggish evolution at a more-rapid pace. These potential change agents include the following: rising global competition, the threat of outsourcing, the knowledge economy (and the resulting wage gap), an increasingly results-oriented school environment, an evolving teacher base, an evolving school leadership base, and a permeating concept of students and parents as consumers with increasing influence over the system. Of these we believe the most significant factors are those which involve people within the system. At a local level school leadership comes from four levels: teachers, principals, district leaders and school boards. With a teacher retirement bubble coming in the next five years (over one million teachers are expected to retire) we believe the new teacher base will be younger and will include more career switchers, both of which are generally more tech-savvy and forward thinking (i.e. education cannot exist in a bubble). In addition, an increasing number of district leaders from non-education backgrounds (military, business, law, etc) may be more willing to take advantage of the tools and services the business world offers. As a result of these trends, we believe the system will finally enter the 21st century in the coming decade. When it does, we believe the \$500-plus billion US K12 education system will be more closely integrated with the business world, allowing for numerous, long-legged investment opportunities.



INVESTMENT THESIS

We believe K12 school systems will be in a position to initiate spending on new or shelved programs in the 2005-2006 and 2006-2007 school years, but we won't begin to see validation of that until late summer, early fall 2005. **However, when the spending environment does regain momentum it will come on the back of three years of state budget cuts and flat to negative sales growth, leaving ample opportunity to post strong growth and solid shareholder returns.** Moreover, when districts and schools are in a position to spend money on supplementary materials and technology more freely, the types of decisions that will be made should illustrate an altered landscape with increased opportunity for private enterprise.

We believe the priorities of the K12 market in the next one to two years will reflect three powerful trends:

1) Increased assessment, data and accountability to that data. A federal mandate for accountability, which has permeated public school planning since early 2002, along with numerous state assessment initiatives has caused the amount of testing in public schools to double in the past three years, according to the Center for Fair and Open Testing. We believe this results-oriented environment should lead to more prevalent use of tools with the ability to raise test scores in the near term, a growing market for consumer funded K12 products and services, and increased use of consumer or public pay supplemental education (e.g., tutoring, after school programs, etc).

2) A greater acceptance of alternative routes to education and "school choice." In addition to accountability, another central goal of the NCLB act is expanding availability of alternative pathways to education (e.g. school choice and alternative education). We believe laws and money paths designed to accomplish this goal have created a growing, although nascent, market for alternative programs, such as virtual schools, charter schools and special needs programs.

3) A more integrated and comprehensive role of technology. The new landscape should reflect a growing presence and more complete integration of technology into the classroom. The past decade's massive investment in hardware and basic functionality software is likely to be followed by a period of heightened investment in software aligned to "real change" as schools seek to make use of their new data and tools. "Real change" suggests that schools not only use technology to get organized, efficient and compliant, but also use tools to directly analyze, interpret and ultimately improve student outcomes. We believe this shift in conceptual focus coupled with loosening purse strings as school budgets begin to grow again will translate into numerous opportunities for companies selling standards based instructional content, assessment, and data management and analysis software into K12 schools.

The Public Market

Investing in the K12 market was a hit or miss activity in 2004, with our K12 index return down 8% and individual stock performance ranging from up 54% (Bright Horizons) to down 47% (Leapfrog). Following a banner year in 2003 (our K12 index increased 81%) several companies grappled with the reality of a still difficult school selling environment while others either fought or benefited from changing conditions in the consumer and business services markets. On average, K12 companies providing traditional products or services (e.g. school supplies, site based services) fared well in 2004 (up 28%). In contrast, companies selling technology to schools suffered (down 27% in 2004) as they missed estimates and posted discouraging financial results in the second half of 2004. Although the past three years have been tough for the industry, this recent disappointment was particularly acute as it came at a time when many (company management and investors alike) expected the economic rebound of the past two years, new federal funding pools, strong political commitment to K12 and more focused demand for products directly improving student outcomes to be more clearly reflected in K12 spending patterns. We believe investor sentiment is low and, in some cases, the compressed valuations do not reflect a long-term view. We also believe that

current market trends have increased the probability that M&A activity in the space may heat up. Either way, we believe there are some interesting investment opportunities in the K12 market today. In this report we explore both why the market has been so slow to recover and when we believe it finally will (yes, we think it will!). We also discuss coverage of four K12 companies which we believe hold particular promise due to their strategic positioning within the evolving K12 landscape: Educate, Plato Learning, Bright Horizons and Scientific Learning.

What to Get Excited About:

- **NCLB: First Three Years Were About Compliance, The Next Four Are About Addressing Problems:**

We believe President Bush's No Child Left Behind Act has had the most noticeable impact on the K12 system since the ESEA act was first passed in 1968. In addition to increasing federal funding for K12 education by over 40% to \$24.4 billion, NCLB essentially redefines the federal government's role in education and sets a mandate of accountability in schools tied to continual student assessment data. Since its inception, the Act's effect on school planning and decision making has been considerable. However, much of the focus thus far has been on becoming compliant, meeting the new requirements of annual testing and properly distributing the new money flows. Looking forward, we believe the next four years will be more about meeting the goal of "adequacy" across student groups. Schools, and school spending, will be more focused on actually improving (rather than just measuring and reporting on) learning gaps among individuals and among student groups. This means that the use of supplemental content tied to state standards and supplemental education services, such as outsourced tutoring and other services, should be in high demand moving forward. Beneficiaries should include Scientific Learning, Plato Learning, LeapFrog School House, and Educate.

- **NCLB and Technology Go Hand in Hand** – The NCLB act requires disaggregated detailed data on student groups by multiple major classifications (e.g. gender, race, special needs). This tremendous requirement can only be realistically met with the widespread use of technology in assessment, data management and deploying individualized instruction. With the law potentially about to be expanded in application to include math and science, as well as to higher grade levels (per Bush's stated goals), we believe these trends will only continue in the next four years. This bodes well for continued technology demand in schools.

- **Clarified Market Demands Are Positive For Private Enterprise** - In the past three years U.S. school systems have narrowed their focus and spending onto addressing critical issues. With more centralized (state and federal) influence over an industry that has historically been a locally controlled affair, widely disparate needs in a fragmented market have converged into several definable market demands. We believe these include improving teacher qualifications (e.g., through training); tools for data collection, analysis and feedback; and preparing all student groups for and implementing increased assessment in schools. The trends open up further, predictable demands. For example, the need to prepare students for ongoing assessment is causing K12 curriculums to converge with state standards. *As a result, we believe teaching aids (whether technology, books or training) that focus on standards aligned content are of growing importance and demand.* In addition, the need to prepare all student groups for AYP is opening up a growing market for remedial programs and products for struggling learners or at-risk youth (potentially benefiting Scientific Learning or Plato Learning). Spending trends such as these have demanded that companies selling into the K12 market adopt and create new offerings (or tailor existing ones) to address the new demands. Although this caused some upfront investment, we believe it is a long run positive as the market has clarified what types of products or services to focus on.

- **Assessment and Transparency Trends Opening Doors for Private Enterprise:** We believe the most-salient change in the U.S. K12 public system over the past three years has been the increased implementation and importance of standardized testing in schools. With both federal and state laws requiring the use of ongoing “high stakes” tests (tests linked to graduation or grade advancement), standardized tests in K12 schools are estimated to have doubled in the past three years, according to the National Center for Fair and Open Testing. Along with assessment, schools are required to report the data to the public (“school report cards”) which increases the transparency of school performance. We believe these trends are unmasking grade inflation and “social promotion” and also heightening parental worry that low scores will penalize a child early in life. As a result, parents are more likely to be aware of their child’s learning level across different subjects and are more likely to take action to fix problems not being adequately addressed by the school. *We believe this trend is increasing consumer behavior among parents of K12 students and thereby is opening several doors to private enterprise.* Product and services which can be bought by parents to assist their child’s ability to perform and excel in primary school assessments include supplemental tutoring services (e.g., Educate’s Sylvan Learning Centers), educational toys (e.g., LeapFrog) and retail educational games (e.g., Riverdeep). When faced with less-than-satisfactory test data, parents may also determine that alternative education programs, such as private schools, charter schools or alternative education programs are more appropriate for their child’s education.
- **Barriers to Entry are High: Entrenched Sales Channels and Demand for Turn-Key Solutions -** The K12 market has traditionally been reluctant to embrace new sales efforts. Tight budgets and multiple decision makers result in an aversion to accountability risk associated with an unknown brand or company that could have faulty products or go out of business altogether. *As a result, the importance of brand name, track record and high-level connections in the industry is paramount.* The upside of this situation is that once established as a trusted source, companies can more-easily penetrate multiple sub-sectors in K12 schools. In addition, the power of word-of-mouth referral leads can be incredibly strong. QED estimates that the most cited factor for district superintendents choosing technology is word-of-mouth recommendations, or “viral marketing.” As larger district and state solutions are implemented throughout the country, other districts are likely to look to their choices as a guide. *As companies capitalize on their sales channels by expanding offerings, they also benefit from the K12 market’s affinity for one-stop shops.* The primary role of most school buyers is teaching and/or administration, which leaves minimal time for well informed buying decisions (e.g. assessing new vendors, comparing pricing). We consider one-stop shops as providers who are able to provide a combination of both on-ground and online services that focus on addressing several needs, such as assessment, administrative functionality, efficiency, and/or instructional content. Often this ability lies with major publishers, but it can also extend to smaller niche players, such as Princeton Review and Plato Learning.
- **Federal Commitment to Technology -** Although federal money still remains a small portion of overall school funding (8%) it has historically accounted for one third of all technology spending, depending on the year. *With federal funding up 40% in the past three years, new money paths for NCLB funds crystallizing, and more focused priorities on outcomes, we believe there is upside for certain technology providers in the next two to three years.* The federal budget currently includes two targeted technology programs– Erate, funded at \$2.2 billion, and Title IID, the Enhancing Education Through Technology (EETT), funded at \$500 million, both of which have been historically primarily used for hardware and infrastructure purchases. EETT appears to be in jeopardy as the FY06 budget takes form (discussed as a risk below). The Bush administration is seeking to provide more flexibility to states by eliminating specific funding pools and shifting the dollars into general funds. Although this may seem alarming, it is important to remember that the total level of funding is relatively stable (up 3.6%) and nearly any category of NCLB funds can potentially be used for technology purchases. We believe the most common federal funding source for software is Title 1, which remains a solid funding

pool. We believe the White House's support of and advocacy for increased technology in K12 education remains strong, although the focus appears to be on data management, rather than infrastructure (according to a recent survey of state technology directors by Education Week). Bush painted technology in K12 schools as the Great Equalizer when NCLB was renewed. The theory is that by ensuring that every public K12 student in the United States is technology literate by grade 8 (a stated goal of the legislation) the country can stem the widening digital divide. Most importantly, we think the requirements of meeting NCLB generate a large market demand for technology, whether the budget sets aside dollars for it or not. It is also important to note that schools are able to access funding for educational technology offerings from various sources, including the Title 1 program, instructional and administrative budgets, and donations and matching funds from hardware vendors. As a result, funding for technology operators in the K12 market has the opportunity to increase from multiple directions. The key technology segments that should benefit are those which provide data analysis to inform instructional decisions, curriculum management and standards-based instruction. Beneficiaries may include Plato (particularly NetSchools and EduTest related sales), Scientific Learning, Princeton Review, Renaissance Learning and AlphaSmart.

- **Next Up: Math and High School Reform** – Following a heightened focus on improving reading instruction in the past three years (Reading First, initiated in FY02, was increased by 25% in three years) reading will have to share the spotlight with math and high school initiatives going forward. Currently only 71% of U.S students graduate high school and only one fifth earn a college degree, according to the National Governor's Association. In their 2005 state of the state addresses 26 state governors emphasized the need for high school reform, versus 5 who did so in 2004. Bill Gates, whose foundation has contributed more than \$1 billion to US public K12 education, has called the current U.S. public high school system obsolete and is publicly advocating the immediate need of change. Meanwhile, the federal budget proposal includes a new \$2 billion fund specifically geared at high school reform. We believe companies that will benefit from the future math and high school focus include Plato Learning, Carnegie Learning, and ProQuest's Voyager Learning.

What to Watch Out For:

- **The Long K12 Sales Cycle is Just Getting Longer**– We believe one of the most significant hurdles that companies selling into K12 schools face today is a lengthening sales cycle. The K12 sales cycle is notoriously long and choppy due to the slow and convoluted process of cash disbursement, the heavily unionized maze through which funding must travel and the red tape involved with product procurement. As the point of sale in the K12 market moves up to the district and state levels, additional layers of approval are needed for larger scale purchase decisions. In essence, larger buyers have more power and little motivation to push purchase orders through to enable a company to meet its deadline for booking quarterly revenue. In fact, products are often shipped (and services delivered) before purchase orders are even received. As a result, visibility is low, hurting credibility with the Street and managements' ability to plan the allocation of resources. We estimate that the typical sales cycle for new, large scale technology purchases has reached 18 months. With the average turnover of a district superintendent at two to three years, it becomes painfully clear what a narrow window operators have to make new customer acquisitions. Subscription purchases or services that play an ongoing and critical role in a district's operations have a much shorter sales cycle, as new superintendents typically carry out previous policies in their initial months. We note, however, that customer credibility in the K12 market is quite high, with buyers rarely making any purchase decision without clear funding paths already designated to pay for it. As a result, we believe companies will benefit from increased overall K12 funding levels and an increased demand for effective technology solutions. But, the rough, choppy sales cycle will cloud this recovery.

- **Striking a Balance: Educating the Millennials Requires Innovation, But Schools Require Simplicity** – Selling technology to school systems is different from selling to consumers and businesses. Simplicity often wins out over the “cool factor” and even higher functionality. Teachers are often pressed for time, are under pressure to raise test scores and other student outcomes, and don't have the training resources, time or motivation to take risks on completely revamping their teaching methods. As a result, they gravitate toward tools that they believe will assist or enhance their tried-and-true methods. Despite this tendency toward products or services that mainly serve to automate the current system, the K12 school system in the United States is evolving with the use of technology. Increasing pressure to raise test scores and report data is causing district administrators and principals to search for new ways to improve education. At the same time, students' demands, interests and lives outside of the classroom are increasingly tech-centric. These forces create demand from both the top down and the ground up that nudges along innovation in schools. Consequently, there is also a place in the K12 market for tools that represent an innovation value proposition. For example, we believe the use of adaptive testing represents a truly novel way of educating and testing. These types of products and services must be carefully deployed however, as many companies have fallen victim to pushing innovation into schools before its time. *The companies with the most success, in our view, will be those that maintain a pace on par with that of the school system – offering tools that assist the slowly evolving system, along with those that work to gently push forward innovation.* Finding this balance is a considerable undertaking, which emphasizes the importance of savvy, experienced management teams.
- **Bush's FY06 Budget Proposal Eliminates a Technology Funding Pool** – The federal government is an important source of funds for K12 technology spending, accounting for up to a third of all technology purchases, depending on the year and fiscal condition of state and local budgets. In a national survey of state technology directors commissioned by the State Educational Technology Directors Association (SETDA), 25% of respondents stated that the only funding for K12 technology available to them at the state level in the 2003 school year was from NCLB federal funds. As a result of this dependence, when Bush published his FY06 proposal for a K12 budget many in the industry were deeply disappointed and concerned that allocations for Title 11D, the Enhancing Education Through Technology (EETT) program, was notably absent. Title 11D funding, designated for all types of technology purchases but primarily used for hardware, has been included in the federal budget for over a decade in various forms, with an average annual allocation of \$500 million. In FY04 that amount was increased to \$800 million, and then reduced by 30% to \$600 million in FY05. If the proposed elimination of this funding pool passes through Congress and makes it in to the final FY06 budget (to be passed in October) it could have a negative effect on the K12 technology market. Although software purchases tend to draw on more general funding pools (e.g. Title 1 and IDEA) the lack of money to renew/replace obsolete hardware may ultimately affect software sales.
- **Finding Good Management is Tough** - A good management team in the K12 market must have business savvy, political acumen and a deep understanding of the labyrinth that is the U.S. public K12 school system. Finding such experienced and talented individuals, who are willing to accept the long, choppy sales cycles (lack of visibility) and the inherent political and press risk can be difficult. In short, to manage a K12 company is no simple task. We believe there are several K12 companies searching to fill high level management positions (CEO, presidents, etc) today. As a result, there may be significant competition to fill those spots. It is not uncommon to see managers move in and out of top level positions relatively frequently in this industry. As a result, we place a high premium on managers that have proven their ability to execute in this market and at the company they currently serve. We note that the high requirement for skilled leadership creates a risk for the industry in general.
- **The K12 Buyer is a Moving Target** - Unfortunately for K12 vendors, depending on the size and the nature of the purchase, the “K12 buyer” is realistically multiple people at different administrative levels,

often including the district superintendent. Establishing a passionate teacher following is still important, but it is not the only hurdle vendors must face when making a sale into the K12 market. When it comes to major purchases, there are often several buyers from multiple vantage points that play a role in making decisions. This begs the question, how important is the teacher voice in the K12 sale today? For many consumable purchases, such as school supplies, we believe it remains critically important. However, as technology has become a more-integral part of K12 education (both administrative and instructional) school systems have developed district-wide technology administrations that seek to rationalize and economize technology purchases throughout a district. According to OED, district superintendents have final approval authority for instructional technology purchases in 86% of districts in the United States. *As a result, we believe that although it remains significant, the value of a strong "grass roots" following in K12 classrooms for companies seeking to sell technology is diminishing over time.* In our opinion, companies that have built success off of ground-up sales channels include Renaissance, AlphaSmart, LeapFrog, and School Specialty. For companies mainly selling technology into schools, Renaissance, AlphaSmart and LeapFrog, solidifying new district relationships is critical to future growth. Companies which we feel already have strong district relationships include large technology companies (such as Apple and Dell), major K12 print publishers (such as McGraw Hill and Pearson) and some smaller, more niche players such as Plato, Educate, and ProQuest.

- **K12 is Vulnerable to Legislative Changes** – The No Child Left Behind act changed key elements of the U.S. public K12 school system, including the direction of large pools of K12 spending, in a short time frame. A top-down change of similar magnitude had arguably not been seen since 1965 when the federal Elementary and Secondary Education Act was first introduced. The change brings to the forefront how vulnerable a government-funded and regulated industry, such as K12, is to unforeseen regulatory changes. At both state and federal levels, key legislation is subject to change as administrations move in and out of power, budgets ebb and flow and political platforms are popularized or upstaged. For example, recent resistance to NCLB (in the form of lawsuits issued by the largest U.S. teacher's union and several states) may result in alterations to the Act and potentially even increase funding. Regardless of the outcome of these lawsuits, we believe the heart of the Act (the concept of accountability) has already made a heavy mark on the industry. However, political dynamics, popularity measures (e.g. press coverage) and funding availability, all of which are generally outside of the private industry's control, may still effect the direction of key trends. We believe a close eye must always be kept on Washington, D.C. and on the state capitals to determine what the most recent trends in government attitude may be. This may create considerable additional cost and mindshare to companies operating within the industry, as well as to investors.
- **A Competitive Environment** – There are over 14,000 districts in the U.S. and over 94,000 schools. However, the largest 6% of districts (or 816 districts) enroll over 50% of the K12 student population and likewise control over 50% of K12 expenditures. With economies of scale more viable in these large districts, which enroll over 10,000 students each, many providers target their efforts at this top tier of school systems. With the point of sale moving up to the district level for many purchases the top level decision makers at the large districts hold the majority of the market opportunity, and the fate of many companies' survival, in their hands. As a result, these potential buyers are increasingly inundated with purchasing options from the thousands of companies offering products and services to schools.

TIMELY THEMES

A Bird's Eye View: Technology's Role in Schools Continues to Grow

Over the past decade, districts, states and the federal government have collectively spent billions of dollars equipping schools with technology and linking them up to the Internet. The tangible results are impressive. In 1994 only 4% of public K12 classrooms in the United States had an instructional computer and 3% had Internet access. Today over 92% of classrooms have at least one instructional computer and 87% provide internet connectivity. This level of investment illustrates strong support on the part of legislators (who allocate ear-marked funds for technology spending) as well as school and district administrators (who often choose to use discretionary dollars in technology purchases). More importantly, however, it also reflects a societal belief that technology has the ability to effect and improve education the way it has improved economic productivity and efficiency in the business world.

But has this impressive level of investment produced the real intended results – a better educational system? Although efficiencies can improve the amount of instruction dollars and time available per student, the real measure of change is student outcome data. And student outcome data is mixed. It has been difficult to link any positive test score data to increased use of technology in schools as standardized tests have changed over time (making year over year comparisons difficult). Meanwhile, some independent longitudinal studies have revealed stagnant student outcome data. For example, a recent widely publicized study by the Organization for Economic Cooperation and Development, a Paris based intergovernmental group, found that in the 2000 - 2003 period, the performance of U.S. 15-year-old students in math, reading and science remained flat on both an individual and comparative basis. Discouragingly, the comparative data revealed that in all three years, U.S. students ranked in the bottom third in math and science proficiency among the 39 industrialized nations in the study. In recent reports, outcome data has looked more positive. The Northwest Evaluation Association found that groups of students tested improved their math proficiency by 9 percentage points, while reading proficiency only improved slightly. According to the Council of Great City Schools' report, *Beating the Odds V*, 70.8% of all grades in cities surveyed improved their math scores, while 41.5% improved their reading. In the end, it is difficult to evaluate the benefit of technology in real life situations. As a result, it is important that K12 technology remains easy to implement and the total cost of ownership is carefully considered and contained.

Critics paint today's educational technology as expensive typewriters or mere tools for distracting students while teachers struggle with overpopulated classrooms. While in the larger picture these criticisms are few, they importantly remind educators that placing devices into classrooms is only the first step in the process of integrating technology into classrooms. We believe that our society's belief in the transformative power of technology will continue to drive investment for the next decade. What the criticisms do bring to light, however, is the need to make the existing technology infrastructure more productive. This implies a strong need for professional development and a shift in investing from hardware and one-off software applications to large, rationalized technology systems which incorporate and enable individualized instruction, new curriculums and adaptive learning methods.

Assessment Trend Opening Doors For Private Enterprise

In Japan it is estimated that 80% of students take after school tutoring programs. Although it is difficult to measure (as many tutoring programs are offered from the home), it is estimated that in the United States closer to 15% of students seek outside tutoring. We are not anticipating U.S. tutoring to approach the penetration of Japanese tutoring programs; however, we do believe the market is moving in that direction. Although parents have always been concerned with education, we believe grade inflation in the past three decades has masked the inadequacy of the public school system. In 2003 47% of all high school students had an "A" average, up from 17% in 1968, according to U.S. News & World Reports. In comparison, in 2002 only 36% of students in grade 12 tested "at or above proficient in reading" (according to NAEP data).

With disaggregated data on student outcomes in the US public K12 school system now collected and made available to the public (per NCLB mandates), we believe parents of public school students are becoming more aware of their child's performance, despite a passing grade. Meanwhile, the recent state fiscal crisis has caused many schools to cut programs and reduce staff over the last few years, exaggerating parental dissatisfaction with the public system. ***As a result, we believe families are increasingly likely to take independent action to address learning problems.*** Compounding this trend is a shift in public perception of the role of public education brought on by the school choice movement. Specifically, we believe school choice stipulations in the NCLB act, which have provided a market for virtual schools and other innovative programs, are causing parents to think and act more like customers when it comes to their child's education, rather than passive recipients of a public service. Looking forward, these trends should only continue. The National Center for Fair and Open Testing estimates that standardized testing in K12 schools has doubled in the past three years. In 2003 52% of public school students were required to take "exit exams" and in 2008 it is expected that over 70% will. Meanwhile, the federal NCLB requirement for annual testing in grades 3-8 is expected to be expanded to include new subjects and more grades (9-12). This data inflow is likely to drive parental awareness and potential anxiety that low scores in the earlier grades may unfairly penalize their children early in life (e.g. set teacher impressions, get the child on the wrong learning track, etc). In addition to increasing remedial tutoring, we believe demand for tutoring accelerated/gifted students is also growing. The college admissions process is becoming more competitive as the population grows and the top tier schools keep enrollments steady. Beneficiaries of these trends may include: Educate, Princeton Review, Kaplan (owned by Washington Post) and alternative school operators.

K12 M&A Market Heating Up

Consolidation in the K12 industry makes good strategic sense, in our opinion. The market is highly fragmented and although its continual inflow of start-ups fuel innovation, it is difficult for new companies to develop the high-level sales channels needed to grow beyond the initial stages. As a result, it makes sense for larger operations with deeper pockets and established sales channels to fold in new attractive products and services into their existing repertoires. The last three years have been particularly difficult for many companies selling into the K12 market as the funding environment dried up, access to capital was minimal and investor sentiment low. We believe motivation for M&A is most immediate on the technology side of the industry. As educational technology is rationalized under district technology plans purchases are generally larger in size, take longer to move through the sales channel, require multiple levels of approval and need to be interoperable to be considered by district buyers. All of these trends point to a low survival rate for small, independent operations with no leverage. ***We believe that with both seller and buyer motivation increasing M&A activity will increase in the next few years. The following is a discussion of likely targets and acquirers:***

Potential Targets – Following three years of a relative capital funding drought, poor public market performance, and disappointing internal cash flow generation due to a tough selling environment, we believe several K12 technology players may be ripe for purchase or mergers. These include a large pool of private operators some of whom have already been snapped up (e.g. Voyager) and also potentially larger public players, such as Plato Learning, Princeton Review, LeapFrog, and Scientific Learning. We discuss the prospects of each below:

- **Plato Learning:** Following major management turnover in late 2004, Plato is still solidifying its new strategy for approaching the market. The sales force was recently realigned by grade level and management has stated that ramp up may take some time. We believe shares remain undervalued, at 4.2x TEV/EBITDA, making the company attractive as a takeout target. However, we also believe management needs to prove to the Street and to potential acquirers that it can close on deals that were delayed or potentially lost during the sales force and management shake-up. We believe the company would most likely be targeted for its well-positioned comprehensive product and service offering, which sits in the sweet spot of increasing funding pools.

- **Princeton Review:** Princeton Review's solid test prep division has been overshadowed for the past two years by a struggling higher education admission services division and a new (and thus unprofitable, albeit growing), K12 division. Following significant disappointments in all three divisions in 2004 we believe the company's reputation with the Street has eroded, thereby cutting off the company's ability to raise cash through the public markets. With the Admissions and K12 divisions still in the red, the company may eventually seek alternative strategic options, including a corporate/management buyout or merging with another K12 player. We believe Princeton Review's strong brand name could be leveraged in multiple directions as the consumer element of the K12 market expands.
- **Scientific Learning:** We view Scientific Learning as a small, but important player in the K12 market. The high-quality and proven success of its product and service offering makes it well positioned to benefit from the heightened accountability-based environment in schools. The years of research and field experience backing the efficacy of the Fast Forward product line advances it leagues beyond the "drill and kill" reputation of some of the alternative reading products in the market today. Its product attempts to create a cognitive basis for learning to read, rather than actually teaching students how to read. As a result, it can be, and is often, used in conjunction with other reading tools. We believe potential acquirers would view the product as unique and as a core quality play to supplement or supplant some "lighter" or more traditional instructional reading technology offerings.
- **LeapFrog:** We believe LeapFrog has an excellent brand name and a far-reaching customer following. However, we also believe that the US toy industry is becoming increasingly difficult to conduct business in. In the case of LeapFrog, we believe this may be prohibitively difficult. The major toy retailer chains have gone out of business (KB toys) or are struggling to survive (Toys R Us), leaving only the major retail chains (Kmart, Wal-Mart and Target) as distribution channels. Largely due to their scale, Mattel and Hasbro can maintain a good degree of negotiating power against the retailer giants. LeapFrog, however, appears to be having more trouble. Although retailers want to have "hot" LeapFrog products on their shelves, they will not only squeeze margins by price cutting but also will make purchase order cycles difficult enough to cause problems for the company. Consequently, we believe merging with, selling out to, or buying another K12 consumer-focused company would allow LeapFrog to establish either a new distribution channel or much-needed larger economies of scale.

Potential Buyers – Given the strong social and funding trends driving growth in the educational technology market, we believe several classes of investors may be interested in scooping up small, troubled, or just plain promising operations. Venture capital firms with existing shares of education companies may seek to build out their portfolios to address the increasing demand for "comprehensive solutions". Major publishers with a strong presence in K12 – namely, Harcourt, Scholastic, McGraw-Hill, Pearson and Houghton Mifflin – are also potential consolidators. Other types of more-lateral mergers are also possible; however, we believe many players are in a position more likely to be rescued by deep pockets, rather than fighting through synergies to generate cash flow.

Historically, the major publishers primarily used educational technology as a way to support and drive their core textbook sales (with the exception of Pearson). As a result, they have layered on minimal technology offerings (through small scale acquisitions or smaller homegrown applications) which are typically offered along with curriculum purchases at no additional charge. The catch is these accompanying software packages and data management systems (e.g. in the case of Houghton Mifflin's Edmark) are tied to the publisher's core textbook curriculum offering. Districts are often hesitant to invest in a large comprehensive technology directly tied to textbook sales, as it would increase switching costs, tie them to one publisher and reduce their buying power. We believe publishers understand this resistance and recognize that there is a strong demand for independent software sales in the K12 market. We believe this opportunity will eventually prove to be too good to ignore. With their strong, far reaching distribution channels we believe a major publisher can bring a smaller technology company's offering to a profitable scale in a short period of time.

McGraw-Hill's acquisition of Grow Network is an excellent example of an attempt at this. In addition, we believe the publishers are poised to benefit in the coming year from healthier K12 budgets, a heavy adoption cycle year and continued flow through of NCLB dollars. As a result, they have the motivation and the money (or easy access to money) to spend on acquisitions.

- McGraw-Hill – With a healthy balance sheet and the ability to generate strong cash flow, the company is in an ongoing position to make a potential acquisition in the K12 supplemental product industry. McGraw has been relatively active in buying back stock recently, which may suggest it is not gearing up toward an acquisition. However, most acquisitions in the K12 supplemental content space are small in nature and could be completed at any time by McGraw, in our opinion. We anticipate McGraw will continue and potentially increase its level of participation in the K12 M&A market going forward.
- Houghton Mifflin – Following its divestiture of Sunburst Technology in October 2002, Houghton has been without a supplemental content provider. We believe there is potential for the company to attempt to re-enter this market in the future. Of note, the company's 2004 acquisition of Edmark illustrates its support of supplemental technology offerings as key to growth in the K12 content market.
- Scholastic – We believe Scholastic's strong K12 consumer brand name and customer channels puts it in a position to potentially extract several synergies from supplemental content and other consumer-directed K12 acquisitions (e.g., LeapFrog). Scholastic already has a strong presence in the supplemental content market with its \$100-plus million Read 180 product, which would allow for immediate sales-channel synergies with other supplemental services. Despite its potential motivation, Scholastic is in a less-flexible financial position than the other large publishers. Its \$400-plus million debt balance and erratic free cash flow may inhibit the company from making strong moves.
- Harcourt – Harcourt's supplemental content division, Harcourt Achieve, is small on a relative basis and includes minimal technology offerings. The last acquisition in this division was the company's June 2004 acquisition of Saxon publishers, a mainly paper based math supplemental content provider. We believe the company may want to increase this division's exposure to technology and supplement the division's operations to reach additional scale.
- Pearson – Pearson made an early, relatively aggressive foray into the educational technology M&A market. Consequently, it stands today with what we view as the most extensive array of supplemental technology companies among the major publishers. Although the return on these investments is proving to take time, we believe the company is committed to its strategy and will continue to entertain buying opportunities as technology becomes an increasingly important factor in both basal and supplemental content purchasing decisions in the K12 market. Of note, recent management changeover in Pearson's K12 division leads us to believe that strong M&A moves are unlikely in the near term.
- ProQuest – ProQuest's acquisition of Voyager for \$360 million in January 2005 marked a significant move into the K12 supplemental curriculum market. ProQuest is attempting to extract some customer channel and product synergies from Voyager with its existing K12 operation, BigChalk, which historically mainly focused on sales to K12 libraries. With a history of conducting tuck-in acquisitions we believe the company may continue to expand on its new and significant K12 platform going forward.
- School Specialty – School Specialty has typically participated regularly in the K12 M&A market, acquiring both similar supply distributors for market-share gains as well as product-based acquisitions intended to boost the company's product mix toward proprietary sales.
- Bright Horizons – Bright Horizons has traditionally grown through a mix of acquisition and organic growth (approximately 30% through acquisition and 70% organic). Acquisition activity, however, has

been largely limited to buying smaller day care center chains. We believe the company could potentially expand outside of its typical pattern and seek to purchase an early childhood curriculum for use in its wide distribution of child care centers.

Recent Acquisition Activity

With M&A activity in the K12 market heating up, we believe current and prospective acquisition multiples will become a greater influence on public company valuation. Using comparative activity as a guide, ProQuest's acquisition of Voyager Learning (announced December 14, 2004), an education technology content provider, was priced at an attractive 4.1x LTM revenue, or 10.3x LTM EBITDA. Voyager is a high-quality provider with EBIT margins at approximately 40%, vs. the industry average of 13% (per our estimates), and is expected to grow its top line 20% in 2005 (versus the industry's expected 8%-10% growth rate). However, within the context of the K12 industry, the level of the premium paid for Voyager is still impressive. We believe it represents the attractiveness of the industry and the importance that supplemental technology is expected to play in the K12 market in the next two to three years.

RECENT K12 M&A

<u>Date</u>	<u>Acquirer</u>	<u>Target</u>	<u>Price (\$ millions)</u>	<u>Price/ LTM EBITDA*</u>
March-05	ProQuest	Explore Learning	NA	NA
January-05	Renaissance Learning	Alphasmart	\$57	8.6x
January-05	ProQuest	Voyager	\$360	10.3x
January-05	Educate	Gateway	\$13	NA
November-04	Knowledge Learning	Kindercare	\$1,040	7.4x
Average			\$368	8.8x

* TEP Estimates

Other recent acquisitions include Educate's acquisition of Gateway (Hooked on Phonics) for \$13 million (undisclosed financials); ProQuest's acquisition of Explore Learning, a science and math content provider for an undisclosed amount; and Renaissance Learning's proposed acquisition of AlphaSmart for 7x forward 12-month EBITDA (or 8.6x LTM EBITDA).

K12 MARKET OVERVIEW

The United States spends just over \$500 billion annually on K12 education, more than it spends on national defense (\$416 billion). The bulk of this money goes to salaries (administration and teachers), healthcare benefits, real estate/construction costs, general maintenance and other – leaving about 15%, or \$59 billion available to private enterprise, per our estimates. Within this funding pool, we estimate that \$8.8 billion (or 1.7% of total K12 spending) is spent on technology. With positive demographic trends (driven by the maturation of the Echo Boom and high immigration levels), and a continued national and local political emphasis on public school funding we expect K12 expenditures to grow at a CAGR of 5% in the next decade.

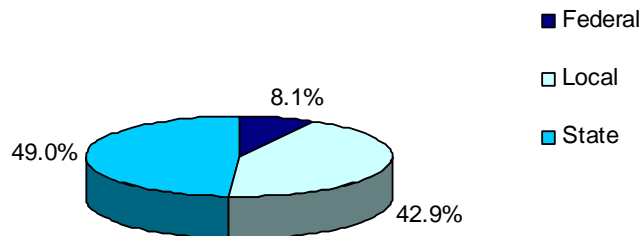
EDUCATION SPENDING MORE THAN SOCIAL SECURITY AND DEFENSE COMBINED

<i>\$ millions</i>	TOTAL U.S. Spend	% of GDP	
GDP	\$11,800,000		
Social Security	\$496,000	4.2%	
Healthcare	\$1,897,000	16.1%	
Defense	\$456,000	3.9%	
			Spend per student
Education Total	\$1,017,100	8.6%	
PreK	\$43,000	0.5%	\$7,620
K12	\$501,300	4.2%	\$9,179
Post Secondary	\$356,508	3.0%	\$21,032
Corporate Training	\$110,000	0.9%	\$833

Source: NEA

Though school financing varies from district to district, domestic K-12 public school budgets are generally put together from a collection of local, state and federal funding sources. Local districts, drawing largely from property tax revenues, contribute approximately 43% to the average school's funding base. States use a combination of income taxes, corporate taxes, sales taxes and fees to generate some 49% of the funding required to operate its schools. Federal sources generally contribute approximately 8% to a school's budget through grants and other targeted programs.

PUBLIC K-12 FUNDING SOURCES 2003-2004 SCHOOL YEAR



Source: NEA

The federal funds are typically distributed to schools on a per-pupil basis, though certain supplementary funding is also delivered on a categorical basis to provide additional dollars for special programs and facilities. Federal sources fund a disproportionate amount of technology spending, with a great deal of grant money implemented for tech purposes. For schools and entrepreneurs, this implies that expense requests often must win approval of not just local schools, but also a federal administrative entity. The most common sources of funds for technology purchases include Title I, Title III, Reading First, Enhancing Education Through Technology and Special Education funds.

K12 MARKET GROWTH DRIVERS

The market fundamentals for K12 education are impressive due to their size and stability, although they are not exceptionally high-growth in nature. We believe that the imposing scale of these market fundamentals, which include enrollment projections and long-term per pupil spending increases combined with a strong domestic mandate for public education, can stimulate growth in total K12 education spending over the next decade despite recent difficulties with state budget crunches.

Strong Demographics Due To Echo Boom - The 1977-1990 "Echo Boom" in domestic births set the stage for heightened numbers of school-age children over the late 1990s and has provided the basis for continued growth into the early 2000s. The National Center for Education Statistics projects that the total enrollment in public and private elementary and secondary schools, which increased steeply from 45.4 million in 1988 to 52.7 million in 1998 (or 16%), will grow at a more-steady pace to approximately 54.3 million by 2008 (or 3%). This continued growth, along with a rapid increase in English as a Second Language (ESL) students, will require more overall spending and will magnify the need for efficiency tools, such as technology.

Spending Should Improve Over the Long Run – Although the past three years have been extremely tough for private vendors servicing the K12 market due to tight budgets, it should be noted that per-pupil expenditures tend to increase in the long run. Per-pupil funding (not including property expenditures) has grown, on an inflation-adjusted basis, from \$6,996 per student per year in 1990 to \$7,780 in 2000, an average annualized rate of 1.2%. **The NCES projects that per-pupil funding will continue to grow at an inflation-adjusted annualized rate of 1.2%, through 2010.** This would create an annual per pupil expenditure of \$8,878 in 2010 (in constant 2002 dollars). We believe this slow but consistent growth echoes the public sentiment to provide adequate, but not extravagant, funding for public education opportunities.

Educational Reform Movement Swelling – We believe the powerful accountability trend in schools will significantly affect the entire educational hierarchy, from politicians to superintendents to principals to individual teachers. At the district, school and teacher levels, school systems are eliciting the aid of standards-based educational technology to help meet the increasingly unavoidable demands of these measures. The market is eager to sift out quality products and services that can improve education through invigorating students and teachers with new methods of teaching and learning and/or a more-enjoyable learning environment. As a result, technology and Internet services that provide student assessment tools and the ability to reliably track individual progress are becoming imperative in the evolving U.S. school system. Meanwhile, we believe the market for alternative routes to education are opening up. The charter school movement, although stymied at the state level in many places, continues to slowly grow across the country. In addition, new at-risk, or dropout programs are growing and the use of supplemental education and tools also grows.

Students Respond to Technology - The K12 student today is not only tech savvy, he/she is also highly exposed to multimedia entertainment on a regular basis. It is estimated that 92% of U.S. children spend 20-33 minutes a day playing video games (Kaiser Family Foundation). Teachers are finding that, in addition to the potential pedagogical benefits of educational technology, connecting with students through the use of technology can be critical in maintaining their attention and interest. In a 2003 survey, 74% of U.S. public schools reported that at least half of their teachers use the Internet for instruction (MDR, 2003). Teachers

know that student attention is a predicate of learning and to the extent that technology can be an effective tool in engaging students they are incorporating the tools into their curriculum.

Teachers Need Time Efficiency Tools – The NCES estimates that the number of teachers in the United States increased 29% from 1988 to 2001, but is expected to increase only 5% from 2001 to 2013. This teacher shortage, along with higher accountability requirements, will increase demands on a teacher's time, creating a burgeoning demand for products and services that enable a teacher to spend more time instructing and less time on administrative tasks. While technology has saved time and increased productivity throughout corporate America, educators have, as a group, had more difficulty procuring and introducing technologically sophisticated equipment into schools. A combination of budgetary pressures and teachers' resistance to technology's learning curve has conspired to keep classrooms less up to date than they could be. We believe this trend is waning as more federal funding finds its way into the classroom and as educators become more comfortable with advancing technology. As this occurs, the variety of software and Internet-based resources that have enabled the workplace to enhance its productivity will be able to run in the classroom. We believe that technology-based classroom aids, such as grading software or online materials ordering, can meet with a similar degree of penetration and acceptance as that garnered by more-traditional supplementary resources. As evidence of this traction, School Specialty recently reported that purchasing through its Internet portal increased 50% in 2004.

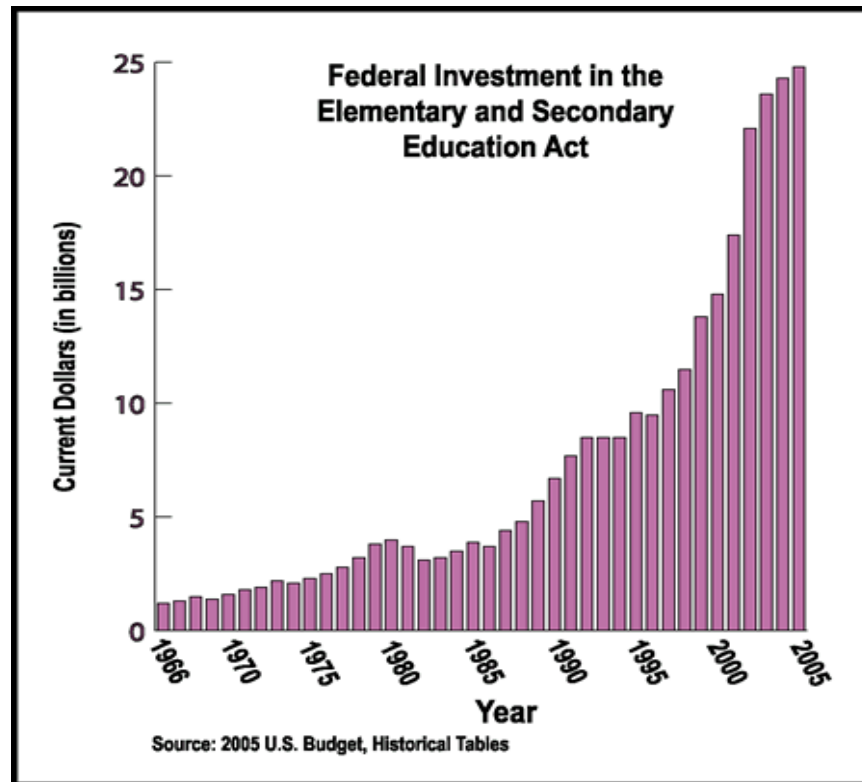
Still A Way to Go in Wireless Technology and One to One Computing Devices – With most schools outfitted in basic PC hardware infrastructure, the next significant push of innovation in schools will likely be in wireless technology and in establishing one-to-one computing (a one-to-one device to student ratio). Already, wireless technology is sweeping U.S. schools. In 2003, approximately 27% of schools in the United States had wireless networks, up from 15% in 2002. One-to-one computing is farther behind, with 3.8% of schools using PDAs for student use in the FY04 school year, up from 3.5% in FY03 (according to MDR). Despite the vast landscape open to educational wireless technology developers, penetration will take time. Thus far, only one state, Pennsylvania, finances a wireless/handheld technology program for use at the classroom level. However, if the rate at which basic hardware swept into K12 schools is any guide, wireless technology and one-to-one computing devices are in a position to grow significantly over time.

K12 FUNDING JUST NOW EMERGING FROM THE 2001-2003 RECESSION

No Child Left Behind: Where's the Money Now?

The No Child Left Behind act (NCLB), signed into law in January 2002, essentially redefined (and increased) the federal government's role in public education, creating a system of accountability based on continual student assessment. To fund the program, Congress has increased federal K-12 spending by 40% in the past four years (2001-2005 fiscal years) to \$25 billion. The Title 1 program, for disadvantaged students, has seen particular increases in the past three years, with Congress appropriating \$13.3 billion to this program for the 2006 fiscal year, up from \$9 billion in 2000.

FEDERAL INVESTMENT IN ESEA



Source: U.S. Department of Education

NCLB is intended to increase accountability in schools, demanding that all students should be proficient (as defined by the state) by the end of the 2013-2014 year, post adequate yearly progress in six subgroups (defined by race and educational needs) in mandatory tests in grades 3-8, and that all teachers be "highly qualified" by the end of the 2006 school year. To do this, the act provides for funding increases for various initiatives, such as teacher training and reading programs. In the long run, the greater funding allocation should boost actual available money in schools and the call for mandatory testing should heighten demand for outcomes-based products and services. However, as with most major legislative changes to bureaucratic systems, change has been slow and choppy. Although the federal government allocated \$26.8 billion to K12 schools through its NCLB act in the fiscal year ending June 2003, it is estimated that only \$18.6 billion was actually received by states and schools (per the National Education Association). Similarly, in the FY04 school year only \$12.3 billion in Title 1 funds made their way into school pockets vs. a budgeted \$18.5 billion (according to the National School Boards Association). The Department of Education estimates that

in June 2004 states collectively had \$2.7 billion in unspent federal education aid. Much of the difference was due to red tape and confusion over appropriate money paths. As states waited for approval from the feds, district administrators waited for guidance before creating spending plans. It is our opinion that as the implementation of the NCLB legislation is ironed out, ultimately a greater percentage of the funds will flow to the hands of purchasers. Today all states have approved accountability plans and school districts are rapidly spending NCLB dollars (most notably in the Reading First program). We believe that following three years of wrangling out how to comply with the new legislation, districts are finally in a position to use the new dollars to meet targeted goals.

K12 FISCAL BUDGET

\$ millions	Appropriated	Appropriated	Growth	Requested	Growth
	<u>2004</u>	<u>2005</u>	<u>2005</u>	<u>2006</u>	<u>2006</u>
Elementary and Secondary Education:					
LEA Grants (Title 1A)	12,342	12,740	3.2%	13,342	4.7%
Reading First	1,118	1,146	2.5%	1,146	78
State Assessments	390	412	5.6%	412	0.0%
Teacher Incentive Fund	-	-	-	500	-
Teacher Corps	-	-	-	40	-
Improving Teacher quality Grants*	2,930	2,917	-0.4%	2,917	0.0%
Charter Schools Program	256	254	-0.8%	256	0.8%
Choice Incentive Fund	-	-	-	50	-
Impact Aid	1,230	1,244	1.1%	1,241	-0.2%
Safe and Drug Free Schools Programs	674	672	-0.3%	317	-52.8%
21st Century Community Learning Center	999	991	-0.8%	991	0.0%
English Language Acquisition	681	676	-0.7%	676	0.0%
Educational Technology State Grants	-	437	N/A	0	N/A
Special Education (IDEA) Funding	10,068	10,590	5.2%	11,098	4.8%
High School Programs:					
High School Intervention	-	-	-	1,240	-
High School Assessments	-	-	-	250	-
Striving Readers	-	25	-	200	-
Math & Science Partnerships	149	179	20.1%	269	50.3%
Advanced Placement	24	30	25.0%	52	73.3%
State Scholars Capacity building	-	-	-	12	-
Other	1,918	1,488	-22.4%	-	-
Total Basic Federal Funding for K12 Schools	32,779	33,801	3.1%	35,009	3.6%

* Up to 50% of the money in these four programs can be transferred at the state level into TITLE 1A - LEA Grants (per NCLB flexibility component)

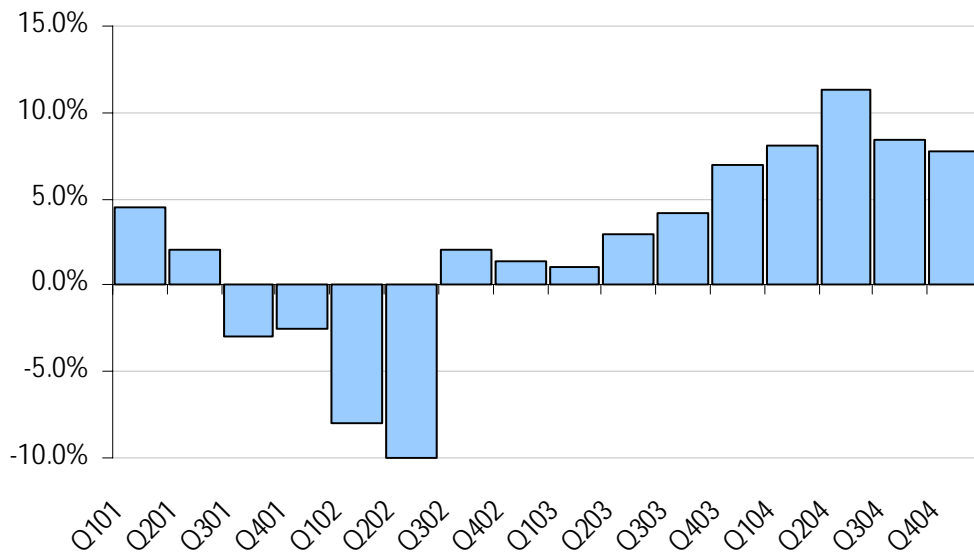
Source: *US Department of Education and ThinkEquity Partners*

Bush's Second Term: Bush's second term in the White House continues to affect K12 funding and legislation. The current administration has already announced that it will seek to expand the NCLB act to include a requirement for testing in grades 9-12. The budget proposal also increases flexibility for states – it moves designated targeted funds into big block, discretionary funding pools. A consequence of this strategy is that a designated technology funding pool, Title IID, is on the block. Overall, the federal budget was roughly flat at 1.1% growth in FY05. With the new Secretary of Education, Margaret Spellings, a long-time supporter of the NCLB act, we believe the industry trends toward assessment and accountability exhibited over the last three years should continue. Congress recently re-authorized the Individuals with Disabilities Education Act (IDEA), the second-largest ESEA funding pool (behind Title 1) with just over \$11 billion allocated, up from roughly \$5 billion allocated in 2000.

The State Budgets: Back to Pre-Recession Levels

Following three years of flat to falling funding allocation, despite rising enrollments, state aid to K12 schools (on average) appears to have turned the corner in the 2004-2005 fiscal year and should show good improvement in the 2005-2006 fiscal year (to begin July 1, 2005 in all but four states). K12 spending at the state level accounts for approximately one-third of all state expenditures, making the fate of the industry closely tied to that of overall state budgets, despite an often strong political commitment to education. As a result, well publicized state budget deficits and spending cuts have created an extremely difficult selling environment for K12 operators in the past three years. We believe we are finally seeing signs the storm over the industry is beginning to lift. With the economy improving and consumer spending up, state revenue has increased for the tenth straight quarter (as of Q404). Of note, the consecutive decrease in growth in Q304 is caused by the unusually high growth rate in Q204 which was boosted by payments from final income tax returns from 2003.

STATE TAX REVENUE GROWTH



Source: *Fiscal Studies Program at Nelson A. Rockefeller Institute of Government*

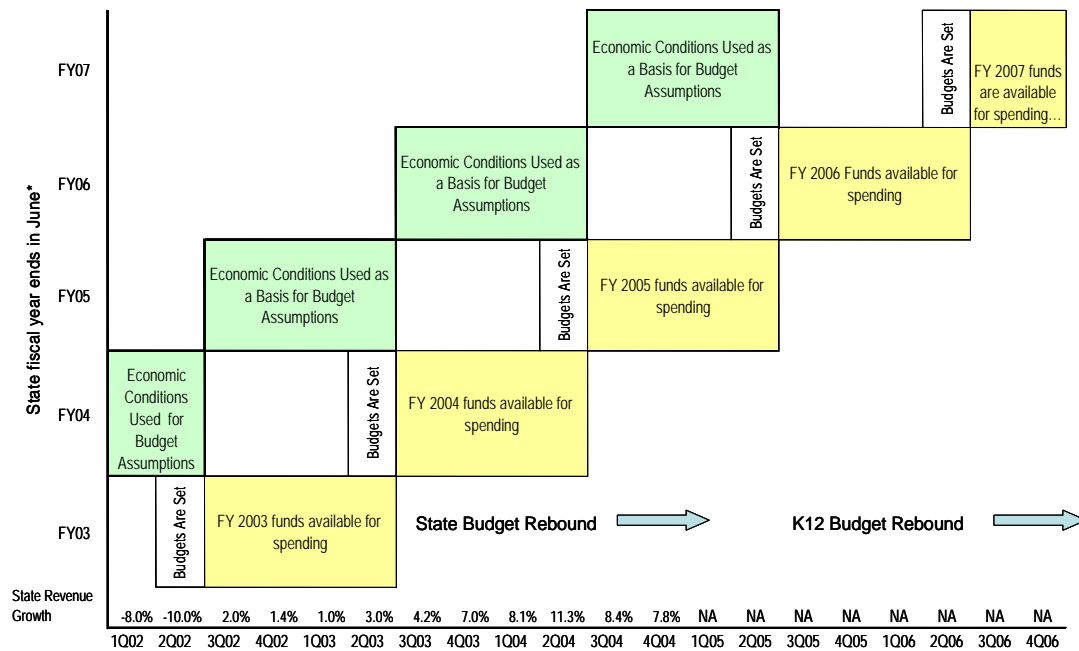
In its annual meeting in December 2004, the National Conference of State Legislators (NCSL) reported that for the first time since FY01, nearly all states are reporting better-than-expected revenues for the FY06 year (only four are reporting revenue shortfalls for the current fiscal year). NCSL also reported that FY05 state revenues in aggregate will be at the level they were in FY02, before the impact of the 2001-2003 recession. Although certain states (notably California) may suffer longer than others due to more extreme deficits (19% of the total budget in FY05), the nation as a whole appears to be seeing relief in 2005. FY04 (June end) state revenue growth was 7.9% over FY03, based on preliminary data from the Rockefeller Institute of Government. Growth was reportedly boosted by all three major state tax categories with personal income tax up 9.3% (first year of growth after two years of declines), sales tax up 6.4% (back to pre-recession growth after two slow years) and corporate tax up 12.5% (representing the second year of strong growth).

With additional state taxes initiated in the past three years and a crackdown on tax shelters (which reportedly grossed \$1.3 billion for California) states appear to be in a position to benefit from the healthier economy. However, increasing costs of Medicaid may mitigate any measure of sharp relief. The National Association of State Budget Officers (NASBO) estimates that states will have to increase healthcare allocations by more than 12% in the coming year to make up for cuts in federal funding. Consequently, the

recovery for K12 budgets will most likely be slower than that of overall state budgets. However, compared to the 2001-2004 period, normal growth has the potential to appear robust.

K12 budgets operate at a significant lag to the general economy and state revenue growth. As a result, the current school year (2004-2005) budgets are based on economic conditions and state revenue in the late 2002 to early 2003 period. State revenue growth during that period was recovering, but at a modest 1.7% over the prior-year period. The significant increase to state revenue began in the late 2003 to early 2004 period (up 7.7% over the prior year period). This period should be reflected in K12 budgets in the coming 2005-2006 school year.

K12 BUDGETS OPERATE AT A LAG TO THE GENERAL ECONOMY



*48 states fiscal years end June 30. The four exceptions (out of the 48) are New York (March 31), Texas (August 31), Alabama (September 30) and Michigan (September 30)

Source: *The Nelson A. Rockefeller Institute of Government*

As this chart would indicate, the trough year for K12 budgets was actually FY03, as that year was based on revenue estimates formed off of FY01 actual revenue. In the FY03 budget year, 40 states had to trim their budgets midyear, compared to 15 states required to do so in FY04 (according to the NCSL).

Budgeting at the School Level: Making up for Lost Time

With federal money log jammed and state funding reduced (on a per-pupil basis) over the past three years, schools have been faced with the choice of making serious cost reductions or finding alternative revenue sources. In most cases, both solutions have been employed. On average, the cuts were in funding for textbooks, non consumable supplies, professional development, after school programs, athletics and art programs. Helping to stem the tide, new funding has come from local funding sources, such as increased property tax revenue (boosted by a healthy real estate market) and increased private fundraising. With relief in site for state funding and a more meaningful impact expected from federal dollars, we believe schools are beginning to reassess sacrifices that have been made in the past three years. The 2005-2006 budgeting season is currently underway and based on preliminary discussions, it appears that schools are pushing through “non consumable” initiatives, such as technology purchases and facility upgrades, that

have been shelved in the past few years. Although this is encouraging, rising health care costs are creating a heavier burden for school budgets and new spending may need to be diverted to cover employee benefits. As a result, we are cautiously optimistic about the portion of K12 budgets that will be available for companies selling technology, supplies, and other services in the 2005-2006 school year.

THE K12 SALES CYCLE

The bureaucracy and red tape of the K12 market generally dissuades for-profit investment, as many entrepreneurs are not able to stomach the choppy, lengthy sales cycles that are intrinsic to this industry. As a result, it is important for investors to understand its intricacies. The classic K12 sales cycle aligns to the typical school and district fiscal year, which ends in May, June or July. Of note, state budgets, which contribute nearly 50% of public school money, end in June, with the exception of Alabama (September), Michigan (September), New York (March) and Texas (August), and the Federal budget, which accounts for approximately 8% of school budgets, ends in October. In the summer months (often the first quarter of the fiscal year) back to school preparations represent the major buying season for many products and services. In addition, there is typically also a buying push toward the fiscal year end (late spring), as school systems clamor to spend leftover money that otherwise will be relinquished back to the state or district (according to the "use it or lose it" policy on some funding). In a few verticals, such as public libraries, there is also a buying push in December, as operations on calendar-year budgets close out the year and spend leftover money. In recent years, the typical K12 sales flow has been irregular as administrators and school buyers were caught in confusion and doubt over total year budget allocations and put off buying decisions until the last possible minute. This type of indecision was based as much on real fiscal difficulties as it was on fear of future potential cuts. As a result, we believe that, although the economic recovery will not be fully reflected in school budgets until FY06 (June 2005) at the earliest, the sales cycle will return to a more-normalized pattern as fears of budget cuts are assuaged by the highly publicized economic turnaround witnessed in the past two years.

The K12 Point of Sale

The trickling down of funding from state and district administrative offices to the classroom can be excruciatingly slow by normal private market standards. Purchasing decisions are made either in a top-down fashion by state/district level administrators or a bottom-up fashion by classroom teachers. Larger orders and discounted bulk purchasing is almost always conducted at the district level, while teachers are more likely to buy smaller amounts of higher-margin products. Supplementary services are generally arranged at the school or district level. While the smaller amount of one-off purchasing conducted by teachers can quite often be conducted through school-level accounts and thereby be executed expediently, larger and higher ticket products and services generally require the separate approvals of teacher, principal, district official, school board and district or state purchasing official.

The Technology Point of Sale Moving Up

In the past, many success stories of technology products and services sold into schools have been based on teacher appeal and a strong grassroots following. Although the importance of teacher appeal should not be discounted, we believe a significant portion of the K12 tech dollar available to entrepreneurs has moved out of the hands of teachers and into the hands of district and state administrators. As technology solutions for K12 schools have broadened their scope and depth, one-off purchases made in uncoordinated efforts are less beneficial for the school systems and their evolving needs. The chief goal of technology in K12 education is no longer to just engage students or to help with particular learning needs, it is now integral to the school's administration, data aggregation and targeted, standards aligned curriculum. As a result, companies have shifted focus to district level sales, both by creating product lines that appeal to administrators (usually more-holistic solutions) and by redirecting sales forces toward a higher level point of

sale. Of note, the non-technology, traditional product K12 sale (such as school supplies) still stems mainly from teacher buying decisions.

Textbook Adoption Cycles

For textbooks and major instructional materials school buying cycles differ from other purchases. The system by which K-12 schools select and purchase new instructional materials is referred to as the adoption process. Currently, 22 "adoption states" select new instructional materials on a statewide basis for a particular subject approximately every five to eight years. Generally, a school or school district within an adoption state may use state monies to purchase instructional materials only from the list of publishers' programs that have been approved by the particular state's governing body. In the other states, referred to as "open territories," individual schools or school districts make the purchasing decisions from the unrestricted offerings of all publishers. After adopting, or selecting, instructional materials, schools later decide the quantity and timing of their purchases. We also note that the seasonality of the budgeting process is exceptionally strong, with product selling occurring in the spring, ordering in late spring/early summer and delivery occurring in August and September. Companies that mis-time or are not prepared for this schedule can be crippled if they miss any of the school system's windows.

K12 MARKET NICHES

We sort the K12 market into nine main verticals of products/services—hardware and infrastructure (computers, PDAs, etc.), instructional content (basal, supplementary, print, electronic), assessment (low stake, or formative, and high stake), professional development (online and face to face), curriculum and data management (SIS, IMS, data management, resource allocation), special education and tutoring, alternative education operators (virtual schools, charter schools, etc), Pre-K childcare services, and school supplies/products.

1. Hardware and Infrastructure (\$6.6 Billion)

NCES estimates that the ratio of public school students to instructional computers with Internet access improved from 12.1:1 in 1998 to 4.8:1 in 2002, implying a CAGR of 24% of computers in U.S. public schools. Much of this investment has been funded by Erate dollars, a \$2.25 billion federal money pool allocated for hardware and telecommunications infrastructure in schools. We believe technology spending for hardware should slow going forward as the march toward the ultimate one to one student to computer ratio, "one-to-one computing", continues at a more-moderate pace. We believe the majority of school systems generally consider the 5 to 1 ratio as critical mass. However, localized one to one computing initiatives are currently underway in several districts (e.g. in Texas and Virginia) as well as in three states (Maine, New Mexico and Michigan). These projects, which seek to provide every student in a certain grade with a laptop computer, are receiving national attention from the press and from other districts or states considering similar initiatives. The key questions the market needs to answer before one-to-one computing can take off is what the effect is on student outcomes (test data) and what the total cost of ownership (TCO) is. We believe it will take some time for most districts to become comfortable with the efficacy and total cost of one-to-one initiatives. However, districts continue to pick away at the 4.8 to 1 ratio by adding computers and updating obsolete machines. By 2006 we believe the ratio should more closely approximate 3 to 1. We believe an additional wave of hardware spending will be focused on wireless and handheld devices (which are cheaper to implement than laptops). Currently, Pennsylvania is the only state with a handheld initiative. However, efficacy and TOC must be clearly established here as well. AlphaSmart (now owned by Renaissance Learning) provides a hybrid laptop, handheld device which boasts a lower total cost of ownership. The value proposition of this product seems to fill a niche in the market as the evolution toward fully outfitted classrooms spans over time. Overall, it is important to remember that with an average 4.8 to 1 computer ratio there are over 10 million computers in schools today. With this ground work laid, we believe the software industry has a strong platform on which to grow.

2. Instructional Content – Basal and Supplemental (\$8 Billion)

The past two years have been difficult for book publishers servicing the K12 market. The Association of American Publishers (AAP) reported that after growing 10% in 2001 to \$4.3 billion K12 book sales dropped 5% in 2002 (to \$4 billion) and then posted modest growth of 2.5% (to \$4.2 billion) in 2003, and 0.1% (to \$4.3B) in 2004. We believe the publishers are poised to benefit in 2005 from healthier K12 budgets, a heavy adoption cycle year and continued flow through of NCLB dollars. Major publishers in the industry include: Pearson, McGraw Hill, Thomson Corporation, Reed Elsevier. We believe that the economies of scale and content control that these publishers enjoy represent significant barriers to entry in this business and limit the opportunities available to smaller entrepreneurs.

We estimate the supplemental content market to be \$3.7 billion, with books comprising \$1.9 billion and technology content \$1.8 billion. We believe instructional technology has become increasingly valuable to administrators and teachers over the past decade, as schools have come close to being fully wired and a wide variety of core administrative tasks have gone digital. Products range from simple “drill and kill” software to time-consuming, in-depth programs that require significant professional development and commitment on the part of students and teachers. In this spectrum of product quality, we believe successful products have historically lied in the middle-left, closer to the “drill and kill” end. Looking forward, we believe viable opportunities for success are moving to the right, as teachers become more comfortable with technology and the use it can have in teaching a wide array of learners.

3. Assessment (\$2.2 Billion)

Although the school market remains generally dependent on paper/pencil based testing it is slowly moving towards the use of online assessment. The infrastructure (e.g. bandwidth) and computer hardware available in schools has ramped up considerably in the past decade, allowing for more realistic use of online testing, which has numerous benefits over the traditional method. Paper/print testing takes 4-6 months on average to return results to teachers, whereas online high stakes assessment can give disaggregated and analyzed results within 24 hours. Recent technology developments have allowed for faster turnaround time for print based testing (using scanning technology), such as a product recently launched by testing technology company Vantage Learning which can turn around print based results within 48 hours. However, over the long run the market appears to be slowly gravitating towards more online assessment. We believe the existing large test providers, including CTB/McGraw, Harcourt Assessment, and Thomson Learning, will retain market share throughout the market's evolution into online assessment.

4. Professional Development (\$2.5 Billion)

While more than \$2.5 billion is spent annually on professional development for teachers, according to *Education Week*, most of those recurring expenditures are for internal staff development provided by district administrators. We believe that just one-fifth of the greater total, or \$500 million, is channeled toward external, for-profit training solutions. However, we see the external market as being a tremendous resource for new and aspiring teachers going forward, as a retirement bubble (over one million teachers should retire in the next five years) and rising student populations require growing numbers of qualified teachers. In addition, we believe that increasing public scrutiny and private competition may introduce a larger element of merit into teacher compensation, rewarding those educators with the most extensive and successful skill sets. We also believe that the overall market size for professional development should increase as NCLB dollars flow through to Local Education Agencies. Currently, the only provision in the NCLB as to how federal dollars are spent by the states is that 10% must be set aside to pay for professional development. This amounts to a considerable funding pool. In a recent survey by Education Week, 28 states listed professional development as a top focus in technology spending. We have watched the “services” line of several operators grow at a healthy clip throughout a period of tight spending for other product lines. In addition, companies providing degree-granting teacher programs, such as Apollo's University of Phoenix, Capella and Canter have all experienced healthy enrollment growth in their programs. We view the non-

degree-granting side of the professional development market, (i.e. for ongoing teacher training) as a large, untapped market opportunity. This sub-market is currently fragmented and there remains confusion as to what type of programs and education qualify as teacher "improvement," per new state and federal guidelines. Small private companies, such as Teachscape and Advanta.net, as well as Classroom Connect (a division of Reed Elsevier's Harcourt) are stepping in to fill the void. Emphasizing the importance of tying professional development to technology, a recent Education Week survey showed 28 states plan to direct a large share of their technology expenditures to professional development in FY05. Looking forward, we believe recent high-profile criticism of the traditional teacher degree granting system and certification process may invoke changes in the near term that could redefine the market further.

5. Curriculum and Data Management (\$500 million)

Administrative software, including Student Information Systems (SIS) and Instructional Management Systems (IMS), is also a hot market niche in K12 following the NCLB mandate for data aggregation and dissemination. We estimate the K12 administrative software market to be \$500 million. This market segment is often blurred into other categories of technology and internet service. These include providing online courses, virtual schools, Internet-based professional development, online commerce and online testing programs. Although still in an early phase, these services represent a new industry sub-sector which has already drawn interest from multiple states. To date, 22 states have developed e-learning initiatives, 16 of those states having established virtual schools, two states offer online assessments, and 10 states are piloting online assessment programs.

Library Market - K12 libraries also represent a market opportunity for electronic content and data management systems. Outside of book sales (included in content) the 18,000+ libraries in the U.S. often purchase electronic information and data systems. The library data automation market, served by companies such as Follett Software, is relatively mature. As a result, the market consists mainly of add-ons, upgrades and new information services (such as those offered by ProQuest, Ebsco and Gale [owned by Thomson Corporation]). Similar to school demands, libraries depend on products to be interoperable. Technology specialists and librarians want subscription services to run on their own data aggregation or electronic catalog system for easier searching. Similar to the K12 market, a trend toward higher level sales (states and districts) is evident in this market sub-segment as well.

6. Special Education and Tutoring (\$4 Billion)

Approximately \$4 billion is spent on tutoring in the United States, according to Eduventures. We estimate that in the next two to four years the federal government's mandate for supplemental education services paid for with public dollars from failing school systems may increase the total size of the tutoring market to \$5 billion. Demographic trends driving the K12 market include a rising student population driven by the maturation of the Echo Boom and high immigration levels. Social trends fueling the tutoring market include a strong nationwide political emphasis on assessment, the increasing competitiveness of the college admissions process into top-tier schools, and a burgeoning concept of consumerism in education. Economic trends, such as rising consumer discretionary income, should have a moderately positive effect on private pay tutoring, while others, such as an inflating advertising market may hinder growth.

School districts regularly contract out a number of ancillary K12 services to outside providers. Realizing that services outside of their core competency are delivered less efficiently, districts started farming out special situations about a decade ago. One of the first companies to step into this service was Sylvan in 1993, opening Learning Centers (owned by Educate, Inc) in Baltimore's public school system to assist students with below grade-level reading and math skills. Other companies providing these services today include Kaplan (owned by the Washington Post), Princeton Review and many other small private players. Today, there are more than 1,800 SES providers approved in the United States. In our opinion, as several key large districts become more comfortable with allowing SES providers into their systems the opportunity for SES

should grow. The primary source of funding for such contract services is Title I federal funds, which assist disadvantaged students and amount to \$13.3 billion in Bush's most recent proposal.

7. Education Operators/ Education Delivery (\$9.3 Billion)

In addition to the mainstream private school market (which comprises 20% of the 115,000+ schools in the country), we believe numerous, relatively new opportunities exist for private enterprise to participate in the operation of public, alternative schools. There are roughly 4,500 alternative schools, 1,600 special schools (as defined by the NCES), and 3,300 charter schools in the U.S. today. Together, these nontraditional schools comprise roughly 10% of all schools.

- **Alternative Site-Based K12 Education (Charter, Alternative and Special Schools)** – We consider alternative site based education as special schools, alternative (at-risk programs, drop-out programs), and charters schools. The charter school landscape has altered significantly in the past three years. Legislation continues to support growth in charter schools in pockets; however, some states have pulled support and/or placed considerable limitations on growth. Today 27 states have a cap on charters. Beyond the stigma against for-profit companies siphoning money for local districts, alternative school programs face a huge challenge in demonstrating their success. Specifically, the students attending alternative schools are not only different from traditional school students but are different from each other. As a result, it is highly problematic to compare student outcome data (test scores) that shows improvement at alternative programs. Other alternative programs, such as those targeting dropouts or special needs students (e.g. obese, socially disruptive students, etc.) are finding new paths to growth as the school reform movement allows and encourages different education options. Aspen Education, a private operator based out of Los Angeles, has grown a successful network of alternative private pay schools which cater to specific student groups which do not fit within the existing system. Similarly, White Hat and Ombudsman run schools with public dollars designed to help high school dropouts complete their education and obtain an actual high school degree (rather than a GED, often the only other viable option for high school dropouts). Both of these companies programs are seeing an up-tick in growth as more-permissive legislation allows for more-flexible use of funds. We estimate the size of the alternative school market (including charter schools and private alternative schools but excluding the mainstream private school market) to be \$7 billion.
- **Online Education Delivery** - The National Center for Education Statistics (NCES) released its first official study on the use of distance education in K12 schools in March 2005, illustrating the growing importance and acceptance of distance (and online) education in the industry. The study found that in the 2002-2003 school year 36% of public school districts offered distance education and 9% (or 328,000 students) had enrolled in distance education courses. A recent survey of district administrators indicated that the vast majority (90%-plus) planned to increase their online initiatives in 2004. The courses were most often offered to students in higher grades (e.g., pre-college courses in high schools), larger districts or rural districts. Most districts which offered distance education to their students planned on increasing enrollment in their programs in the future. We believe heightened national attention (exemplified by the NCES study) on K12 distance learning (which includes online, or virtual education) is both a reflection of current trends and also a potential catalyst for accelerated industry growth. Of note, we believe an important barrier to growth in this market is a lack of consistent or reliable funding pools targeted at technology and/or virtual programs. This makes undertaking these initiatives risky for districts and states. However, as news of successful innovation takes place we believe districts will be more apt to move forward with innovation themselves and as the prevalence and acceptability of virtual programs grows, funding pools may become more reliable. Growth in this sub-market touches private enterprise in multiple ways. Comprehensive virtual schools, such as those offered by K12, White Hat, and Education 2020, all clearly stand to benefit as more students enroll fulltime in their programs. Digital textbook publishers (such as KineticBooks), instructional software publishers (such as Plato Learning), and online tutoring offerings (such as ESylvan) are used as

content in both for-profit and nonprofit virtual school programs. Course management providers, such as ECollege or WebCT, are being commissioned by traditional universities and various private organizations to provide tools for creating online courses directed at high school students. We estimate the virtual school market to be \$2.3 billion.

8. PreK Services (\$43 Billion)

As dual-income families seek high-quality childcare we believe they are more likely to seek out well-known programs with clear educational benefits. Research continues to pour in that confirms the positive link between early childhood education and improved student learning performance in the longer term. Meanwhile, an increasing number of women with children under the age of six are re-entering the workforce (70% in 2004 versus 17% in 1963). The childcare market is highly fragmented, with more than 500,000 total child care centers, according to the Children's Foundation. Of these centers, only 112,000 (22%) are regulated child care centers with formalized programs, such as Bright Horizons and KinderCare. The remainder mainly consists of family day care providers operating from their homes, public sector agencies, churches, hospitals, universities, and community service organizations (such as the YMCA). We estimate approximately 39,000 centers (or 35% of all regulated child care centers) are operated on a for-profit basis, while the remaining 65% are non-profit centers. Bright Horizons is the largest provider of work-site childcare while KinderCare (owned by Knowledge Learning) is the largest chain of consumer based centers. Other major companies in the market include La Petite Academy, Childtime Learning Centers, Nobel Learning Communities and Childcare Network. We estimate the current size of the childcare market to be \$43 billion. With the U.S. Census estimating the 0 to 5 year old population will grow at a 1.05% annual clip through 2015, there is a strong base support for continued growth in this market. On top of population increases, we expect continued expansion of the proportion of preK children attending formalized programs to fuel another 1-2% annual growth. With childcare programs holding relative pricing power (parental decisions are typically made based on quality and convenience first, and price second) we believe the market should support price increases of 5% annually. Piecing together these trends, we are estimating that the childcare market is growing at a 7% CAGR, and will reach a total market size of \$60 billion by 2010.

9. School Supplies and Products (\$6 Billion)

Spending on non-textbook, non-software school supplies totals approximately \$6-plus billion annually, per our estimates. We estimate that approximately \$4 billion originates from school budgets while \$2 billion is private pay – out-of-pocket expenses from either teachers or parents. More than half of the private pay expenditures are derived from teachers, who, according to *Education Week* estimates, spend between \$200 and \$500 of their own money on classroom materials annually.

More than 3,400 independent school supply distributors operate in the U.S., however they are mainly regional boutiques offering either limited geographical distribution or limited product selection. The industry leader in is School Specialty, which is some 3.5x the size of its nearest competitor. Supplementary educational supplies for the home market represent a smaller, but more rapidly growing, segment of this market, as an increasing amount of evidence points out the value of at home educational activities for children. Top competitors include LeapFrog, VTech, Mattel and Hasbro. The market for educational toys targeted at preschool children is estimated to have grown 11% in 2004 to \$600-plus million, per market research firm NPD Funworld. In contrast, we estimate that the overall market for school supplies is growing at a rate closer to 2-3% annually.

K12 COMPETITIVE LANDSCAPE

Hardware/Infrastructure		Apple, Dell, IBM, HP, Compaq, Palm, Texas Instruments, AlphaSmart
	Basal	Pearson, Harcourt (Reed Elsevier), McGraw-Hill, Thomson, Houghton Mifflin
Instructional Content	Supplemental	Scholastic, Plato, Renaissance, Riverdeep, Scientific Learning, LeapFrog, NCS Pearson, WRC, Compass, Cognitive Concepts, Voyager (ProQuest), Carnegie Learning, Princeton Review, Don Johnston, Tom Snyder, Peoples Educational Holdings, Cambium Learning
	Reference/Libraries	Britannica.com, Learning Network, ProQuest, Jones Eglobal Library, McGraw-Hill, Primis Online, Sagebrush, EBSCO, Gale (Thomson) ABC-Clío
Assessment		CTB McGraw, Harcourt Assessment, Thomson, Plato, Renaissance, Riverdeep, TestU, Princeton Review, NCS Pearson, Scantron (John Harland), Scholastic, Compass Learning, Northwest Evaluation Association
Curriculum and Data Management		Edmin, Plato, Chancery, MindSurf, NCS Pearson, AOL, Schoolnet, Powerschool (Apple), IBM, ETS, EduSoft (Houghton Mifflin)
Professional Development		Teacher colleges, for-profit degrees (University of Phoenix, Capella, Canter), Classroom Connect (Harcourt), Teachscape, Advanta.net, Scholastic, Riverdeep
Tutoring/ Test prep	Private pay	Educate, Huntington, Kumon, Oxford Learning, Kaplan (Washington Post), Princeton Review, Collegeboard, SmartThinking
	Public pay	Platform Learning, Educate, Princeton Review, Plato, Edison, Tutor.com, Peoples Educational Holdings
Alternative Education	Site based programs	Mosaica, Edison, Aspen Education, Children's Comprehensive Services, Edsolutions, Ombudsman, National Heritage Academies, KIPP, Aspire
	Online/distance programs	Explore, Apex Learning, K12, Class.com, Education 2020, CCUP, VSU, Florida Virtual University
Childcare		Bright Horizons, Knowledge Learning, Childtime Learning Centers, La Petite Academy, Nobel Learning
Supplies & Products		School Specialty, LeapFrog, Vtech, First Years, Excelligence, Harcourt School, Educational Insights, HigherMarket.com, Way2Bid, Office Depot

Source: *ThinkEquity Partners*

VALUATION

We have outlined what we believe are the important factors to consider when valuing a K12 company and then ranked the companies based on our analysis. Companies with higher scores should support higher average valuations while companies with lower scores have more obstacles to overcome.

VALUATION ANALYSIS OF K12 COMPANIES

Low	1
Medium	2
High	3

	BFAM	EEEE	PQE	SCHS	TUTR	RLRN	SCIL	REVV	LF	ALSM
Brand and Reputation	3	3	2	3	3	3	1	2	3	1
Target Market Growth Prospects	2	3	2	1	3	1	3	3	2	2
Breadth and Depth of Offering	3	3	2	3	3	2	2	1	1	1
Growth Stage/Product Penetration	1	2	3	1	3	1	3	2	1	1
Profitability	3	2	3	2	1	2	1	1	1	2
ROIC	3	2	3	2	1	3	1	1	1	1
Visibility	3	3	2	2	1	2	2	1	1	1
Demonstrated Management Success	3	2	1	3	1	2	1	2	2	1
Liquidity	2	1	2	2	2	1	1	2	3	1
Interoperability*	NA	NA	2	NA	3	2	2	2	2	1
Subscription vs License*	NA	NA	3	NA	2	1	1	2	1	1
Research Based Claims*	NA	NA	3	NA	2	2	3	2	2	2
Average Score	2.56	2.33	2.33	2.11	2.08	1.83	1.75	1.75	1.67	1.25
EV/LTM EBITDA	16x	13x	9x	9x	7x	14x	NM	15x	38x	10x
P/NTM EPS	29x	20x	13x	16x	39x	24x	17x	35x	50x	NA

*Criteria we have applied only to technology companies (excluded from calculation for non-tech peers)

Source: *FactSet and ThinkEquity Partners*

1. **Reputation and customer relationships** – When selling into the public school system, relationships are paramount. K12 decision makers are inundated with product/service choices due to the fragmented nature of the industry and tend to stick with what they know has worked in the past. This type of consistency absolves the buyer of the responsibility of a failed choice (a company goes under, a product fails, etc.), and frees up time and energy for either administration or instruction. Of importance, as large scale RFPs, consortiums and state contract negotiations become more prevalent in the market, high level relationships are increasingly critical. We believe companies that already boast these types of district relationships have a leg up on the competition.
2. **Target market** (preK, K-3, entire K12, special needs, general, niche) – Different sub-segments of K12 have different prospects growth depending on market dynamics and the degree of market maturation. We believe the childcare market is large, but well penetrated and able to support healthy, long-term growth for providers. However, the school supply market is a largely stable business. In general, we believe technology still offers one of the greatest growth opportunities in K12. However, even within that space, there are differentiated growth prospects. Thus far, most technology has been spent in the higher grades and special needs areas. The younger age group may represent a future growth avenue but, to date, has been harder to penetrate. We believe companies targeting on-line text, before/after school programs, early learning, assessment, data driven decision making and/or language/cultural diversity may find growth servicing hot niche markets. However, other K12 companies, such as those distributing school supplies, seek to gain share in a stable to flat market.
3. **Interoperability and Ability to Partner** – Products and services that integrate well with a district's existing technology infrastructure have a strong advantage over competition that may be viewed as "on-off." Schools fear that purchasing decisions today will box them in and inhibit future choices. In addition, if a product does not fit in well within the existing or greater structure it can be more trouble than its

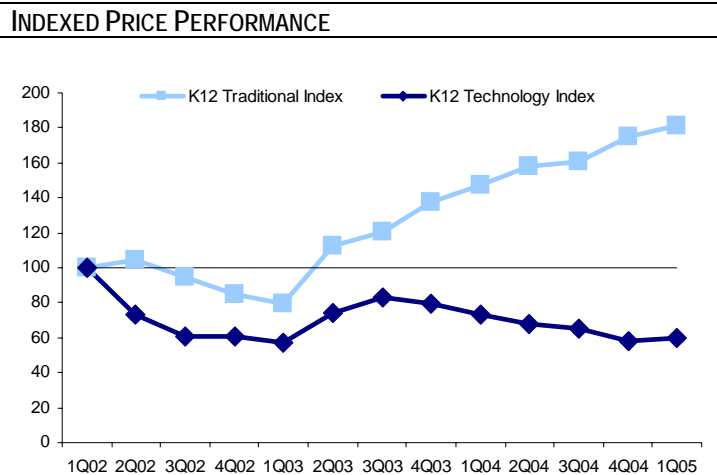
worth, given schools' lack of onsite technology aids. A prime example of good interoperability is Plato's Orion product, a student information management system with an open architecture that allows it to be used with products and services from other vendors. In the traditional services area, efforts being made to integrate with the technology system (such as those by School Specialty and Princeton Review) will also ultimately be rewarded, in our opinion.

4. **Breadth and depth of offerings** – We believe companies that have the ability to address multiple pain points in the K12 system will be favored by district buyers. Not only does the breadth of the offering address part of the interoperability issue (above), it also alleviates the need to manage several different vendors and pricing schedules.
5. **Research and standards based products** – Although the mandate for “scientifically research-based” products stemming from the NCLB act was introduced over three years ago, the effects are still filtering through the market, in our opinion. Going forward, companies that can show their products' effectiveness through officially “research-based” studies will be favored. In addition, companies that can modify products to align closely with state standards, which are the focal point in this new age of assessment, will beat out competitors that have difficulty showing alignment.
6. **Subscription versus License Sale** – With the sales cycles for major technology purchases increasing up to 18 months and the average district superintendent tenure only two to three years, sales of one-time software licenses are increasingly hard to come by. As a result, many operators are trying to phase in subscription sales to make their products more sustainable from one superintendent to the next. We believe the extent to which a company has successfully made this transition should be given a premium.
7. **Growth Phase/Product Penetration**– Clearly, the growth potential and stage of the company's business cycle and/or key product lines should play a large determinant in valuation. We see growth potential in tech companies with newer, hotter product lines, such as Scientific Learning, LeapFrog's School House division, ProQuest's Voyager Learning and Plato (based on expected new integrated product offerings and updated products). Slower growth companies include Renaissance Learning, which has already saturated the market with its core reading product, and School Specialty.
8. **Profitability** – Due to the wide variety of services and products sold into schools (hardware versus software, supplies versus site-based education) and in the highly variable cost structure of some models, there are wide differences in profitability margins between K12 companies. Companies such as Renaissance have consistently reported software-like margins for years, while those of Plato Learning have swung wildly as the company integrated multiple acquisitions. Voyager Learning's 40% EBIT margins show what a supplemental provider's operating margins can be.
9. **ROIC** – K12 is a tough market to operate in. Many companies have difficulty reaching and/or sustaining profitability due to the choppy nature of the sales cycle. As a result, a healthy and/or improving ROIC should garner a premium in our view. Companies with strong ROIC measures to date include Bright Horizons (16%) and Renaissance Learning (26%) and ProQuest (10%).
10. **Visibility** – Given the difficulty of the K12 market sales cycles and uncertain budgets, visibility in the K12 market should garner a premium. One form of classic visibility comes from a subscription-based revenue base; however, in K12 there are drawbacks to subscription models. Sometimes subscription services are avoided because, as with many government-run operations, schools and districts don't know if the funding for certain initiatives will be there from one year to the next. That said, there are many subscriptions that schools do feel comfortable entering into and companies are being quick to capitalize on those opportunities (e.g. Plato and ProQuest). Another attractive business model is based on recurring revenue stream, such as with Renaissance's initial software sale and quiz-pack follow-on sales. Other models should be discounted for the one-time nature of their sales model (such as AlphaSmart). School and childcare operators generally enjoy good 12-month visibility which can extend longer based on student pipelines.

11. **Demonstrated Management Success** – K12 is an industry that has historically felt a dearth of highly skilled business managers, due to the difficulty of getting started and making money in a choppy sales environment. As a result, a strong management team with years of proven experience is worth a premium, in our opinion. Several companies in K12 have experienced recent management changeover. Although the track records of the individuals running them may be impressive, we apply a discount for a lack of history at the current operation with the current team in place. Similarly, we believe companies should receive a premium in this measure if current management teams have years of experience and demonstrated success at the firms. We believe particularly strong and stable teams are at the helm of Bright Horizons and School Specialty.
12. **Liquidity** – Several companies in the K12 space have very low floats due to strong insider ownership. This type of liquidity can be problematic for investors wishing to enter and exit the stock based on fundamental factors. Companies with notably limited floats include Renaissance, LeapFrog and Educate.

Historical Valuation

Price performance of K12 companies in the past two years has been mixed. Shares of companies generally providing traditional offerings to schools or consumers (e.g. site based services, rather than online services and school materials, rather than technology) have performed well (up 82% since Q102). In contrast, shares of companies offering more tech-oriented offerings to schools have plummeted (down 40% in the same time frame).

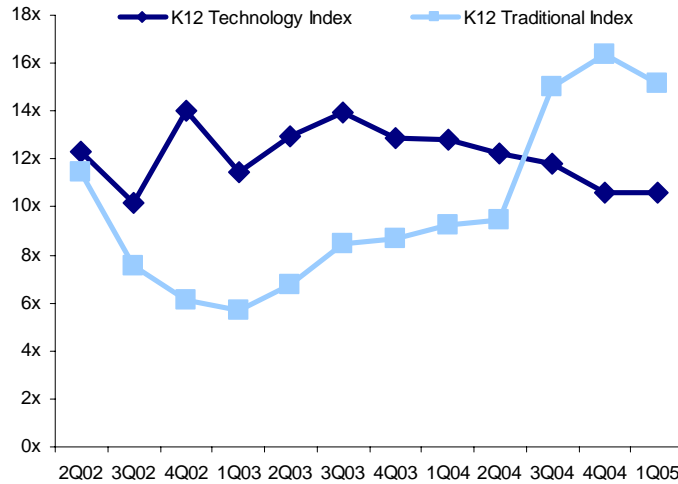


Source: *FactSet and ThinkEquity Partners*

Our K12 traditional index includes Bright Horizons, Educate, Excelligence Learning and School Specialty. Our K12 technology index includes AlphaSmart, LeapFrog, Princeton Review, ProQuest and Renaissance Learning.

We believe the reason for the divergent performance is twofold. First, although we believe there is more upside to come, K12 budgets turned a corner over a year ago and we believe the first inflow of new money went to much needed more traditional products, such as supplies and materials, rather than technology programs. Second, several of the companies in our traditional index serve the consumer education market (childcare, tutoring) which has grown through increased consumer awareness and concern regarding education, including an emphasis on early childhood center-based education and the importance of tutoring from a results-based K12 environment.

HISTORICAL EV/ LAST TWELVE MONTHS EBITDA



Source: Company reports, ThinkEquity Partners

Over the past four quarters there has also been a noticeable divergence in the valuation of our two K12 indexes. We believe this demonstrates investors' expectations for continued strength in traditional K12 stock performance, and potential oversight of the opportunity of increased technology spending in schools. We believe the technology focused companies offer the highest potential return to investors given the lower relative valuations and the possibility of an improving market.

K12 PUBLIC COMPANIES

Company	Ticker	5/25/05		Market		Return 12mo	EBITDA		EPS				P/E ratio			EV/Rev	EV/EBITDA		EV/ROIC	EV/FCF
		Price	Rating	Cap	TEV		LTM	NTM	CY04	CY05	CY06	NTM	CY05	CY06	NTM	CY05	LTM	NTM	LTM	LTM
Alphasmart	ALSM	3.62	NR	54	50	(26.02)	4	N/A	0.15	N/A	N/A	N/A	N/A	N/A	N/A	N/A	12	N/A	22.4	N/A
Bright Horizons	BFAM	37.10	ACCUM	1,018	965	57.52	63	74	0.98	1.05	1.14	1.28	35.3	32.5	29.0	1.5	15	13	32.6	30.68
Educate, Inc	EEEE	12.09	BUY	532	662	N/A	50	60	0.49	0.59	0.74	0.64	20.5	16.3	18.9	1.8	13	11	29.9	143.28
Excellence Learning	LRNS	6.05	NR	54	50	1.69	5	N/A	0.22	0.45	N/A	N/A	13.4	N/A	N/A	0.4	10	N/A	17.3	-39.27
LeapFrog	LF	10.95	NR	384	507	(43.97)	-4.5	N/A	-0.24	0.11	0.37	0.19	99.5	29.6	57.6	0.8	NM	N/A	-44.9	-13.88
Learning Care Group	LCGI	3.65	NR	72	85	54.66	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	48.9	-30.08
Nobel Learning Communities	NLCI	8.80	NR	66	86	30.60	18	N/A	-0.13	0.36	N/A	N/A	24.8	N/A	N/A	0.5	5	N/A	141.3	17.43
Plato Learning	TUTR	7.03	BUY	165	123	(20.92)	18	29	-0.08	0.21	0.35	0.18	33.5	20.1	39.1	0.8	7	4	-48.6	10.00
Princeton Review	REVU	5.50	NR	152	156	(22.80)	12	N/A	-1.10	0.13	0.26	0.16	42.3	21.2	34.4	1.2	13	N/A	-4.8	-82.19
ProQuest	PQE	32.85	NR	987	1,506	27.49	169	N/A	1.73	2.27	2.76	2.47	14.5	11.9	13.3	2.5	9	N/A	30.3	39.58
Renaissance Learning	RRLN	20.04	NR	611	553	(7.16)	39	N/A	0.73	0.77	0.90	0.82	26.0	22.3	24.4	4.9	14	N/A	23.5	5.50
School Specialty	SCHS	38.67	NR	886	1,051	11.22	115	N/A	2.27	2.41	N/A	2.46	16.1	N/A	15.7	1.0	9	N/A	23.8	23.57
Scientific Learning	SCIL	5.85	BUY	98	87	12.44	-0.3	7	-0.04	0.36	0.39	0.35	16.3	15.0	16.7	1.8	NM	12	-126.0	14.37
<i>Average</i>						<i>6.23</i>							<i>31.1</i>	<i>21.1</i>	<i>27.7</i>	<i>1.6</i>	<i>10.8</i>		<i>11.2</i>	<i>9.9</i>

Data & estimates for BFAM, EEEE, SCIL, TUTR per TEP estimates, FactSet, and company reports.
 All other data & estimates per FactSet.
 ROIC calculated as LTM NI/IC 4Q ave.
 FCF is calculated as CFO less Capex.

Source: Company reports, TEP estimates

COMPANIES MENTIONED

Company	Ticker	Exchange	Price	Rating	Price Target	TEP Coverage
AlphaSmart	ALSM	NASDAQ	\$3.64	Not Rated	N/A	N/A
Apollo Group	APOL	NASDAQ	\$76.70	Accum.	\$83	Kirsten Edwards, CFA
Apple	AAPL	NASDAQ	\$39.70	Not Rated	N/A	N/A
Bright Horizons	BFAM	NASDAQ	\$37.60	Accum.	\$41	Kirsten Edwards, CFA
Dell	DELL	NASDAQ	\$40.25	Not Rated	N/A	N/A
eCollege	ECLG	NASDAQ	\$10.45	Not Rated	N/A	N/A
Educate Inc.	EEEE	NASDAQ	\$12.50	Buy	\$16	Kirsten Edwards, CFA
Excelligence Learning	LRNS	NASDAQ	\$6.00	Not Rated	N/A	N/A
Hasbro	HAS	NYSE	\$20.38	Not Rated	N/A	N/A
LeapFrog	LF	NYSE	\$11.25	Not Rated	N/A	N/A
Learning Care Group	LCGI	NASDAQ	\$3.65	Not Rated	N/A	N/A
Mattel	MAT	NYSE	\$18.68	Not Rated	N/A	N/A
McGraw-Hill Companies	MHP	NYSE	\$43.95	Accum.	\$105	Neil Godsey, CFA
Nobel Learning Communities	NLCI	NASDAQ	\$8.75	Not Rated	N/A	N/A
Pearson	PSO	NYSE	\$12.15	Not Rated	N/A	N/A
Plato Learning	TUTR	NASDAQ	\$7.07	Buy	\$10	Kirsten Edwards, CFA
Princeton Review	REVV	NASDAQ	\$5.52	Not Rated	N/A	N/A
Reed Elsevier	RUK	NYSE	\$39.34	Not Rated	N/A	N/A
Renaissance Learning	RLRN	NASDAQ	\$19.96	Not Rated	N/A	N/A
Scholastic	SCHL	NASDAQ	\$38.20	Accum.	\$35	Neil Godsey, CFA
School Specialty	SCHS	NASDAQ	\$38.85	Not Rated	N/A	N/A
Scientific Learning	SCIL	NASDAQ	\$5.86	Buy	\$8	Kirsten Edwards, CFA
Thomson Corporation	TOC	NYSE	\$33.57	Accum.	\$41	Neil Godsey, CFA
VTech	VTKHY.PK	PNK	N/A	Not Rated	N/A	N/A
Washington Post	WPO	NYSE	\$838.50	Not Rated	N/A	N/A

Source: *FactSet and ThinkEquity Partners*

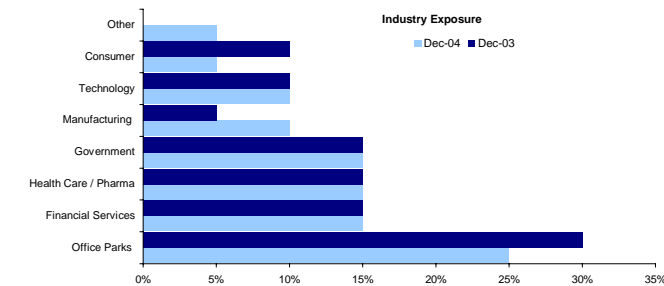
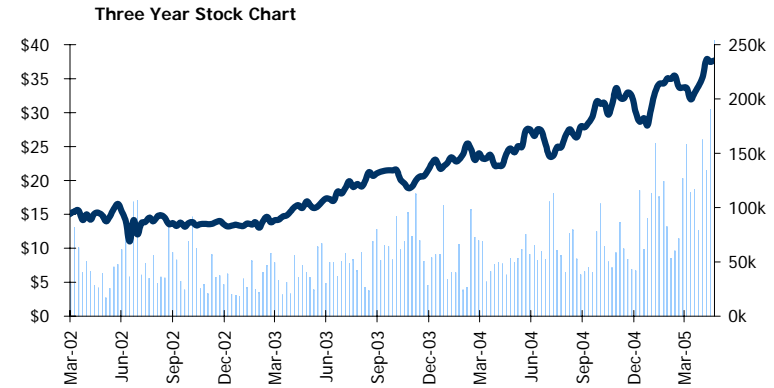
Bright Horizons Family Solutions, Inc. (NASDAQ: BFAM)

Rating: Accumulate, PT: \$41
 One-Page Snapshot

ThinkEquity Partners
 Kirsten Edwards, CFA (415) 249-1362
 Ryan Mahoney (415) 249-6320

Price 5/25/05	\$37.10	LT Growth:	25.0%
Shares:	28,203	Net Debt:	(53,503)
Mkt Cap (000):	\$1,046,331	EV:	\$992,828

	FY02A	FY03A	FY04A	FY05E	FY06E
Sales	\$407,532	\$472,756	\$551,763	\$641,431	\$744,375
YTY Growth	N/A	16.0%	16.7%	16.3%	16.0%
EBITDA	\$36,009	\$45,610	\$59,110	\$71,392	\$85,733
YTY Growth	N/A	26.7%	29.6%	20.8%	20.1%
EPS	\$0.59	\$0.75	\$0.98	\$1.22	\$1.47
YTY Growth	N/A	27.2%	31.1%	24.2%	20.3%
EV / Sales	2.44 x	2.10 x	1.80 x	1.55 x	1.33 x
EV / EBITDA	27.6 x	21.8 x	16.8 x	13.9 x	11.6 x
P / E	63.1 x	49.6 x	37.8 x	30.4 x	25.3 x
P / E to Growth	2.5 x	2.0 x	1.5 x	1.2 x	1.0 x



Key Operating Metrics (1Q05)

# of Centers	577
Enrollments	64,285
Capacity Per Center	111

Other Metrics (1Q05)

Debt/Equity	0.6%
Debt/Total Cap	0.4%
ROIC	16.3%
EV/LTM FCF	31.7x

Guidance

2Q05 EPS	\$0.29 to \$0.31
3Q05 EPS	\$0.28 to \$0.30
FY05 EPS	\$1.18 to \$1.22
FY05 Rev	\$623.5M to \$645.6M

Company Description

Bright Horizons Family Solutions is a leading provider of employer-sponsored child-care, managing more than 577 child care centers which enroll roughly 64,000 children in the United States, Europe, and Canada. Bright Horizons serves more than 400 clients, including 80 Fortune 500 companies. Bright Horizons has earned its status as the leader in corporate family services not only through its size but also through its Blue Chip client list, the range of services that it can offer, and the quality of those services.

Investment Highlights

- The perceived educational and social benefit of center-based childcare, growing competition in the labor market, and increasing corporate spend should drive demand for worksite childcare.
- The company has achieved significant operational improvements in the past two years: reduced employee turnover, improved utilization rates, and margin improvement of 100+ basis points annually.
- We believe 2005 and 2006 will show more moderate improvement as the initial effect of the improving economy is already reflected in performance.
- Looking forward, incremental upside could come from increased spending in more cyclical sectors. Due a long sales cycle, the company has likely not yet shown the benefit of this renewed demand.

Investment Conclusion

Bright Horizons is an impressive, market-leading company in an expanding industry. However, recent stock price appreciation may be over-estimating the company's ability to drive near-term growth at recent historical levels. Long term, we believe the company is poised to capitalize on an increasingly competitive labor market and a positive outlook for corporate spending in more cyclical sectors. However, in the near term several risks remain. The company is reliant on opportunity-dependent acquisitions and center transitions to meet current expectations and may have a lessening capacity to impress the Street with earnings outperformance. We are anticipating continued strong performance in the next few quarters. However, we believe price appreciation will be driven by earnings growth, rather than expansion from a multiple which we believe already reflects a healthy dose of optimism.

Key Concerns

- Increased dependence on center acquisitions and take-over contracts.
- Dependent on economy and corporate spending outlook.
- Wage-price growth parity must be closely managed.
- Increasingly competitive environment. The number of NAEYC accredited providers increased by 15% in 2003 alone, and have more than tripled since 1993.

Educate, Inc. (NASDAQ: EEEE)

Rating: Buy, PT: \$16

One-Page Snapshot

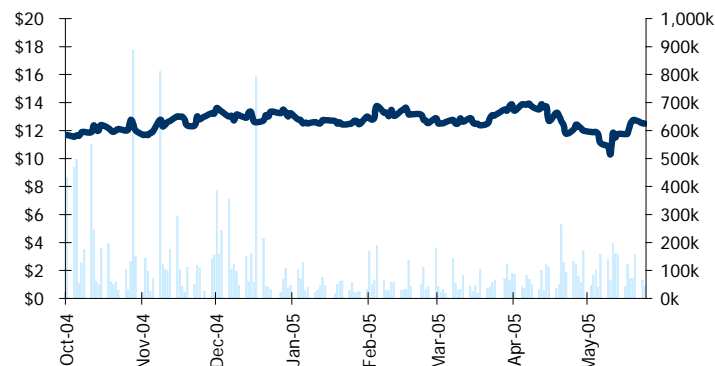
ThinkEquity Partners

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Price 5/25/05	\$12.09	LT Growth:	25.0%
Shares:	44,022	Net Debt:	129,219
Mkt Cap (000):	\$532,226	EV:	\$661,445

One Year Stock Chart



	FY03A	FY04A	FY05E	FY06E
Sales	\$242,327	\$300,277	\$361,160	\$425,737
YTY Growth	N/A	23.9%	20.3%	17.9%
EBITDA	\$37,974	\$47,318	\$56,094	\$70,566
YTY Growth	N/A	24.6%	18.5%	25.8%
EPS	\$0.29	\$0.49	\$0.59	\$0.74
YTY Growth	N/A	67.0%	21.7%	24.3%
EV / Sales	2.73 x	2.20 x	1.83 x	1.55 x
EV / EBITDA	17.4 x	14.0 x	11.8 x	9.4 x
P / E	41.5 x	24.8 x	20.4 x	16.4 x
P / E to Growth	1.7 x	1.0 x	0.8 x	0.7 x

Learning Center Guidance

2Q05 Rev	\$68M to \$70M
FY05 Rev	\$230M to \$240M

Institutional Services Guidance

2Q05 Rev	\$34M to \$36M
FY05 Rev	\$120M to \$125M

Total Company Guidance

2Q05 Rev	\$102M to \$106M
2Q05 EPS	\$0.23 to \$0.25
FY05 Rev	\$350M to \$365M
FY05 EPS	\$0.58 to \$0.60

Key Operating Metrics (1Q05)

Same Center Growth	5%
Same Territory Growth	4%
Franchise Centers	898
Franchise Territories	736
Co. Owned Centers	185
Co. Owned Territories	128
Buybacks	17

Other Metrics (1Q05)

Debt/Equity	100.9%
Debt/Total Cap	39.8%
ROIC	6.8%
EV/LTM FCF	142

Company Description

Educate, in business since 1970, provides academic tutoring services to K-12 students in the United States and Europe through more than 1,045 franchised and company-owned store locations and select U.S. public schools. Through Educate's Catapult division, the company sells tutoring and professional development services in packages directly to K12 districts. Educate is also chasing a large pool of new funds available through the federal government's No Child Left Behind act.

Investment Highlights

- Strong growth prospects in end markets
- Near term growth strategy to recapture demand should deliver (05 & 06)
- Long term growth strategy to enter new markets also promising (06 & beyond)
- Both strategies provide support for 20-25% long term EPS growth rate
- Market leader advantages (90%+ brand recognition)
- Solid free cash flow prospects

Investment Conclusion

- Demand for tutoring services is growing as the accountability trend in schools modifies the concept of public education.
- The NCLB SES market, while contentious, is gaining acceptance and provides a real opportunity for profitable growth in the next two to three years.
- K12 funding is increasing and districts will continue to outsource educational services not core to their mission.
- Visibility should improve as tutoring demand nationwide is reflected in key metrics.

Key Concerns

- Anemic same center growth metrics may shake investors.
- Online division is not profitable and has been burning cash at a \$4M annual rate.
- Timing of new center openings and buybacks may effect quarterly results.
- The NCLB SES program, while profitable, is vulnerable to legislative changes and carries press-risk associated with making profits off of contentious public dollars.

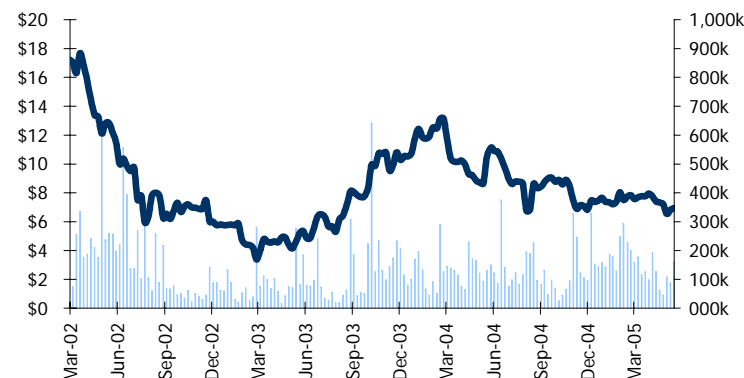
Plato Learning, Inc. (NASDAQ: TUTR)**Rating: Buy, PT: \$10****One-Page Snapshot****ThinkEquity Partners**

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Price 5/25/05	\$7.03	LT Growth:	25.0%
Shares:	23,110	Net Debt:	(38,859)
Mkt Cap (000):	\$162,463	EV:	\$123,604

	FY02A	FY03A	FY04A	FY05E	FY06E
Sales	74,391	82,192	141,801	150,510	165,478
YTY Growth		10.5%	72.5%	6.1%	9.9%
EBITDA	6,098	7,921	17,859	28,329	31,779
YTY Growth		29.9%	125.5%	58.6%	12.2%
EPS	(\$0.07)	(\$0.10)	(\$0.08)	\$0.21	\$0.35
YTY Growth		44.3%	-18.7%	-357.6%	69.8%
EV / Sales	1.66 x	1.50 x	0.87 x	0.82 x	0.75 x
EV / EBITDA	20.3 x	15.6 x	6.9 x	4.4 x	3.9 x
P / E	N/M	N/M	N/M	33.8 x	19.9 x
P / E to Growth	N/M	N/M	N/M	1.4 x	0.8 x

Three-Year Stock Chart

	CY02A	CY03A	CY04A	CY05E	CY06E
Sales	\$73,949	\$90,853	\$141,139	\$152,356	167,568
YTY Growth		22.9%	55.3%	7.9%	10.0%
EBITDA	\$4,411	\$8,301	\$17,667	\$28,638	\$31,281
YTY Growth		88.2%	112.8%	62.1%	9.2%
EPS	(\$0.15)	(\$0.20)	(\$0.12)	\$0.22	\$0.34
YTY Growth		31.1%	-41.5%	-294.5%	52.7%
EV / Sales	1.67 x	1.36 x	0.88 x	0.81 x	0.74 x
EV / EBITDA	28.0 x	14.9 x	7.0 x	4.3 x	4.0 x
P / E	N/M	N/M	N/M	31.4 x	20.5 x
PEG Ratio	N/M	N/M	N/M	1.3 x	0.8 x

Revenue Breakdown (1Q05)

License Fees	11,095
% Revs	44%
Services	8,196
% Revs	32%
Subscription Revenue	4,533
% Revs	18%
Other	1,631
% Revs	6%

Other Metrics (1Q05)

Debt/Equity	43.1%
Debt/Total Cap	0.0%
ROIC	-1.6%
EV/LTM FCF	9.7x

Company Description

Plato Learning provides online instructional content and related services to elementary and secondary schools, colleges, job training programs, correctional institutions, the military, and individuals. Plato's course library includes over 4,000 hours of award-winning content, covering over 12,500 learning objectives in the subject areas of reading, writing, language arts, math, science, social studies, and work skills. The company offers a comprehensive instructional software system that can serve as a supplement or alternative to teacher-led instruction.

Investment Highlights

- Product line is targeted at appropriate buyers with increasing dollars at their disposal.
- Company continues to gain market share in a fragmented market.
- Identified costs savings should increase profitability in 05.
- Strong operating cash flow performance and outlook.
- Healthy balance sheet (\$42m in cash and no debt).
- Following a 30% stock price decline valuation does not reflect long term fundamentals.

Investment Conclusion

We believe Plato's assimilated product and service offering is in demand and targeted at appropriate buyers with improving budgets at their disposal. Meanwhile, we view downside risk as mitigated by a strong balance sheet, good prospects for cash flow generation, stricter accounting practices and improved data management systems. In addition, we believe that given the recent restructuring and valuation compression the company may be increasingly viewed as an attractive acquisition target.

Key Concerns

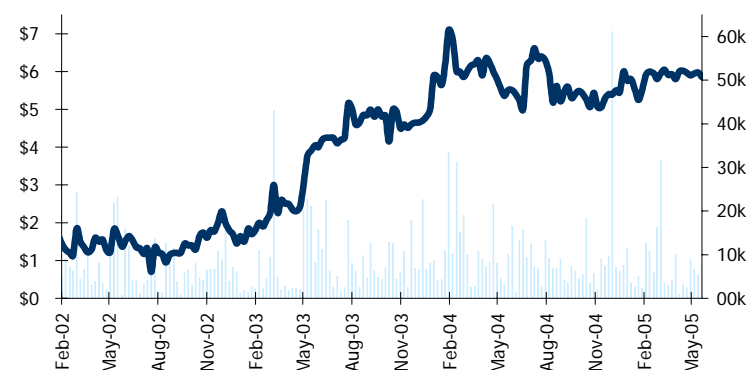
- Sales force is being reorganized in peak selling season.
- FY05 estimates are back end loaded.
- Lack of visibility related to choppy, large software license sales.

Scientific Learning (NASDAQ: SCIL)**Rating: Buy, PT: \$8****One-Page Snapshot****ThinkEquity Partners**

Kirsten Edwards, CFA (415) 249-1362

Ryan Mahoney (415) 249-6320

Price 5/25/05	\$5.85	LT Growth:	25.0%
Shares:	16,616	Net Debt:	(\$10,281)
Mkt Cap (000):	\$97,204	EV:	\$86,923

Three-Year Stock Chart

	FY02A	FY03A	FY04A	FY05E	FY06E
Sales	\$21,837	\$29,916	\$30,976	\$47,990	\$53,674
YTY Growth		37.0%	3.5%	54.9%	11.8%
EBITDA	(\$3,007)	\$3,648	(\$307)	\$6,750	\$8,987
YTY Growth		221.3%	-108.4%	2298.6%	33.2%
EPS	(\$0.34)	\$0.13	(\$0.04)	\$0.34	\$0.44
YTY Growth		138.9%	-129.8%	953.1%	29.1%
EV / Sales	3.98 x	2.91 x	2.81 x	1.81 x	1.62 x
EV / EBITDA	N/M	23.8 x	N/M	12.9 x	9.7 x
P / E	N/M	44.1 x	N/M	17.3 x	13.4 x
P / E to Growth	N/M	1.8 x	N/M	0.7 x	0.5 x

Guidance

FY05 Rev	\$46M to \$49M
FY05 EPS	\$0.34 to \$0.37

Upcoming Events

Asian Brain-Based Learning Conference 5/27
AASA Summer Leadership Institute 7/17
CGCS- Council of the Great City Schools 10/19
ALAS Conference 10/20
NASDSE Conference 10/23
USAA Conference 10/26
ASHA Conference 11/18

Booked Sales (1Q05)

K12 Booked Sales	8,212
Yr/Yr Growth	18%
Non-K12 Booked Sales	364
Yr/Yr Growth	13%

Metric (1Q05)

Debt/Equity	0.0%
Debt/Total Cap	0.0%
ROIC	10.5%
EV/LTM FCF	10.6x

Company Description

Scientific Learning is an education software company selling into K12 schools, private clinics, and correctional institutions. The company's core product line, Fast ForWord (FF), is a series of products intended to build the cognitive skills underlying the ability to read and write fluently. Students use the product typically in 50-minute sessions for 4 to 12 weeks. FF products can and are used in conjunction with other mainstream reading software products which focus on learning how to read, rather than building the ability to do so.

Investment Highlights

- The company may be able to double its potential market size if it can move its products mainstream.
- Sales force expansion and new product introductions (3 in FY05) should drive sales, profitability and average full license sale (to \$100,000 from \$85,000).
- "Early adopter" deals in large schools districts, such as Philadelphia, should lead to increased exposure and more "referral" sales.
- New marketing & branding efforts should allow the company to better target mainstream sales.

Investment Conclusion

We believe Scientific Learning is at a crossroads. The success of the company is dependent on its ability to bring its Fast ForWord products mainstream. The company has launched a targeted effort to accomplish this, and is being aided by current trends in legislation and in the market. We believe the company will be successful in its efforts to drive larger volume sales, as demonstrated by the recent large scale deals in Philadelphia, Dallas and Cumberland County.

Key Concerns

- New product launches may be delayed or unpopular.
- Sarbanes-Oxley costs are still unknown.
- Heavy inside ownership (60%) and low float.
- Seasonality of reported revenue may be exacerbated by a recent change in reporting.

Company Initiation Report

Bright Horizons Family Solutions, Inc (NASDAQ: BFAM)

“Horizon Still Bright”

Accumulate Rating

\$41 Price Target

We view BFAM as an impressive, market-leading company in an expanding industry. However, recent stock price appreciation may be over-estimating the company's ability to drive near-term growth at recent historical levels. Long term, we believe the company is poised to capitalize on an increasingly competitive labor market and a positive outlook for corporate spending in more cyclical sectors. However, in the near term several risks remain. The company is reliant on opportunity-dependent acquisitions and center transitions to meet current expectations and may have a lessening capacity to impress the Street with earnings outperformance. We are anticipating continued strong performance in the next few quarters. However, we believe price appreciation will be driven by earnings growth, rather than expansion from a multiple which we believe already reflects a healthy dose of optimism. As a result, upside to our 12-month price target of \$41 is minimal at 11%.

INVESTMENT POSITIVES

Industry trends support growth in the childcare market – We believe demographic, social and economic trends are converging to drive increased demand for out-of-home childcare services. We estimate the current U.S. childcare market to be \$43 billion, with approximately \$34 billion in consumer or corporate funded programs. Within this market, we believe demand for established, center-based services (such as Bright Horizons') is growing at a particularly healthy rate as research and press emphasize the value of early childhood education and socialization. For example, a well-publicized 2004 research study conducted by Stanford, Berkeley and Columbia Universities found that children attending established, center-based childcare programs had more cognitive, academic, social, and behavioral skills than young (3 to 5 year old) children at home or attending home-based childcare programs. Research and press of this nature has helped drive attendance in center based childcare programs from 5.1 million in 1998 to 5.6 million in 2004. In 2004 approximately 64% of American children ages 3 and 4 were enrolled in center-based childcare programs, up from 10% in 1960. Of interest, the rate of participation has increased at an approximately equal rate in the last two decades for children with a stay-at-home parent versus dual-working families. This suggests that the strongest driver of growth in the market is actually the perceived educational and social benefits of center based programs, rather than direct need (both parents are working). In the corporate-sponsored childcare market, we believe growth will be driven further by increasing competition in the labor market for skilled employees, the increased outlook for corporate spending and the growing value of employee retention.

Competitive Advantages – The childcare market is highly fragmented and competitive. However, we believe Bright Horizons has several competitive advantages that should allow it to continue to take market share and consistently consolidate smaller players in the space. First, we believe the company provides a healthy value proposition to its corporate customers. Sponsoring a corporate center typically has a healthy ROI for the client, driven by reduced employee turnover, improved job satisfaction, and lower absenteeism/improved productivity. With the labor market tightening in particular sectors and the knowledge

economy demanding higher-skilled workers we believe all of these factors will be heightened concerns for corporations, making the ROI proposition even more immediate. The company's long track record of providing reliable, high-quality centers provides comfort to corporations entering into new agreements. Second, we believe Bright Horizons has a competitive advantage in attracting parents to corporate center locations. Parents typically consider convenience and quality as the top two reasons for choosing a childcare provider, followed by price. In addition, providing consistent caregivers is an important factor to parents and Bright Horizon's impressively low 20% annual turnover rate is well below the industry average of 50%.

Growth Comes at a Lag to the Economy: More Upside May Remain - Growth in the corporate childcare market reportedly slowed from a 12% CAGR in the 1996-2000 period to a 4-6% CAGR in the 2001-2002 period, according to the Child Care Information Exchange. We believe industry growth should return to a 10% CAGR for the next several years. The company's reported pipeline remains around 50, compared to pre-9-11 levels when the reported pipeline was regularly described as "over 60." Of note, the economy slowed a full year before the pipeline dropped, reflecting the lag effect of economic conditions to demand for corporate daycare. This lag may also partially explain the impressive rebound in 2004 following improved economic conditions in 2003 (51 net center openings in 2004 vs 44 in 2003). With the job market and corporate profits continuing to improve, we believe the company may see additional increases in demand for new centers in 2005 and 2006. We believe that eventually the company may be able to begin reporting "high 50s" or even "60" pipelines again, which could have a positive impact on the stock. Encouragingly, capital expenditure guidance is \$17-\$19 million for 2005 (up from \$13 million in 2004), indicating that the company is planning on spending more money on new center openings.

Increasing Corporate Focus on Employee Benefits - With employee-retention issues not a major focus at corporations in the past few years (due to the difficult job market) we believe the reality of high turnover costs is just starting to become a pain-point for corporations again. As evidence, performance management and compensation management companies have reportedly seen increased demand from Fortune 500 companies that are picking up spending on human capital retention. As job opportunities pick up, the demand for skilled workers should compound the problem for companies that are highly dependent on skilled human capital. With companies less willing to turn to stock based compensation as a way to entice employees, childcare is an attractive substitution. We believe this rebound may not be fully reflected in Bright Horizon's business.

Opportunity to Capitalize on Rebound in Corporate Spending in Cyclical Sectors - We believe the potential exists for Bright Horizons to begin to see an increase in the number of new corporate contracts from companies in sectors that have been weak the past few years due to prolonged economic difficulty, such as technology. For the last two years clients in the healthcare, child park and government sectors have dominated BFAM's focus, pipeline and new client base. However, prior to the most recent recession, IT, consumer and financial service sectors comprised 40% of the company's client base (vs 30% now). In recent quarters the company has reported more interest from previously out-of-favor industries, although management is careful to remind investors that upside will not likely translate into new contracts until 2006 due to the long sales cycle. We believe this up-cycle in more cyclical sectors will be accompanied with continued strong growth in the company's more stable industries, such as education and healthcare. The Department of Labor (DOL) estimates continued high job growth in industry verticals that BFAM has a high exposure to -- namely healthcare, education, leisure and hospitality, and IT and engineering.

Potential for Continued Strong Organic Growth - Organic enrollment growth at mature centers (open more than two years) averaged 1%-2% in 2004, which was an impressive up-tick from flat growth in 2001 and 2002, slightly stronger 1% in 2003. It also appears impressive next to the more moderate, regular 0.5% growth posted prior to the recession. We believe the reason for this swing was that following a difficult job market, utilization of some mature centers dropped below optimal capacity levels during the recession,

providing room for strong growth when the job market began to improve. We believe there may be more upside to come from improving utilization rates. We note that although job opportunities are increasing in certain sectors, the employment rate (62.6% in April 2005) remains well below pre-recession levels (64.7% in April 2000). As job opportunities continue to increase (especially in sectors hit the hardest in the recession, e.g. technology) improving utilization rates at mature campuses could drive this metric further at a healthy 1% -1.5% level in 2005, tapering down to a 0.5% - 1% level in 2006 (a rate still above pre-recession levels). In addition, existing clients in expanding sectors may choose to add services to their centers, such as after-school, summer school, special hour and tutoring services. This could provide incremental revenue per center with minimal additional capital outlay. With the number of net new center openings also increasing (from 44 in 2003 to 51 in 2004 and our estimated 50 in 2005) there should be incremental upside in overall organic growth.

Increasing Capacity per Center May Provide Margin Upside– A series of center acquisitions in the UK which operate with a much smaller typical center capacity has pulled Bright Horizon's average center capacity down over the past few years. U.S. centers are estimated to have a 122-student capacity, while UK centers have an average 54-student capacity. We believe both metrics have the potential to improve going forward. The company's recent acquisition of Seven Oaks in Colorado will add 11 new centers operating at a capacity of 130-135. In addition, the UK capacity per center is increasing as management adds larger centers to the mix – it has increased average capacity to 54 at 1Q05 end from 40 at 2Q02 end. We estimate that a one student up-tick in average capacity per center for a year would equate to one penny extra in EPS.

International Operations are Beginning to Contribute to Earnings– Management noted on the Q1 call that its international operations (U.K. and Ireland centers), which have been operating at an accounting loss for several years, are ramping up quicker than expected and should contribute to earnings in FY05. As a result, management raised its guidance for FY05 operating margin improvement to 30-50 bps from 20-40 bps at the Q105 call, just two months after its Q4 report when previous guidance was issued. International center capacity metrics have ticked-up to 54 in Q105 from 53 in Q304 and 40 in 2Q02. We believe the potential exists for further outperformance in the U.K./Ireland division as the company continues to add new larger capacity centers to leverage overhead. We note that a positive contribution to earnings from the international division may moderately improve the reported tax rate in 2005 and 2006.

Room to Move – Employee Wages Are Already High - Childcare workers have high average attrition rates in the range in the 50% across the industry. This troublesome turnover is attributed to low typical pay and the life circumstances of the average worker (i.e. a part-time working mother). To stem this unwieldy cost factor, Bright Horizons has made a point to be one of the best ranked employers in the industry. Through a mixture of good benefits, employee training programs and salaries at a 15-20% premium to the market, the company has managed to make the list of Fortune magazine's "100 best company's to work for in America" for six years. *These efforts enabled the company to post average worker turnover at a rate closer to 20% in 2004, down from 30% a few years ago.* To achieve this impressive reduction, Bright Horizons has raised average compensation of its childcare workers at rates well above inflation, roughly 3-4% a year. In comparison, the Department of Labor estimates that national wages for childcare workers increased only 0.6% in 2003. This disparity has allowed the company to boast premium compensations and should allow the company to continue to attract and retain employees at current or moderately higher levels even if the labor market becomes more competitive. We note that although this mitigates the difficulty of managing wage-price growth parity (discussed as a risk below), it remains an important and complex balance to maintain.

Possibility of an Accretive Acquisition May Boost Estimates and Outlook - As the largest corporate childcare provider with a healthy balance sheet (\$54 million in net cash) and a history of successfully tucking in acquisitions we believe there is the potential that BFAM can conduct an accretive acquisition beyond its "normal" acquisition strategy that could provide upside to our numbers. In 2004, 17 (or 28%) of the 60 new

centers the company added were through acquisition, vs 27 (or 45% of new centers) in 2003. This shift was partially due to a focus on transitioning "contract takeover" centers. We believe the company could ramp up its "normal" acquisition activity of small childcare provider chains in 2005 and 2006 or take the opportunity to enter a new vertical more meaningfully, such as a private elementary school operation. The company's six center elementary school pilot program has performed well and we believe the company may buy versus build to reach scale in the new market. With the company typically paying 4x-6x cash flow for small chains of centers we believe the ROI is typically immediately attractive, whereas new center openings typically take two to three years to ramp up. We believe the market remains sufficiently fragmented for BFAM to continue its acquisition strategy going forward.

Solid Management Team - The established management team has proven its ability to steer the company through difficult economic conditions while still posting healthy 25% CAGR (2000-2003). We believe it is likewise equipped to take advantage of improved economic conditions through increased expansion activity. As evidence, in the last nine quarters management has consistently beat estimates and raised forward looking guidance.

Highly Visible and Profitable Business Model – Bright Horizons is typically able to open childcare centers with low capital costs, often using the facilities of their clients. In addition, contracts are typically multi-year in length and centers average a waitlist with 10% -15% of capacity, providing a high degree of revenue and earnings visibility. Its rolling last twelve month (LTM) ROIC has averaged a robust 15.5% in the past two years and is on an upward trajectory, ending 2004 with a 16% LTM ROIC. We estimate LTM ROIC could reach a robust 17.7% by FY06 end.

Well-diversified Operations – BFAM has corporate day care centers in a wide array of industries including a-cyclical sectors (healthcare, education) and more cyclical industries (technology and finance). This diversity should allow the company to weather storms in specific industry downturns, as well as in broader economic cycles. In addition, the centers are diversified geographically throughout the U.S. and the U.K.

INVESTMENT NEGATIVES

New Composition of Growth May Be More Risky - BFAM has historically maintained an annual growth ratio of approximately 70% through organic expansion and 30% through acquisitions. Although management intends to maintain this ratio going forward, we believe the composition of both acquisitive and organic growth may be changing the risk profile of the company's overall growth strategy. First, the company is acquiring chains and opening new centers with lower average capacity metrics. In 2004 the company acquired 17 centers with an average capacity of 93, versus its typical US center average of 127. In addition, BFAM entered into new contracts with lower average capacity centers (such as its 18 center contract with UAW Ford) and as a result, organic growth in 2004 also pulled down the capacity per center metric. In sum, new centers (through acquisition or new contracts) had an average center capacity of 45 in 2004, versus 90 in 2003. Second, a growing portion of the company's 70% organic growth is coming from "contract takeovers" (when BFAM assumes control of a pre-existing center previously operated by another provider or by the client itself). In 2004 the company transitioned 27 centers (including 18 Ford family centers), compared to 13 in 2003. In our opinion, contract takeovers carry similar characteristics to acquisitions in that expansion becomes opportunity dependent, there is integration risk, and during the initial period of management there are numerous factors outside of management control (e.g. previous track record and reputation, and facility set up). If acquisitions and transitions are combined and compared against greenfield organic growth, the 28% growth through acquisition in 2004 (as determined by new centers) actually becomes 73%, up from 66% in 2003. The upside to this shift is that management takeover contracts and acquisitions typically have shorter ramp up times and immediate revenue contribution (as

opposed to greenfields) which helped boost the 2004 margin and continue to help drive growth in 2H05 and 2006. Clearly the downside is that more acquisition/contract takeover dependent growth carries more risk.

Growing number of “multi-site” Clients May Lead to Increased Customer Buying Power – Management has stated that over 70% (or 217 centers at 2004 end) of its centers are in “multi-site” client locations. In other words, it has a strong and growing repeat customer business. We believe this illustrates the high quality and reputation of these offerings. However it also may ultimately present a risk: growing customer buying power. In recent years management has reported that several of its “cost plus” clients reduced the amount of subsidies it provided to its employees and therefore to BFAM as operating cost reimbursement – although the negotiated management fee payment remained steady. This was likely due to difficult economic times and necessary cost cutting on the client’s part. However, the ability for multi-site clients to establish favorable contracts should increase as their volume increase. We believe the company’s contract with Ford is an illustration of this. Although the contract is clearly profitable for Bright Horizons, its average center capacity is low and on a per center basis profitability may be compromised.

Impressive Utilization Rate Gains May Be Mitigated Going Forward– Due to state and licensure requirements, centers must maintain a certain staff-to-child ratio. As a result, gains in utilization rates of centers are ultimately capped. With the job market at a low in 2002, we believe some mature centers may have experienced a drop in utilization rate. As evidence, the blended utilization rate (which is also affected by new centers and acquisitions) dropped from 76.7% in FY01 to 75.7% in FY02, per our estimates. In contrast, we estimate the average utilization rate improved to 76.5% in FY03 and then to 77.8% in FY04, reflecting increased employment at existing corporate clients. Although this level of improvement is impressive, we believe it may not be sustainable at current levels. Ultimately, we view the optimal blended utilization rate as 82-83%, which still provides room for upside. However, we are expecting to see more moderate year over year increases in this metric going forward driven by continued minimal up-tick in utilization at mature locations, as well as potentially shorter ramp-up times for new centers.

Wage-Price Growth Parity Must be Closely Managed – The company’s low 20% turnover rate is impressive, however we believe maintaining the wage-price growth parity should still be considered an important ongoing risk. As the job market improves, the company must immediately pay its employees more as they are continually filling in positions at competitive (and premium) rates. In the past two years, we believe the company has proven its ability to keep labor costs in check as the job market improved as it raised prices beyond costs increases and posted impressive a 130-190 basis point margin improvement (versus the historical average of 50-60 bp improvement). However, management of this balance is tricky as labor costs increase throughout the year and tuition increases only occur at one point. Although this is an ongoing risk, it is important to remember that as the economy improves labor costs may increase, but so will opportunities for new or expanded corporate client contracts, albeit at a lag.

Increasing Accredited Competition – There are more than 500,000 accredited childcare providers in the U.S., however only 9,000 are accredited by the premier accrediting organization, the National Association of the Education of Young Children (NAEYC). With over 80% of Bright Horizons centers accredited by the NAEYC, these centers have a clear competitive advantage over the 92% of the industry that isn’t, in our opinion. However, the NAEYC has experienced a recent boom in the number of high quality providers and, in 2003, accredited 15% more providers. Since 1993 the number of providers approved by the NAEYC has more than tripled. The impact of this increasing number of high quality, accredited providers represents an expanding, but also more crowded market place.

INDUSTRY

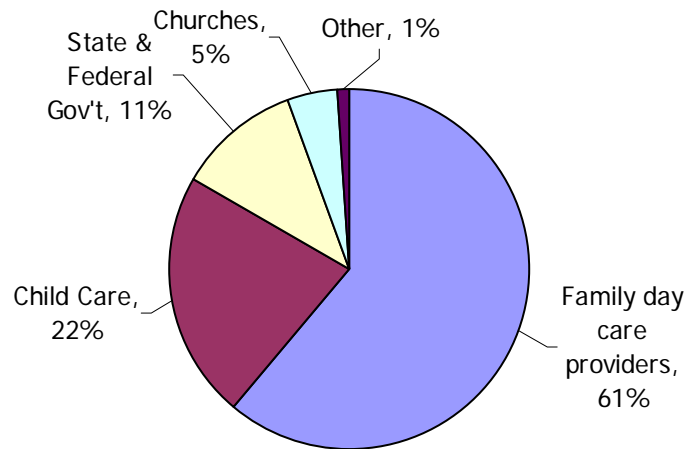
We estimate the current size of the childcare market to be \$43 billion, with approximately 76% of the market private pay and the remaining 24% government funded programs. There has been impressive expansion of the proportion of 3 to 5 year old children enrolled in non-parental, preK programs in recent decades. In 1960 only 10% of U.S. children age 3-5 were enrolled in center based childcare programs. Currently, more than 64% of children in this age group are enrolled. We believe this shift is due to heightened awareness of the value of early childhood education and a growing percentage of two parent worker families. With the U.S. Census estimating the 0 to 5 year old population will grow at a 1.05% annual clip through 2015, there is a strong base support for continued growth in this market. On top of population increases, we expect continued expansion of the proportion of preK children attending formalized programs to fuel another 1-2% annual growth. With childcare programs holding relative pricing power (parental decisions are typically made based on quality and convenience first, followed by price) we believe the market should support price increases of 5% annually. Piecing together these trends, we are estimating that the childcare market is growing at a 7% CAGR, and will reach a total market size of \$60 billion by 2010. The market for corporate childcare centers should grow incrementally as the job market becomes more competitive and corporations spend more dollars on benefits such as childcare. We estimate corporations will add new centers at roughly a 3% rate a year going forward. As a result, our estimate for corporate center childcare market growth is 10%.

INDUSTRY GROWTH	
Population (0-5 year old)	1%
Proportion of young children attending center based care	1%-2%
Price increases	<u>4%-5%</u>
Center based childcare market growth	6%-8%
Corporate spending for childcare centers	<u>3%</u>
Worksite center childcare market growth	9%-11%

Source: *NCES and ThinkEquityPartners*

The childcare market is highly fragmented, with more than 500,000 child care centers, according to the Children's Foundation. Of these centers, only 112,000 (22%) are regulated with formalized programs, such as Bright Horizon's. The remainder mainly consists of family day care providers operating from their homes, public sector agencies, churches, hospitals, universities, and community service organizations (such as the YMCA). Bright Horizons is by far the largest provider of work-site childcare and one of the top three corporations providing center based childcare overall, in terms of capacity to serve children.

ESTIMATED NUMBER OF DAY CARE PROVIDERS (2000)



Source: *MarketData Enterprises*

We believe the corporate sponsored childcare market represents a particularly strong and unique growth vertical within the childcare market. The number of corporate childcare centers has reportedly grown from 1,000 in 1986, at which time most were sponsored by hospitals, universities, government agencies and real estate developers, to more than 6,000 in 2000 (a 12.7% CAGR), sponsored by companies in a wide array of industries. Based on expectations for a tightening labor environment, the knowledge economy and increased corporate spending in certain sectors where human capital is the largest and most important expense we believe growth in this sub-market will continue to out-pace industry growth overall. As a result, we are anticipating growth in Bright Horizon's core market – worksite-based childcare centers – to approximate 10% annually.

Growing Awareness of Early Education

Scientific research into early childhood education has drawn widespread media and political attention, increasing parents' awareness of, and demand for, quality educational facilities for their young children. Children in preschool settings develop both academic and behavioral skills that are crucial to school success, such as cognitive skills, language ability, math skills, and social adjustment. We believe that regulated, accredited center-based child care centers (such as BFAM's) typically offer more structured curriculum and a higher level of social interaction for children than alternative forms of child care and are therefore benefiting from increased demand. As evidenced in US Census Bureau data, preschoolers with working mothers who attended day care by home-based relatives declined from 28% in 1985 to 20% in 1999. In contrast, enrollment rates in early education center-based programs increased from 53% in 1991 to 56% in 2001, according to the most recent study from NCEES.

Two Working Parent Families

Over the past two decades, mothers of young children have been heading back to work more frequently and earlier than ever before. In fact, women with children under the age of six have been the fastest growing segment of the American workforce since 1980. In 1960, only 19% of women in this category worked, compared to an estimated 70% today. This shift means that an increasing amount of employees are working parents who must find ways to cope with the demands of both work and child care. It also means that employers must pay attention to the needs and demands of working parents of young children. Many have turned to subsidized childcare as a way to reduce employee turnover, improve employee productivity and as an effective recruiting device.

Economic ROI

An improving economy should drive further growth in child care locations as corporations open more centers to attract and retain employees. A 1997 Simmons College study of employees with children in employer-sponsored child care programs found that 93% of respondents said that work-site child care was an important factor in considering a job change, 19% turned down a job opportunity due to childcare and of those, 26% were managers. With these metrics in hand, Bright Horizons has been consistently able to convince employers of the ROI of a sponsored center, driven by reduced employee turnover, improved job satisfaction, and lower absenteeism/improved productivity.

Universal Preschool Programs (UPK)

A growing public awareness and research emphasis on the importance of early childhood education has led to increasing media attention and political traction of government funded pre-K programs. Total state spending on preschool increased by more than 37% in 2003, to \$2.54 billion. However, due to an enrollment boom per child spending actually declined 2.5%. Forty states offer some form of support for pre-kindergarten education programs, but only Georgia, New York, and Oklahoma have implemented universal pre-kindergarten programs (UPK). UPK programs are intended to provide "universal" access to children of a certain age, regardless of income level. In contrast, most state programs today offer access on an economic need basis. We believe the emergence of UPK programs is a new, unknown factor to the industry. Florida is set to offer a voluntary UPK program for children four years of age beginning in the 05/06 school year, along with summer school beginning in 2006. The voluntary program is receiving a lion's share of public attention and is expected to enroll 150,000 children in the coming school year. It remains unclear what role for-profit private providers will be able to play in this new potential market. Although the program allows for-profit centers to take the public dollars the \$2,500 per student allocation would only subsidize the typical tuition of a Bright Horizons center. It is possible that Bright Horizons may be able to subsidize its tuition with UPK dollars in its Florida centers. However, it is also possible that the programs may draw students away from more expensive for-profit centers or lessen corporations' perceived need to offer subsidized childcare.

The feasibility of a state or federally funded UPK program remains in question. As a result, we do not believe an adoption of UPK on a federal level will take place in the near term. However, new state and district initiatives continue to appear on ballots (such as in California and Los Angeles) in different forms. The proposed California initiative (set for the 2006 ballot) would not allow for-profit center use of state dollars. As a result, the impact on corporate chains such as Bright Horizons could be more negative than Florida's initiative. Whether national or state funded, we are not anticipating the new UPK programs to have a significant effect on Bright Horizons' enrollments. The following are several key points to clarify what UPK are today, based on the limited data available.

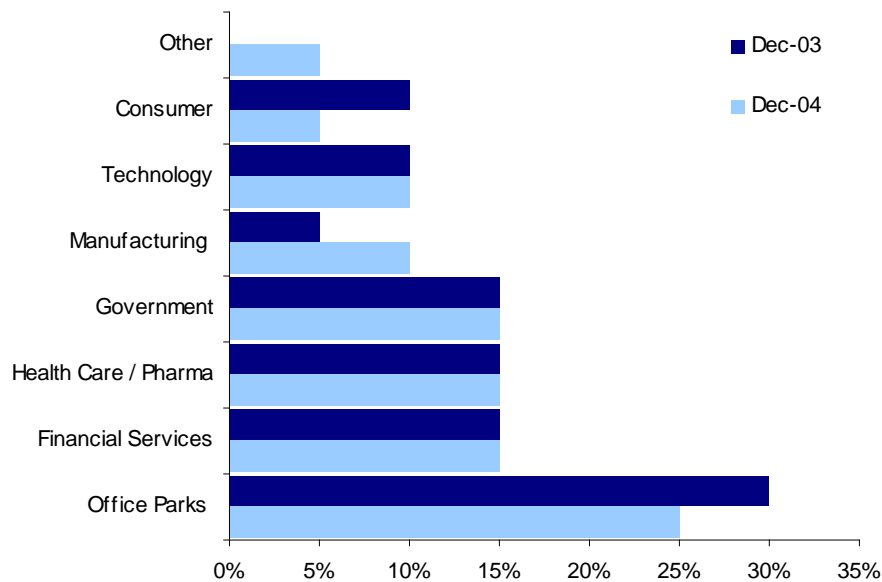
1. There are different ideas of what exactly "universal pre-k" means. To some it is a free service that is mandatory, much like primary public school, and to others it is voluntary to attend but mandatory for districts to provide.
2. Programs differ from state to state. There is no standard curriculum, and different programs operate for various hours during the day or months throughout the year.
3. Centers will be required to keep certain minimum quality standards while maintaining licensing and staffing qualifications, group sizes and ratios. Florida has chosen to have the DOE regulate the standards that must be held.
4. Parental choice is another differentiating point between state programs. Florida's most recent bill gives parents a choice among different programs offered by either public or private (including for-profit) providers. However, per-student dollars will not likely amount to enough to enroll students full time on a profitable basis.
5. How much will it cost? The Brookings Institute estimates that the federal government spends approximately \$14 billion on early child care, and that it could cost twice that amount to provide

UPK. Florida has budgeted close to \$400 million to fund its program, which would only provide enough per student dollars to send children to three hours of childcare a day.

COMPANY DESCRIPTION

Bright Horizons Family Solutions is a leading provider of employer-sponsored child-care, managing 577 child care centers which serve roughly 64,000 children in the United States, Europe, and Canada. Bright Horizons serves more than 400 clients, including 80 Fortune 500 companies. The company was created by a merger in 1998 between Corporate Family Solutions and Bright Horizons, two market leading companies that essentially founded the work-site childcare industry. Bright Horizons has earned its status as the leader in corporate family services not only through its size but also through its Blue Chip client list, the range of services that it can offer, and the quality of those services.

BRIGHT HORIZONS INDUSTRY EXPOSURE



Source: *Company reports and ThinkEquity Partners*

Since it opened in 1987, Bright Horizons has grown through internal development and acquisition of small child care center chains. The following are some of company's corporate clients: Abbott Laboratories, AstraZeneca, Bank of America, Bristol-Myers Squibb, British Petroleum, Citigroup, Eli Lilly, Glaxo SmithKline PLC, IBM, Johnson & Johnson, JP Morgan chase, LandRover, Microsoft, Motorola, Pfizer, Reebok, SAS, S.C. Johnson & Son, Starbucks, Timberland, Time Warner, Universal Studios and Wachovia. The company also provides services for well-known institutions such as Cambridge University, Duke University, JFK Medical Center, Johns Hopkins University, the IMF, MIT, and the PGA tour.

Products and Services

Bright Horizons provides center-based child care, early education, back-up care (serving parents when their primary care options are unavailable), elementary schools, before and after-school programs, summer camps, vacation care, and work/life consulting services.

Center Economics

The company utilizes two business models under which it manages its centers, the management cost-plus model and the profit and loss model. Each client contract is individually negotiated but generally fits within these two structures. Under both models, Bright Horizons is fully responsible for all aspects of operating the center, including the hiring and paying of employees, contracting with vendors, purchasing supplies, and collections.

The Management (Cost-Plus) Model

Centers operating under the Cost-Plus model represent approximately 40% of Bright Horizons' centers. Under the Cost-Plus model the company receives a management fee from a corporate sponsor, and an operating subsidy to supplement tuition based on an agreed upon budget and center capacity. The sponsor typically pays for all start-up and maintenance costs while BFAM is responsible for staffing the center, maintaining quality standards, implementing the curriculum, and interaction with parents. Contracts typically range between one and five years and in some cases can be terminated without financial penalty.

The Profit and Loss Model

Profit and Loss (P&L) centers represent approximately 60% of Bright Horizons' centers. Under the "sponsored" P&L model (35% of centers) the company designs and operates a work-site family center in exchange for some form of financial support from the sponsor. The sponsor typically funds the construction of a center and may also provide funds for pre-opening, start-up, and maintenance and repair expenses. Contracts range from three to ten years and in some cases limit the amount of tuition increases.

Centers that operate under the "lease" P&L model (25% of centers) are typically located in a building or office park in order to add to the site's value, thus attracting quality tenants to the developer's site. Bright Horizons usually receives support from the real estate owner in the form of reduced rent or tenant improvement allowances, and contracts range from ten to fifteen years. The company's six elementary schools fall under the "lease" P&L model.

GROWTH STRATEGY

Increased Utilization at Existing Centers – As more new campuses come to maturity (typically centers ramp up in 2-3 years) and mature campuses potentially improve utilization due to rising employment rates average campus utilization should improve. This increasing enrollment should be augmented by consistent 4%-5% price increases every year.

New campus Organic Expansion – The company has historically opened 43-45 net new centers a year (excluding small capacity center acquisitions). In 2004 the company opened 60 centers and closed nine, for a net new center opening of 51. In 2005 we estimate the company will open 62 centers and close 12 centers, for a net center addition of 50. We expect the company to continue on this relative stable new campus addition strategy throughout 2006. However, we note that we do anticipate the average capacity per new center to improve, which should help drive capacity growth at 9.2% in 2005 and 10% in 2006, per our estimates.

Acquisitions – Bright Horizons regularly seeks to acquire existing early education and child care centers to quickly expand into new markets and increase market share. Typically, 30% of the company's new centers each year are added through acquisition. 2004 was an exception with only 25% of the 60 new centers added through acquisition. We believe this percentage should return to 30% as the company pursues additional acquisition opportunities in the US and UK. Of note, management maintains that the typical purchase price of acquisitions is 4x - 6x cash flow.

Contract Takeovers of Preexisting Centers – BFAM strategically seeks to assume control of child care centers previously managed by a corporate sponsor or other child care provider as clients choose to concentrate on their core businesses and/or consolidate the number of providers they do business with. In the past two years, BFAM has “transitioned” more than 40 centers. This strategy gives the company an immediate revenue stream as well as the use of existing facilities with lower start-up costs, such as a shorter ramp up time. Opportunities for contract takeovers have increased in the last few years as clients faced economic difficulties and turned to outsourcing as an answer. Management estimates that there are more than 1,200 centers that would be appropriate for management take-over.

Additional Services – Bright Horizons is actively pursuing new ways to capitalize on its reputation, client base and resources. For example, it has opened six elementary schools that enroll 233 students each. We believe this pilot program has proven successful with site-level operating margins of 20-22%. As a result, we believe the company may expand the program as opportunities arise. The company has also found a new healthy business in providing back-up centers to clients. These centers serve students aged 5 through 12 and act as “back-up” for parents who can’t find childcare at the last minute. BFAM currently has 39 dedicated back up centers in its network.

COMPETITION

There are more than 112,000 licensed childcare centers in the U.S., in addition to many localized home-based facilities. The six largest childcare center chains (Knowledge Learning, Bright Horizons, La Petite Academy, Childtime Learning Centers, Nobel Learning (NASDAQ: NLCI, \$8.80, Not Rated), and Childcare Network) own roughly 4,000 centers, or less than 4% of the center based market. As a result, Bright Horizon’s main competition comes from home-based family child care, small chains of center-based child care (residential & work-site centers), nursery schools, church-affiliated and other non-profit centers, and alternative or less expensive means of child care (nannies, relatives, or the other parent). Although the National Association of the Education of Young Children (NAEYC), the premier accrediting body for childcare centers, only accredits 8% of licensed childcare providers the resulting 9,000 accredited providers does create a large pool of high quality competition. We believe Bright Horizons successfully competes against other high quality operations through its ability to attract and retain qualified staff, which is highly attractive to parents who want consistent caregivers, its attractive centers and its long track record of reliable, successful operations which provides comfort to corporations entering into agreements.

Competitive Advantages

NAYEC Accreditation - The NAYEC is an organization well-known for its high standards of faculty qualification requirements, staff to student ratios, health and safety, and physical environment. While the NAYEC examines the whole program, emphasis is placed on the quality of interactions between staff and children, and the developmental appropriateness of the curriculum. Nearly 80% of Bright Horizons’ US centers have been accredited by the NAEYC, compared to only 8% of licensed centers nationwide.

High-Quality Staff and Retention Rates – The child care industry lacks a large amount of quality workers due to notoriously low salaries. Unlike a majority of child care providers, Bright Horizons has been able to attract highly qualified staff by offering directors a 30% pay-premium to the market and attractive employee benefits. In fact, a typical center director has more than 10 years of child care experience and a college degree in an education-related field. Turnover rates for the company are about 20% for the year, well below the estimated industry average of 50%. The company also offers training programs, and by contract, guarantees its teacher to student ratios will remain at the high end of the range of state approved ratios.

Dynamic Curricula – Bright Horizons uses two different teaching methods (“World at Their Fingertips” and “Montessori”), each placing a strong emphasis on the development of language, math, science, and technology skills in an interactive learning environment. All Bright Horizons schools meet or exceed state or national guidelines, and incorporate in the expectations of the schools that children will be attending in later years, and the goals of the family.

Attractive Care Centers – State-of-the-art centers take advantage of technology for administrative and classroom use. They also offer safe open access to indoor and outdoor play facilities, and can be designed to fit clients’ specific sites and budgets.

MANAGEMENT TEAM

Linda Mason, Chairman, Founder – Ms. Mason and her husband, Roger Brown, founded the company in 1986. She has served as a director of the company since 1998 and as a director and President of Bright Horizons, Inc. from its inception until the merger in 1998.

David Lissy, CEO – Mr. Lissy joined Bright Horizons, Inc. in 1997. He has served as a director of the company since 2001 and as CEO since 2002. Prior to his appointment to CEO, Mr. Lissy served as Chief Development Officer from 1998 to 2002, and Executive VP from 2000 to 2002.

Elizabeth Boland, CFO – Ms. Boland joined Bright Horizons, Inc. in 1997 and served as CFO until the merger in 1998, at which point she was appointed Senior VP of Finance. She resumed her role as CFO in 1999.

Mary Ann Tocio, President and COO – Ms. Tocio joined Bright Horizons, Inc in 1992 as VP and General Manager of Child Care Operations, and was initially appointed COO in 1993. She was appointed President in 2000, has served as a director since 2001, and as COO since inception in 1998.

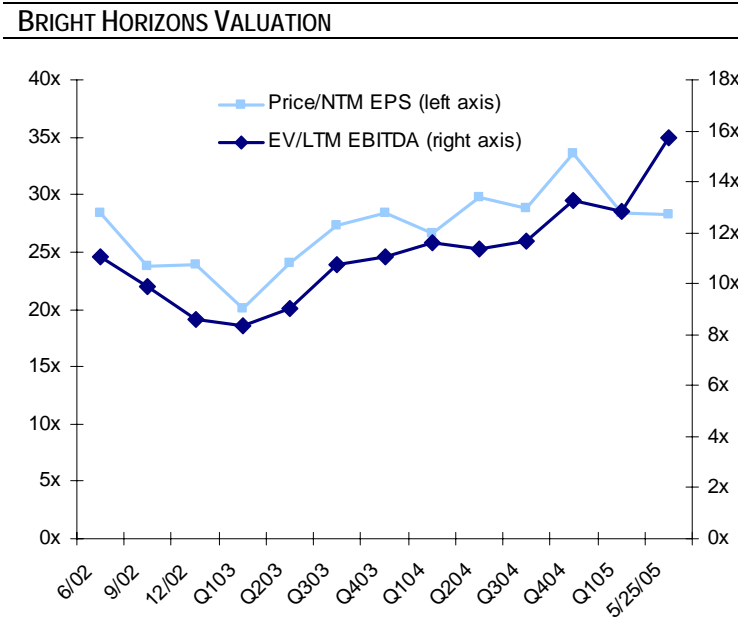
FINANCIAL PERFORMANCE

We are estimating top line growth of 16% in 2005 and 2006 driven by enrollment growth of 10-12% and price per student increases of 4-5%. We are estimating site margins will improve by 70 basis points in 2005 and 30 basis points in 2006, driven by ramp up of new centers, acquisitions, and transitioned centers, as well as a growing average capacity per center and less of a drag from international operations. Of note, Sarbanes-Oxley costs drove up the G&A margin in 2004 to 8.0% from 7.9% in 2003, despite 17% growth in revenue. We expect this cost expansion to level off in 2005 as most of the new costs are cycled out. Looking ahead, we believe the G&A margin should begin to modestly improve as a percent of revenue, to 7.8% in 2006. Overall, we are estimating operating margin improvement of 50-60 basis points a year in 2005 and 2006, which represents a slow down from the 130 basis point improvement in 2004. Our EPS estimate of \$1.22 in FY05 and \$1.47 in FY06 represent growth of 24% and 20%, respectively.

Of note, we have not included our estimates for stock based compensation expense, although the company will be required to expense fair value estimates of the cost starting January 1, 2006.

VALUATION

Bright Horizons shares have climbed more than 180% on a split adjusted basis since January 1, 2003. Much of this impressive appreciation has been related to earnings out-performance, with the company beating estimates and raising future guidance in each of the last nine quarters. However, expectations for future growth (based, in part on an improved outlook of the employer sponsored childcare market) have also considerably expanded valuation multiples. In that time period (Q103 – Q105) the EV/LTM EBITDA multiple expanded from 8.3x to 16x LTM EBITDA currently and the price to NTM EPS multiple is up to 30x from 20x in Q103.



Source: FactSet and ThinkEquity Partners

Although we believe the company has an impressive management team, a highly visible business model with improving profitability it is important to remember that risks still remain. At 30x NTM EPS estimates and a projected EPS growth rate of 25%, we believe the market is pricing in a penny or two of out-performance a quarter for the rest of 2005. For example, if BFAM beats quarterly consensus estimates for the rest of 2005 by 5% (or one to two pennies a quarter (the company has beat the high end of its range of guidance by an average of 2 cents a quarter in the past nine quarters) then the current share price would reflect a PEG of 1.0, or 28x NTM EPS and a 28% EPS growth rate. We believe the market may be correct in assuming the company will continue to out-perform its own expectations, however we believe the 30% average annual growth rate posted in the last three years (up from lower 22% and 17% growth in 2000 and 2001) should taper down to a more normalized 25% level going forward. We believe a slight valuation premium to this growth is warranted given the company's relatively low risk profile and strong recent operating performance. As a result, we believe the company's valuation multiple will revert to its LTM mean of 27x NTM earnings. At 27x our NTM EPS estimate twelve months from now (Q206 through Q107), or \$1.53 per share, BFAM shares would trade at \$41 per share. With 11% upside to our price target we recommend investors accumulate shares upon weakness in the stock.

RISKS TO TARGET PRICE AND INVESTMENT THESIS

Significant risks to our price target include: increased dependence on center acquisitions and take-over contracts, dependence on economy and corporate spending outlook, wage-price growth parity must be closely managed, and an increasingly competitive environment.

Bright Horizons Income Statement (\$Mils.)

Fiscal Year Ends December	2003A				2003A FY	2004A				2004A FY	2005E				2005E FY	2006E				2006E FY
	Mar-03	Jun-03	Sep-03	Dec-03		Mar-04A	Jun-04A	Sep-04	Dec-04		Mar-05A	Jun-05E	Sep-05E	Dec-05E		Mar-06E	Jun-06E	Sep-06E	Dec-06E	
Total revenues	\$112.41	\$117.05	\$118.09	\$125.22	\$472.76	\$131.35	\$136.80	\$138.95	\$144.66	\$551.76	\$150.76	\$159.07	\$161.46	\$170.14	\$641.43	\$176.32	\$187.96	\$185.00	\$195.09	\$744.37
Operating costs & expenses	95.30	99.03	100.18	105.90	400.41	110.41	113.80	116.03	119.58	459.81	123.86	131.45	134.25	140.47	530.03	144.33	154.76	153.27	160.49	612.84
Gross profit	\$17.11	\$18.02	\$17.91	\$19.32	\$72.35	\$20.94	\$23.00	\$22.93	\$25.08	\$91.95	\$26.90	\$27.62	\$27.21	\$29.67	\$111.40	\$31.99	\$33.20	\$31.73	\$34.61	\$131.53
Selling, general & administrative	9.23	9.23	9.12	9.64	37.22	10.29	10.99	10.99	11.92	44.19	12.56	12.62	12.53	13.76	51.47	14.34	14.53	13.99	15.39	58.24
Amortization	0.13	0.09	0.07	0.27	0.55	0.20	0.25	0.35	0.21	1.01	0.38	0.40	0.44	0.47	1.69	0.47	0.47	0.47	0.47	1.90
Operating Income	\$7.75	\$8.70	\$8.72	\$9.41	\$34.58	\$10.45	\$11.77	\$11.58	\$12.95	\$46.75	\$13.97	\$14.60	\$14.24	\$15.43	\$58.24	\$17.18	\$18.20	\$17.27	\$18.74	\$71.39
Interest income (expense)	0.04	0.08	(0.03)	(0.02)	0.06	0.04	0.06	0.07	0.18	0.34	0.23	0.23	0.33	0.35	1.14	0.31	0.40	0.54	0.54	1.79
Non recurring expense																				
Pretax income	\$7.79	\$8.78	\$8.69	\$9.39	\$34.64	\$10.49	\$11.83	\$11.66	\$13.13	\$47.10	\$14.20	\$14.83	\$14.57	\$15.78	\$59.38	\$17.49	\$18.60	\$17.81	\$19.28	\$73.18
Income tax	3.27	3.65	3.64	4.07	14.63	4.38	4.95	4.88	5.56	19.77	5.84	6.15	6.04	6.62	24.64	7.16	7.67	7.34	8.05	30.22
Total net income	\$4.53	\$5.13	\$5.05	\$5.31	\$20.01	\$6.10	\$6.88	\$6.78	\$7.57	\$27.33	\$8.36	\$8.68	\$8.53	\$9.16	\$34.74	\$10.34	\$10.93	\$10.46	\$11.23	\$42.96
EPS	\$0.17	\$0.19	\$0.19	\$0.19	\$0.75	\$0.22	\$0.25	\$0.24	\$0.27	\$0.98	\$0.30	\$0.31	\$0.30	\$0.32	\$1.22	\$0.36	\$0.37	\$0.36	\$0.38	\$1.47
Shares outstanding	26.02	26.48	27.05	27.40	26.75	27.64	27.76	27.88	28.11	27.85	28.20	28.40	28.60	28.80	28.50	29.00	29.20	29.40	29.60	29.30
Operating Metrics:																				
Total number of centers (beg. Q)	465	476	481	487	487	509	515	525	555	555	560	577	589	601	601	610	624	637	649	649
Total capacity	54,870	55,216	55,796	57,515	55,849	59,299	59,998	60,900	61,755	60,488	62,330	64,285	68,619	69,416	66,162	70,455	72,072	74,529	75,284	73,085
Average capacity per center	118	116	116	118	115	117	117	116	111	109	111	111	117	116	110	116	116	117	116	113
% of Revenue																				
Operating costs & expenses	84.8%	84.6%	84.8%	84.6%	84.7%	84.1%	83.2%	83.5%	82.7%	83.3%	82.2%	82.6%	83.1%	82.6%	82.6%	81.9%	82.3%	82.8%	82.3%	82.3%
Gross margin	15.2%	15.4%	15.2%	15.4%	15.3%	15.9%	16.8%	16.5%	17.3%	16.7%	17.8%	17.4%	16.9%	17.4%	17.4%	18.1%	17.7%	17.2%	17.7%	17.7%
Selling, general & administrative	8.2%	7.9%	7.7%	7.7%	7.9%	7.8%	8.0%	7.9%	8.2%	8.0%	8.3%	7.9%	7.8%	8.1%	8.0%	8.1%	7.7%	7.6%	7.9%	7.8%
Operating income	6.9%	7.4%	7.4%	7.5%	7.3%	8.0%	8.6%	8.3%	9.0%	8.5%	9.3%	9.2%	8.8%	9.1%	9.1%	9.7%	9.7%	9.3%	9.6%	9.6%
Pretax income	6.9%	7.5%	7.4%	7.5%	7.3%	8.0%	8.6%	8.4%	9.1%	8.5%	9.4%	9.3%	9.0%	9.3%	9.3%	9.9%	9.9%	9.6%	9.9%	9.8%
Tax rate	41.9%	41.6%	41.9%	43.4%	42.2%	41.8%	41.9%	41.8%	42.3%	42.0%	41.1%	41.5%	41.4%	41.9%	41.5%	40.9%	41.3%	41.2%	41.7%	41.3%
Net income	4.0%	4.4%	4.3%	4.2%	4.2%	4.6%	5.0%	4.9%	5.2%	5.0%	5.5%	5.5%	5.3%	5.4%	5.4%	5.9%	5.8%	5.7%	5.8%	5.8%
Percentage Change (Yr/Yr):																				
Revenues	19.0%	17.1%	12.1%	16.2%	16.0%	16.8%	16.9%	17.7%	15.5%	16.7%	14.8%	16.3%	16.2%	17.6%	16.3%	17.0%	18.2%	14.6%	14.7%	16.0%
Gross profit	20.7%	20.5%	20.0%	21.9%	20.8%	22.4%	27.7%	28.0%	29.9%	27.1%	28.5%	20.1%	18.7%	18.3%	21.2%	18.9%	20.2%	16.6%	16.6%	18.1%
Selling, general & administrative	20.6%	13.3%	7.0%	7.7%	11.9%	11.6%	19.1%	20.5%	23.6%	18.7%	22.0%	14.8%	14.0%	15.5%	16.5%	14.2%	15.2%	11.6%	11.8%	13.2%
Depreciation & Amortization	17.4%	18.9%	-34.3%	189.1%	45.6%	54.7%	179.5%	428.4%	-19.5%	84.3%	89.9%	64.5%	23.9%	121.7%	67.4%	26.2%	17.3%	8.2%	0.0%	12.0%
Operating income	18.9%	27.6%	36.2%	36.6%	29.9%	32.6%	33.9%	31.9%	33.9%	33.1%	31.2%	21.5%	19.3%	17.2%	21.9%	19.8%	21.3%	17.6%	17.8%	19.1%
Pretax income	21.1%	30.0%	37.9%	38.4%	31.9%	34.5%	34.7%	34.2%	39.8%	35.9%	35.4%	25.4%	25.0%	20.2%	26.1%	23.2%	25.4%	22.2%	22.1%	23.2%
Net income	21.8%	29.5%	34.6%	36.5%	30.6%	34.8%	34.2%	34.4%	42.4%	36.6%	37.0%	26.2%	25.9%	21.1%	27.1%	23.6%	25.9%	22.6%	22.6%	23.7%
EPS	30.6%	21.4%	28.0%	29.6%	29.6%	27.2%	26.9%	28.0%	30.4%	38.8%	31.1%	34.3%	23.4%	22.7%	18.2%	24.2%	20.2%	22.4%	19.3%	19.3%

Company Initiation Report

Scientific Learning (NASDAQ: SCIL)
“Scientific Learning at a Crossroad”
Buy Rating
\$8 Price Target

We believe Scientific Learning is at a crossroad. Its products, although effective in developing the cognitive skills necessary to read fluently, are also considered expensive and difficult to implement on a large scale. As a result, sales in the past five years have been largely limited to programs for students with learning disabilities. This market opportunity, although large, lacks the large volume sales necessary to bring the average price per unit down, which we believe would significantly help drive growth overall. With a growing, diverse user base able to be used as references, the company has launched a new, targeted effort to bring its products into the mainstream. We believe current trends in legislation will support this endeavor. If or when this door is opened, we believe the company's unique and effective product line will support strong growth for several years. Our \$8 price target provides upside of 37%.

INVESTMENT POSITIVES

Small Penetration in a Large Market – There are approximately 6.9 million students with disabilities in the United States and only 420,000 enrolled or previously enrolled in SCIL's core Fast ForWord product line, reflecting a market penetration of 6%. The company may be able to effectively double its potential market size to include the 10-20 million struggling school-aged readers in the United States if it is effective at moving its products into the mainstream reading intervention market.

A Uniquely Positioned, Research-Based Product – Scientific Learning's Fast ForWord product line attempts to help struggling students learn to read fluently by “remapping” the brain. More than 600 independent studies have shown efficacy of the products among various student groups. For example, Stanford University released a study in 2000 that found improved (i.e., more normal) brain patterns in student readers with dyslexia after using Fast ForWord. We believe third-party validation from prestigious institutions and researchers such as this have considerable value in winning deals with large school districts. Once large, “early adopter” deals are won and demonstrate success in real world environments, a much larger customer base that depends more on referrals than academic studies has the potential to open up to the company. This step will allow the company to reach true critical mass. Although competition in the general K12 reading product market is fierce, very few can lean on this type of research-based validation. In addition, Fast ForWord can and is often used along with other reading aid products, allowing Scientific Learning to strategically accompany, rather than always compete head to head with, other providers. We believe Fast ForWord occupies a much-less crowded corner in this market and has the ability to approach the broader market with a unique offering.

Converging Forces Create Opportunity To Move Products More Mainstream – We believe the key to this company's large-scale success is its ability to move the Fast ForWord product line into the mainstream reading intervention market. With the tremendous political emphasis and targeted funding pools to help the literacy problem in U.S. public schools (approximately 40% of U.S. school students read below grade level), Scientific Learning's products appear ideally positioned. However, since its inception, the company has been effectively locked out of mainstream dollars for reading intervention. *We believe a combination of*

shifting market conditions and a targeted new company strategy makes success of this long sought after goal increasingly likely. These include:

1. Newly restructured and more-permissive funding paths (IDEA and Title 1) should allow schools to have more options for funding Fast ForWord for use in mainstream classrooms.
2. Respected industry researchers from influential institutions (such as University of Texas, University of Florida, and University of Washington) are increasingly voicing support for the value of FF products when used by struggling readers without major disabilities (i.e., mainstream reading intervention). Support from the academic community can often break down barriers to entry and be an impetus for wide-scale adoption of products in the K12 market.
3. As the company's influential customer base grows (e.g., Philadelphia, Dallas, Miami-Dade), so should its ability to capture new "referral" customers, which represent the largest part of the market. We believe the company is close to reaching a complete array of different customer types (size, region, focus, etc.) which should provide applicable successful stories to use in selling to new customers.
4. Schools and districts are placing a heightened value on "research based" products in response to stipulations of the federal government's No Child Left Behind Act (NCLB), passed in January 2002.
5. Increased assessment in schools (also magnified by NCLB) has created a more results-based environment that should open doors for products that effectively improve scores, but are based on less-traditional learning theories. We believe the chief theoretical barrier to widespread school acceptance has been convincing schools that reading problems should be addressed with two steps (developing cognitive skills and, then, reading instruction) as opposed to reading instruction alone. Score results should alleviate theoretical concerns.
6. Management is ramping up its marketing efforts to bring the products more mainstream by using new strategies (executive forums, user conference, etc.) and branding efforts. Attendance at the annual user conference was up 47% in 2005 and the company plans to increase its executive forums from 6 in 2004 to 9 in 2005.
7. The missing piece of the product line may be an assessment element that is norm referenced and standards based. We believe if the company can keep its products interoperable with the leading assessment packages in schools today, and/or build or buy an assessment offering of its own, then it will be able to more accurately fit the needs of NCLB.

	Barriers to Mainstream Use	Catalysts for Mainstream Use
Product perception	Product has been perceived as a niche product for disabled learners – third-party studies previously focused on use with learning disabled students.	As large districts buy products for use with mainstream students, and as research is released supporting the value of the products with mainstream readers, this image is changing.
Pricing	At a list price of \$85,000 buyers may have sticker shock. In addition, the product can't be sold to principals, who typically only make spending decisions up to \$50,000.	As the company makes more high-volume sales it is lowering its average price per unit (list price is at \$85,000 but average full license sale is \$50,000-\$60,000 due to volume discounts).
Ease of Implementation	Product is innovative but not simple to implement - it requires changing a teacher's daily schedule and curriculum.	Newer protocol (50-minute sessions) makes implementation easier
Management turnover	Change in management in 2002 – the current team is experienced, but still has only had two years at the company.	As management is able to focus on the business, rather than the financial reporting, we believe significant change could emerge.
Funding Options	IDEA and Title 1 are largest funding source. IDEA dollars are traditionally only used for students with disabilities - a niche market	Recent changes to IDEA legislation should allow for use of dollars in the mainstream reading market
Theoretical Debate	Curriculum coordinators may not have historically considered reading a two-step process: building a foundation and then teaching how to read	A results-based environment driven by accountability measures should focus attention on a product's link to improved test scores, regardless of theory

Source: *ThinkEquity Partners*

Increase in Large Deals is Evidence of Products Moving Mainstream – The company is ramping up a marketing campaign in 2005 to convince schools and researchers that its products are appropriate for use among students without disabilities. We believe the increase in large-scale, wide distribution deals, such as Philadelphia, Dallas and Cumberland County, which include purchases for use across multiple grade and ability levels (including use with “normal” students) reflects initial success in this initiative. The company closed 66 deals in 2004 above the \$100,000 mark, compared to 59 deals closed in 2003. We will be looking for the company to continue to close an increasing number of large-scale, broad-reaching deals as evidence of continued success in this initiative.

New Funding Opportunity From Recent Changes to IDEA – We estimate more than one-third of SCIL's revenue comes from federal Individual with Disabilities Education Act (IDEA) dollars, although the breakout of revenue sources is difficult to determine. IDEA, first passed in 1975, seeks to ensure that students with disabilities receive “free and appropriate” education, by providing additional funding for the education of these students. IDEA funding has seen substantial increases in the past decade, increasing to \$11 billion in 2005 from \$2 billion in 1996. President Bush's proposal for FY06 funding includes an increase of 5% in IDEA funds. The funding pool is estimated to reach more than 6.7 million students annually. Congress recently renewed the act (in November 2004) and initiated changes to the legislation for the first time in seven years (since 1997). **We believe these changes include an important new opportunity for SCIL.** Specifically, the language in the new IDEA legislation allows for up to 15% of IDEA funds to be used for use with “normal” students for the purpose of prevention and appropriate identification of students with disabilities. We believe this shift should help SCIL move its products further into the mainstream reading intervention market. With regular schools soon able to capture IDEA funds, the Fast ForWord family of products has the opportunity to establish more beachheads in normal school environments. Management portends that in addition to being effective with students with disabilities (6.9 million students), its products are also of high value when used by “normal,” struggling readers (10-20 million students). Although these changes were enacted in November, it should take some time to flow through to purchasing decisions in schools. We would anticipate that the 2005-2006 back-to-school buying season (Q3 and Q4) could reflect

some of these new purchases, with 2H06 reflecting an even larger impact. Overall, this legislative change should help enable SCIL in its efforts to move more mainstream.

Title 1 Funding a Solid Long-Term Source of Funds– Title 1 dollars are federal funds designated for low income students (or “reduced fee lunch” students). Currently SCIL receives the bulk of its funding sources from IDEA and Title 1 dollars. Title 1 funds have increased 14% over the past three years to \$13.3 billion. This increase in funding may be further assessable to SCIL going forward, as new language allows for the use of Title 1 dollars for all students in schools receiving the funding (so not specifically for the Title 1 students).

Second Half of 2005 Should be Robust – We believe the second half of 2005 will be strong for several reasons. Not only do we expect the overall K12 funding environment to improve in 2H05 (driven by higher FY06 budgets set in June), we also expect specific funding pools used by SCIL (IDEA and Title 1) to include more opportunities for sales to mainstream students. In addition, the company expects to increase its sales force (to 37 from 28, a capacity increase of more than 30%) and have a wider product line to sell (three new products are expected to be introduced in the next two quarters). Finally, prior year comparisons should be easier due to the unusually light 2H04 resulting from the Hurricanes in the Southeast (hurricanes occurred in Q304 but spending was still not up to speed in Q404). In contrast, 2Q05 will likely look anemic on a comparative basis due to the unusually high 2Q04 resulting from the \$6 million in revenue from the Philadelphia contract and a positive impact of the company's product protocol adjustment to 50-minute sessions (down from 100-minute sessions). In addition, some revenue (and booked sales) from large deals may be pushed into Q305 from Q205 as the company will wait to ship (and recognize) large deals until its product launch of FF5, scheduled for Q305.

Expanding Sales Force and Product Line– Throughout 2004, the company employed approximately 28 sales reps on average and ended the year with 32 (and four regional managers). Management expects to employ an average of 37 reps in 2005. This level of expansion will require significant upfront expenditures but should, ultimately, drive sales and profitability. Of note, of the current sales force, we estimate that 18-20 have more than three years of experience at the company. As the total forces grows, the average tenure of the sales force will diminish, which may mitigate the impact of management's ability to improve productivity in the near term. Our FY05 booked sales estimate of \$46 million does not include any assumption of improved sales force productivity, despite the fact that the company improved productivity to \$1.3 million per rep in 2004, up from \$1 million per rep in 2003. The company also plans to introduce three new products in 2005 (vs. two in each of the last fiscal years). In 2004, the entire potential product suite sale (with no discounts) amounted to \$85,000; in 2005 it should amount to \$100,000. Of note, the average actual full license sale was closer to \$60,000 in 2004 and the average sale per school was \$26,000.

Ancillary Market Sales Could Contribute to Revenue Growth in 2005 and 2006 – The company's historical market was sales to private professionals and clinics, rather than to K12 schools. In order to gain volume and tap a larger market, the company shifted its focus to K12 schools and districts. Meanwhile, the economic recession stymied growth in the private professional end-market. As a result, from 1999 to 2003 non K12 sales declined, both in absolute terms and as a percentage of sales. In 2004, however, non-K12 sales picked up, growing 8%, as the company's reputation grew and disposable consumer income increased. Going forward a new focus on adult and correctional markets (new marketing efforts and sales efforts will target these segments) as well as continued economic health in the private professional market may allow the non-K12 revenue stream to contribute to overall sales growth at a moderate rate. We estimate top-line growth of 5% in this segment in 2005 and 2006.

Secure Financial Position Offers Flexibility – With no debt and \$10.3 million in cash, we believe the company stands in an adequately healthy financial position. We expect the company to generate \$8 million in free cash flow in 2005 (up from \$6.1 million in 2004) and end the year with an even more improved \$21

million in net cash. We do not believe it is outside of the realm of possibility that the company would conduct an acquisition, such as an assessment product.

INVESTMENT NEGATIVES

Product Protocol is Difficult to For Schools to Follow – We believe that in spite of what are impressive research-based results, the Fast ForWord product line has remained out of the mainstream market due, in part, to its difficult protocol. The majority of teachers are crunched for time and want simplicity. However, the successful use of FF products take consistent, focused student attention for the product to work. The Fast ForWord product requires 48-50 minutes of student time on a computer, five days a week for two to three months. For middle and high school students, this may mean an entire course must be substituted for Fast ForWord. For elementary school students this means teachers must handle difficult scheduling conflicts. This can seem like an overwhelming burden to a teacher trying to juggle schedules and book students in computer labs with limited space. In addition, teachers must closely monitor and help implement the program correctly to gain the desired results, which requires additional professional training that they may not be able or willing to commit to. We believe this barrier to implementation has kept a strong grassroots following from emerging, despite widespread student outcome success at locations where the products are already used. **Although reducing the protocol to 50-minute sessions from 100-minute sessions (introduced in summer 2004) greatly improved implementation problems in schools (almost all customers now use the 50-minute sessions) we do not believe the company will be able to further reduce its required session time without sacrificing efficacy.** As a result, to further break through the barrier of difficult protocol, the company is conducting more user group meetings and conferences to encourage teacher support, along with its increased efforts to reach district decision makers.

Reputation as a Special Needs Only Product May be Difficult to Break – We believe the product's reputation as a last resort for students with special needs will be difficult break. The space and time issue may inhibit use with mainstream students. In addition, the bulk of "referral schools," the current user base which has had success with the product in schools, are still schools that use the product mainly for special needs students. We believe the only real way for the company to cross this road into the mainstream market is to close more large contracts that include use with mainstream struggling readers. Recent success in this area, such as the Cumberland and Miami-Dade contracts closed in Q404, will eventually build a reputation for the company that its products work in real-life application for mainstream students. However, time and effort is required to get the message fully conveyed to new potential customers.

Management Needs To Rebuild Credibility – Following several quarters of delayed and restated earnings, we believe Management needs to report several clean, straightforward quarters to gain credibility with the Street. In addition to reporting practices, one of the company's recent large-scale product launches, (FF Gateway edition in 2003) experienced several key delays and technical errors in its initial applications, which negatively impacted Q403. New field test procedures and automatic update features (as opposed to downloadable CDs that may conflict with internal security walls) promise to prevent this type of problem happening again. Another round of new editions of FF Gateway is expected to be introduced in 2Q, along with two new FF product launches. We believe that if/when management launches its three new product lines in FY05 on schedule and with no major implementation issues, it will go a long way in regaining investor and customer confidence.

Low Visibility To Quarterly Sales Due To The Lengthening Sales Cycle – Similar to many other K12 technology vendors today, Scientific Learning is increasingly targeting large, district-wide sales. We believe the point of sale for K12 technology is rising across the country as district CIOs are hired and technology

purchasing is rationalized at higher levels. Although this creates large revenue opportunities, it also effectively lengthens what was already an extremely long sales cycle. We estimate that for sales over \$1 million, the cycle averages between 12 and 18 months. For smaller sales, the typical cycle approximates six months. The effect of this cycle makes quarterly visibility limited. In addition, it becomes more difficult for management to allocate resources efficiently. Normal seasonal trends dictate that the second and third quarters of the year are the largest. However, large purchases may be booked, but not recognized for several quarters as the company waits to deliver its orders until all new products are launched.

Sales Team Expansion May Weigh on the Cost Structure – SCIL is planning to expand its sales force from an average of 28 in 2004 to 37 in 2005. This is a considerable ramp up given that the company has maintained an average sales team of 28 for the last three years. Although we believe this will be a positive driver of revenue and booked sales, it will probably also impact sales productivity. Currently, 60% of the sales force has more than three years experience at SCIL, which allows for a highly productive sales force. SCIL products are unique, somewhat complicated, and the company is attempting to change its products' image. We believe these factors put a heavy requirement on the sales force and may lengthen the average ramp-up time for new employees, thereby, weighing on the cost structure for a period of time before related sales are booked.

Strong 2004 Sales Growth Was Largely Due to One Sale – The company's \$10 million sale to Philadelphia (\$6 million recorded in 2004 with \$4 million deferred) boosted booked sales growth to 24% for the year. Without that sale, growth would have been a meager 1.8%. Of course, it is impossible to quantify the opportunity cost of Philadelphia; sales and management focus may have brought in significant sales elsewhere if it had been available. However, we still note the dependence of 2004's performance on a large one-time sales event. Of note, Philadelphia's 2Q order was large enough to merit a separate company announcement in the quarter in which the sale was booked. Going forward, we do not believe management will announce large scale deals during the quarter unless they reach a level approximating this deal (i.e., \$5-\$10 million in revenue).

Large Reading Product Funding Pool Still out of Reach - Reading First dollars were first initiated in 2002 when the Bush Administration reauthorized the federal Elementary Secondary Education Act (ESEA) under the name No Child Left Behind (NCLB). The chief goal of the legislation is for all student subgroups to reach reading and math proficiency by the year 2014. To accomplish this goal, the legislation introduced several measures of accountability in schools but, also increased federal support for K12 education by more than 40%. A significant piece of this new funding pool, \$2 billion, was specified for reading initiatives. Although SCIL's products assist students with reading problems in reaching proficiency, they have not yet been considered appropriate for Reading First dollars by most school systems. The Fast ForWord product line is not an instructional reading product, but rather a more fundamental learning tool that seeks to lay the framework from which students learn to read. As a result, the company has been more or less shut out of Reading First dollars. Although the potential exists for the company to start capturing Reading First money as it moves the perception of its products more mainstream, we believe this should not be considered a significant new opportunity in the short run. The company's practice of pairing up with other vendors which do provide more direct learn-to-read instructional products (such as Voyager and Scholastic's Read 180) will likely maintain its reputation as a more foundational and/or specialized cognitive skills product.

FY05 Estimates Are Back-End Loaded; No Near Term Catalyst - Although we are seeing signs that the Fast ForWord products are successfully becoming more mainstream reading tools, we do not believe 1H05 will amount to impressive performance. The company views 2005 as a year of change and will be willing to ramp up expenses if it gets extra room to beat estimates on the top line. From 2002-2004 management focused on keeping costs in check while growing revenue to establish profitability. In 2005, however, the company is ramping up spending in multiple areas as it invests in future growth. Although this is promising for the long-term prospects of the company, the real benefits from these initiatives won't be immediately

visible. As a result, we do not see significant upside until 2H05 or even FY06, when we believe larger deal flow may start appearing in reported metrics.

COMPANY DESCRIPTION

Scientific Learning is an education software company selling into K12 schools, private clinics, and correctional institutions. The company's core product line, Fast ForWord (FF), is a series of products intended to build the cognitive skills underlying the ability to read and write fluently. Students use the product typically in 50-minute sessions for 4 to 12 weeks. The company plans to introduce three new products in FY05: Fast ForWord Language Basics (aimed at 4-7 year olds) and Fast ForWord to Reading Prep (aimed at K) in Q2 and Fast ForWord to Reading 5 (aimed at middle and high school) in Q3.

PRODUCTS & SERVICES

Scientific Learning's products under the Fast ForWord brand require the use of between 50 and 100 minutes a day, five days a week. The 50-minute session products require daily use for a period of eight to 12 weeks, while the 100-minute session products require daily use for a period of four to eight weeks. In 2004, the Fast ForWord family of products accounted for 72% of revenue with the remainder coming from services and smaller, ancillary products.

Main Products and Services

Fast ForWord Language – is the first stage of the family of products. The product includes exercises that focus on developing the prerequisites for reading, including oral language comprehension, listening skills and working memory.

Fast ForWord Middle & High School – has a similar use as Fast ForWord Language, but is designed for adolescents and teenagers who lack reading proficiency. The exercises are similar to Fast ForWord Language but contain graphics and an interface better suited for older students.

Fast ForWord Language to Reading – helps students make the link between spoken language and written language.

Fast ForWord to Reading Series (1, 2, 3, and 4) – builds essential reading skills such as vocabulary, fluency, and comprehension. Each product corresponds to the grade level reading standards. The company plans to introduce Fast ForWord to Reading Prep (for kindergarten students) in 2Q05 and Fast ForWord to Reading 5 in 3Q05.

Progress Tracker – Progress Tracker is an optional remote progress tracking system that is offered with all of the main products. Schools upload data to a server hosted at Scientific Learning, and the company provides data analysis feedback to the schools. In addition to being an important tool for customers to keep track of attendance and progress data, the data base is highly useful to the company in its own future product development and strategic decision making. Of note, the data is not public and, therefore, is not and cannot be used as a marketing tool. More than 95% of the company's customers use Progress Tracker.

Other Products & Services

Fast ForWord Language Basics – is targeted to children 4-7 years old and is used as a precursor to Fast ForWord Language. This product is expected to replace **Fast ForWord Basics** in 2Q05.

Fast ForWord Bookshelf – is an early reading kit that includes a set of books and CDs to help students practice reading.

Reading Edge – is an assessment tool for K-2 students.

BrainConnection - Online courses about the brain and learning, designed especially for educators.

MARKET POSITION

At first glance, Scientific Learning may look like one of more than 1,000 companies selling reading software into schools. However, the company's market position is much more defined. SCIL's core product line, Fast ForWord, is considered by the research community and customers alike to be a highly differentiated product offering. In essence, Fast ForWord seeks to build the critical cognitive skills that are the foundation of reading and communication, rather than actual reading instruction. These targeted skills include building attention, working memory, processing speed, and sequencing abilities which have been shown in multiple studies to be the foundation for fluent reading. Again, the products do not actually teach a student to read. As a result, the company and the market place often pair the Fast ForWord products with other vendors' reading instruction products. This puts the company in a unique position of being compatible with a school's existing reading software products, rather than redundant, which keeps the market wide open for new sales. Examples of the major reading instruction products in the market today include Scholastic's Read 180, ProQuest's Voyager, Pearson's Waterford and Renaissance Learning's Accelerated Reader.

Sales Channels

K12 schools and districts- The company's core FF products are generally targeted at district-level decision makers for use in elementary schools. However, some of its products are targeted for use in middle and high schools. Although these products may require sales reps to contact additional points of sale, they also open up new opportunities. In general, selling K12 technology products into middle and high schools is a less time-intensive process as the higher grade schools generally have fewer levels of approval and retain a greater degree of autonomy in purchasing decisions.

Private clinics (speech and language professionals), hospitals, clinics – This segment declined from 1999 to 2003 as the company focused its sales efforts on the K12 market. However, with the improved economy and consumer spending, the company posted some growth (up 8%) in this revenue segment in 2004. In addition, several of the company's new products are a good fit with this group of buyers.

Correctional and adult market – The company recently expanded its sales force to include reps focused on this market sub-segment. Inside (or telesales) reps may pave inroads into this market.

Competitive Environment

Scientific Learning's products are uniquely positioned in the market as learning software that actually attempts to "re-map" the brain in a way that makes learning to read easier. Most reading products on the market today use more traditional approaches to learning to read (such as phonics) and are, therefore, more easily recognized and incorporated into existing curriculums. Of importance, SCIL's products are often purchased and used along with other more conventional reading products, such as Renaissance Learning's (NASDAQ: RLRN, \$20.04, Not Rated) Accelerated Reader, ProQuest's (NYSE: PQE, \$32.85, Not Rated)

Voyager, and Scholastic's (NASDAQ: SCHL, \$37.13, Accumulate, PT: \$35) Read 180. As a result, they are only competition in the respect that they can be competing for the same dollars in limited budgets. The only other major product on the market that also attempts to build foundational reading skills using cognitive research is Earobics, offered by Cognitive Concepts (owned by Houghton Mifflin). However, the Fast ForWord product line is generally considered more comprehensive and more effective.

GROWTH STRATEGY

1) Gaining acceptance as a mainstream reading product. The company has initiated several new marketing strategies to increase the acceptance of its products into the mainstream reading intervention market (struggling readers without major impairments). These include:

- Hosting executive forums. Management expects to host nine in 2005, up from six in 2004 and three in 2003. In these meetings, generally 150-200 superintendents meet for the day to listen to scientists and company reps about the use and success of Fast ForWord.
- Advisory board members (ex-superintendents or former education leaders with no other affiliation to SCIL) and company scientists speak at major industry conferences.
- The company now hosts a national reference program where customers and potential customers can interact and share ideas. We believe this type of user conference will help generate ground-level support from teachers. Teacher support can be critical to the actual success of a product, as teachers often resist technology or change pushed on them from the top down.

2) Increasing size and productivity of sales force – SCIL had average sales of \$1.3 million per sales person in 2004, up from \$1.1 million in 2003. The company is also working on expanding its sales force from an average of 28 direct reps in 2004 to 37 in 2005. As of March 30, 2005, the company employed 35 direct reps. The company is also ramping up initiatives to improve its marketing, with sales and marketing costs up 860 basis points in 2004. We expect S&M costs to grow close to 50% in 2005, as management continues to build out its sales force and increase marketing initiatives.

3) Building research base differentiation. SCIL has more than 600 independent studies published that support the efficacy of its Fast ForWord products. As more schools and districts use the products and publish their results there should

4) Expanding Product Offering – the company plans to introduce three new products in 2005, Fast ForWord Language Basics (aimed at 4-7 year olds), Fast ForWord to Reading Prep (aimed at K) and Fast ForWord to Reading 5 (aimed at middle and high school). Without these products, the largest potential sale to a district is \$85,000. With the three new products, the total potential sale is \$100,000 (not including ongoing service and Progress Tracker revenue).

MANAGEMENT TEAM

Scientific Learning's management team was restructured in 2002 when Bob Bowen, the company's CEO, was hired. Mr. Bowen was formerly the president of National Computer Systems, which is now a part of Pearson Corporation. Prior to that, he served as Senior Vice President of McGraw Hill's. Education and Training group, which included seven divisions with revenue of roughly \$350 million. Mr. Bowen filled out his management team with other former NCS personnel, including the Head of Sales, Chief Education Officer, Vice President of Operations and the Head of Business Development. The company's CFO, Jane Freeman,

also joined the company in 2002 following a 20-plus year career in business and finance. We believe the company's results should begin to reflect the depth of its current team in the next few years.

FINANCIAL PERFORMANCE

A change in accounting and a change in product pricing (at FY04 end) will inflate FY05 revenue and deflate FY06 revenue, in our opinion. As a result, we believe it is important to also track the actual value of sales booked in the quarter (a reported company metric), which should not be affected by varying revenue recognition schedules. FY05 revenue should be a higher percentage of booked sales than in prior years due to the change in accounting and a heavy deferred revenue balance (resulting from the large Philadelphia contract) that will flow through the income statement. We are estimating that the robust FY05 revenue growth will mitigate in FY06 as the effects of the accounting changes have cycled through. Our estimate for FY05 revenue is \$48 million (vs. guidance of \$46-\$49 million), or growth of 55%, which includes \$5 million in extra revenue related to the change in accounting. We estimate booked sales of \$46 million in FY05 (vs. guidance of \$44-\$47 million), up 24% for the year. Of note, our FY05 sales estimate does not include any assumption of improved sales force productivity. If the 32 reps at FY04 end pull in \$1.3 million each (the average sale per rep in 04) and the five new reps produce \$800,000 each (the typical first year performance of a rep) then the company will post \$46 million in sales.

Gross Margins – The gross margin declined 200 basis points in 2004 due to a sales mix shift toward lower-margin service sales. However, the service and product gross margins each improved by 1040 bps and 90 bps, respectively. Looking forward, we estimate that volume discounts in product revenue will weigh on the product cost margin, although we still anticipate an improvement of 10 basis points in the product revenue GM line in 2005 due to leverage over fixed amortization costs. Service revenue is not discounted, so the company should see strong 220 basis point increase in the service gross margin line in 2005. Product revenue should increase as a percent of total sales in 2005 as the change in pricing left a considerable amount of sales booked in 2004 to be recorded in 2005. In 2006, the revenue mix should return to its normal shift to include more service revenue. Overall, we anticipate the blended gross margin to improve 90 basis points to 79.1% of revenue in 2005 and 20 basis points to 79.3% in 2006.

Operating Costs – Operating costs were up 19% in 2004, excluding \$550,000 in nonrecurring costs recorded in G&A associated with the restatement. We estimate that operating expenses should increase 28% in 2005 as management ramps up sales and marketing spending and R&D. Included in these costs is a \$1.5 million estimate for expected stock option expense costs that may not be recognized depending on the company's discretion.

EPS - We are estimating net income of \$6.1 million in 2005 (versus guidance of \$6.2-\$6.8M) and EPS of \$0.34 (versus guidance of \$0.34-\$0.37 in EPS. Our estimates assume a 2% Alternative Minimum Tax only and include an assumption for option expense cost of \$1.5 million.

Revenue versus Booked Sales Accounting - As the company targets higher-level sales, it is likely to receive a larger percentage of sales from large, multi-year contracts. The Progress Tracker element of this sale will be recorded over the length of the contract (which will draw out related revenue over a longer time horizon); however, the perpetual license fee for the software will be recognized upon delivery. We believe this change will exaggerate the normal seasonality of the business, making Q3 and Q4 stronger than normal quarters. However, as the percentage of larger, longer-term contracts grow near term profitability may improve.

Early Adoption of Stock-Based Compensation – Management guidance for FY05 includes an assumption of \$1.5 million in costs associated with expensing options. Management has noted that even if it

doesn't have to expense the \$1.5 million in stock-based compensation for the year, it may use the extra room in its expense structure to invest in new initiatives. As a result, we believe management's decision to include options expense in its FY05 guidance (regardless of the requirement) is reflective of its business prospects.

Sarbanes-Oxley 404 Expenses Unknown - If the company's shares are trading below \$10.50 at July end, it will not have to officially expense options until FY06. In this case, the company will still spend money in 1H05 to become compliant (approximately \$200,000 a quarter is budgeted), then may have the option of pulling back expenses somewhat in 2H05. As a result, if the stock remains below \$10.50 before July the company may have \$400,000 upside to current guidance and estimates. Either way, the internal controls necessary to comply with SOX 404 should be in place by 2005 end.

Cash Flow: FY04 cash flow was negatively impacted by a \$1.7 million in costs related to the restructuring. FY05 should include a \$3.7 million one-time benefit from the repayment of an outstanding loan due in Q405. CapEx should be up slightly in FY05 from FY04.

VALUATION

DCF - Based on our five year DCF analysis we arrive at a target price of \$8.00. Using a 12% discount rate, an annualized free cash flow (CFO less capital expenditures) growth rate of 25%, and a terminal value of 7x our 2010 FCF estimate of \$24.2 million shares are worth \$8.

TEV/EBITDA - Due to the volatility of past (negative) earnings and the company's potential for growth we are also considering valuation on TEV/ NTM EBITDA basis. Scientific Learning is currently trading at 13x our TEV/ FY05 EBITDA estimate. At 13x our TEV/ FY06 EBITDA estimate, shares would be valued at \$8 per share. For a company growing at 35+% with operating margins potentially in the mid-teens, we believe a multiple of 13x TEV/NTM EBITDA is justified. Our price target of \$8.00 offers 37% upside from current levels.

KEY INVESTMENT RISKS

Product Launches May be Delayed or Unpopular - The company is planning to launch three new products in FY05: Fast ForWord Language Basics (aimed at 4-7 year olds) and Fast ForWord to Reading Prep (aimed at K) in Q2 and Fast ForWord to Reading 5 (aimed at middle and high school) in Q3. Any delay in these launches may impact recognition of large deals in Q3 and Q4. Specifically, deals which include multiple levels of FF which include FF5 must wait for FF5 to launch before any of the purchase can be delivered and recorded as revenue. As a result, a delay in FF5 could affect more than just FF5 sales. In addition, the company has a limited history of launching new products. A recent launch in 2003 of Fast ForWord Gateway Edition, which updated the entire FF product line, was marred by a technical glitch which caused the company to delay the launch and lose sales in Q403.

Sarbanes-Oxley 404 May Need to be Implemented in 2005- Management does not yet know whether it will have to comply with the internal controls measure of the Sarbanes-Oxley Act by 2005 end or 2006 end. The decision will be effected by the company's stock price. It has incorporated its estimate of what those costs would be in guidance; however, we believe the management mindshare (opportunity cost) and

additional costs may surpass management's estimate. In our experience watching companies of SCIL's size react to SOX requirements, the expenses have been hard to target and often exceed initial estimates.

Recent Restatement Creates a Risk of Lawsuits and an SEC Investigation – Scientific Learning recently restated its results as a public company following a change in accounting. The restatement itself cost the company more than \$500,000 and caused management to delay reported earnings three times. SEC investigations are common following restatements and lawsuits of this nature. Although we do not believe there is a basis for impropriety related to the restatements, we also believe an SEC investigation would negatively impact the stock.

Heavy inside ownership and Low Float – Currently, 60% of the company's shares are held by company insiders (executives and affiliates) and the venture capital firm Warburg Pincus (46% ownership). Although this positively aligns management's interests to shareholders, it also creates a limited float and low average trading volume of 9,000 in the past three months.

Seasonality of reported revenue may be exacerbated by a change in reporting - The company is no longer recognizing product revenue ratably over a 12-month period, but is instead recognizing it upon delivery. This will cause the company's seasonally heavy quarters (2H) to be heavier and its seasonally light quarters (1H) to be lighter. This effectively backend loads the year even more than it has been in the past and decreases investor visibility to the year. We believe it is important to remain focused on the booked sales number which should more appropriately reflect true buying patterns.

Scientific Learning Balance Sheet (\$000's)

Fiscal Year Ends December	2003A FY	2004A				2004A FY	2005E				2005E FY	2006E				2006E FY
		Mar-04A	Jun-04A	Sep-04A	Dec-04A		Mar-05E	Jun-05E	Sep-05E	Dec-05E		Mar-06E	Jun-06E	Sep-06E	Dec-06E	
Current Assets:																
Cash and cash equivalents	3,648	3,089	4,438	10,286	10,281	10,281	14,500	11,416	14,513	21,153	21,153	22,810	22,250	27,360	31,936	31,936
Investments in government securities	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Accounts receivable, net	5,117	4,494	15,760	5,094	5,661	5,661	3,335	5,660	4,874	5,523	5,523	4,336	6,905	5,947	6,739	6,739
Notes & Int Receivable	-	-	-	-	3,688	3,688	3,688	3,688	3,688	-	-	-	-	-	-	-
Prepaid & other current assets	1,144	1,207	955	1,324	1,306	1,306	1,000	1,249	1,718	1,491	1,491	1,076	1,237	1,771	1,514	1,514
Total Current Assets:	9,909	8,790	21,153	16,704	20,936	20,936	22,523	22,013	24,793	28,168	28,168	28,222	30,392	35,078	40,188	40,188
IPO costs	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Restricted cash deposit	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Property & equipment, net	-	-	-	-	-	-	-	-	-	3,688	3,688	-	-	-	-	-
Loans to current and former officers	3,533	3,114	3,114	3,114	-	-	-	-	-	-	-	-	-	-	-	-
Other assets	1,618	1,985	1,940	1,908	1,267	1,267	1,753	3,581	3,410	2,039	2,039	1,957	3,934	3,867	2,289	2,289
Total Assets	\$15,597	\$14,461	\$26,892	\$22,471	\$22,958	\$22,958	\$24,985	\$26,295	\$29,104	\$31,074	\$31,074	\$31,014	\$35,160	\$40,029	\$43,525	\$43,525
Current Liabilities:																
Accounts payable	481	456	661	657	603	603	380	1,178	1,130	921	921	423	1,287	1,268	1,022	1,022
Accrued liabilities	3,875	2,973	3,406	2,999	4,338	4,338	2,477	6,068	5,158	6,626	6,626	2,758	6,633	5,790	7,349	7,349
Deferred revenue	16,884	14,128	15,548	14,883	15,079	15,079	20,047	13,901	14,104	14,028	14,028	19,028	14,251	15,168	15,799	15,799
Current portion of borrowings	-	2,600	3,000	-	-	-	-	-	-	-	-	-	-	-	-	-
Current portion of capital lease obligations	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Current Liabilities	21,240	20,157	22,615	18,539	20,020	20,020	22,904	21,147	20,391	21,575	21,575	22,209	22,171	22,227	24,170	24,170
Borrowings under bank line of credit	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Deferred revenue, long term	2,616	2,726	11,990	10,842	10,705	10,705	9,809	9,976	9,756	9,479	9,479	8,743	9,470	9,574	9,595	9,595
Other liabilities	285	295	306	333	344	344	261	565	595	554	554	291	621	675	622	622
Total Liabilities	24,141	23,178	34,911	29,714	31,069	31,069	32,974	31,687	30,742	31,608	31,608	31,244	32,261	32,476	34,387	34,387
Shareholders Equity:																
Redeemable convertible preferred stock	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Convertible preferred stock	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Common stock	74,460	74,577	75,326	75,435	75,586	75,586	75,586	75,586	75,586	75,586	75,586	75,586	75,586	75,586	75,586	75,586
Deferred Compensation	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Accumulated deficit	(83,004)	(83,294)	(83,345)	(82,678)	(83,697)	(83,697)	(83,576)	(80,979)	(77,225)	(76,119)	(76,119)	(75,816)	(72,689)	(68,035)	(66,448)	(66,448)
Total Shareholder's Equity	(8,544)	(8,717)	(8,019)	(7,243)	(8,111)	(8,111)	(7,990)	(5,393)	(1,639)	(533)	(533)	(230)	2,897	7,551	9,138	9,138
Total Liabilities & SE	\$15,597	\$14,461	\$26,892	\$22,471	\$22,958	\$22,958	\$24,985	\$26,295	\$29,104	\$31,074	\$31,074	\$31,014	\$35,160	\$40,029	\$43,525	\$43,525

Scientific Learning Cash Flow Statement (\$000's)

Fiscal Year Ends December	2003A	2004A				2004A	2005E				2005E	2006E				2006E
	FY	Mar-04A	Jun-04A	Sep-04A	Dec-04A	FY	Mar-05E	Jun-05E	Sep-05E	Dec-05E	FY	Mar-06E	Jun-06E	Sep-06E	Dec-06E	FY
Cash Flow from Operating Activities																
Net income (loss)	2,130	(290)	(51)	667	(1,018)	(693)	(254)	2,222	3,379	730	6,078	(109)	2,715	4,242	1,174	8,022
Depreciation and amortization	721	198	183	177	(130)	428	189	177	175	225	766	217	209	208	271	905
Amortization of software development costs	617	-	-	-	351	351	-	-	-	-	-	-	-	-	-	-
Amortization of deferred financing costs	1,215	99	100	33	-	232	-	-	-	-	-	-	-	-	-	-
Stock based compensation	245	96	7	70	8	181	375	375	375	375	1,500	413	413	413	413	1,650
Amortization of deferred compensation	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Asset impairment write downs	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Write down of long lived assets	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Accounts receivable	(250)	623	(11,266)	10,666	(567)	(544)	2,326	(2,325)	786	(649)	138	1,187	(2,569)	958	(792)	(1,215)
Notes receivable	-	-	-	-	-	-	-	-	-	3,688	3,688	-	-	-	-	-
Prepaid expenses and other current assets	428	(162)	152	(402)	250	(162)	306	(249)	(469)	226	(185)	415	(161)	(534)	257	(22)
Accounts payable	194	(25)	205	(4)	(54)	122	(223)	798	(48)	(209)	318	(498)	864	(19)	(247)	100
Accrued liabilities	(1,339)	(902)	433	(407)	1,339	463	(1,861)	3,591	(911)	1,468	2,288	(3,868)	3,875	(843)	1,559	723
Deferred revenue	788	(2,646)	10,684	(1,813)	59	6,284	4,072	(5,980)	(17)	(352)	(2,277)	4,264	(4,051)	1,022	652	1,887
Other liabilities	(199)	10	11	27	11	59	(83)	304	30	(42)	210	(263)	330	54	(53)	68
Net Cash Provided by Operating Activities	\$4,550	(\$2,999)	\$458	\$9,014	\$249	\$6,721	\$4,846	(\$1,086)	\$3,301	\$1,774	\$8,835	\$1,758	\$1,624	\$5,502	\$3,234	\$12,118
Cash Flow from Investing Activities																
Sale of government securities	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Purchases of property and equipment, net	(256)	(143)	(212)	(167)	(124)	(646)	(142)	(170)	(376)	(192)	(879)	(184)	(207)	(458)	(234)	(1,084)
Notes receivable from current and former officers	-	-	-	-	-	-	-	-	-	3,688	3,688	-	-	-	-	-
Increase in capitalized software development	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other non-current assets	(703)	(38)	(39)	(38)	(272)	(387)	(486)	(1,828)	171	1,371	(772)	82	(1,977)	67	1,578	(251)
Net Cash Used in Investing Activities	(\$959)	(\$181)	(\$251)	(\$205)	(\$396)	(\$1,033)	(\$628)	(\$1,997)	(\$204)	\$4,867	\$2,037	(\$102)	(\$2,184)	(\$391)	\$1,343	(\$1,334)
Cash Flow from Financing Activities																
Proceeds from issuance of common stock	444	21	742	39	143	945	-	-	-	-	-	-	-	-	-	-
Borrowings under bank line of credit	2,000	2,600	400	-	-	3,000	-	-	-	-	-	-	-	-	-	-
Repayments on borrowings under line of credit	(7,000)	-	-	(3,000)	-	(3,000)	-	-	-	-	-	-	-	-	-	-
Net Cash Used In Financing Activities	(\$4,556)	\$2,621	\$1,142	(\$2,961)	\$143	\$945	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net increase (decrease) in Cash	(\$965)	(\$559)	\$1,349	\$5,848	(\$4)	\$6,633	\$4,218	(\$3,083)	\$3,097	\$6,641	\$10,872	\$1,656	(\$560)	\$5,111	\$4,577	\$10,783
Cash at beginning of period	\$4,614	\$3,649	\$3,090	\$4,439	\$10,287	\$3,649	\$10,282	\$14,500	\$11,416	\$14,513	\$10,282	\$21,154	\$22,810	\$22,250	\$27,360	\$21,154
Cash at end of year	\$3,649	\$3,090	\$4,439	\$10,287	\$10,282	\$10,282	\$14,500	\$11,416	\$14,513	\$21,153	\$21,154	\$22,810	\$22,250	\$27,360	\$31,936	\$31,937

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