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ENTERPRISE SOFTWARE

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NASDAQ: ARBA
PRICE: \$9.30
RATING: HOLD

ARBA: NOT LOCO FOR ARIBA; INITIATING COVERAGE WITH A HOLD RATING

Investment Conclusion: We are initiating coverage of Ariba with a Hold rating as we believe valuation at current levels is reasonable given the risk reward profile. The advancements in Internet based technologies (i.e. Web 2.0) are moving applications that once resided solely behind corporate firewalls into the unknown world of the Internet cloud. The client/server framework is shifting towards open standards and reusable component based architectures enabling advancement in conductivity between voice, data, media and mobile devices. We believe the advancements in interoperability, computing standards, and enhanced network performance changes the playing field and expands current market opportunities in the business-to-business (B2B) and Supplier Relationship Management (SRM) space. That said, we believe investors need to refocus their attention on the SRM space, and names like Ariba that are uniquely positioned to leverage markets being created by Service Oriented Architecture (SOA) technology to drive new business and revenue opportunities.

Accordingly, we are continuing to expand our coverage universe to include logistics management [i.e. CMGI, Inc. (CMGI: Buy)] and the SRM space, which we believe offer investors a desirable risk/reward profile and are under-followed and under-appreciated sectors within software at this time. That said, based on our earnings model forecasts through FY:09E, we have yet to see evidence that growth in subscription revenues will offset the decline of the legacy license business. Overall, this concern mutes our expectations for total revenue reacceleration in the near-term, limiting growth to the mid- to high-single-digit range through FY:09. In addition, with the upcoming rolloff of the Softbank litigation settlement income (ending in October 2007), we believe the stock is facing difficult compares in FY:08. Accordingly, with the bulk of good news already factored into the Ariba story, in our view, we are launching coverage of Ariba (ARBA) with a Hold rating.

Stock Data

12-Month Price Target	NE
52-Week Range	\$11.08 - 6.44
10-Day Avg. Daily Volume	805,378

Revenues

FY ends September	2006A	2007E	2008E
Revenue (MM)	\$296.0	\$306.8	\$328.6
Previous Estimate (MM)	-	NE	NE
Price/Revenue	2.3x	2.2x	2.1x
EV/Revenue	1.7x	1.6x	1.5x
Secular Growth Rate			20%

Capitalization

Shares Outstanding (MM)	72.9
Market Capitalization (MM)	\$677.8
Enterprise Value (MM)	\$503.8
Debt/Total Cap. (12/31/06)	0.0%
Cash (12/31/06) (MM)	\$174.0
Cash/Share (12/31/06)	\$2.39

Earnings Per Share*

Q1	\$0.14	\$0.13 A	\$0.09
Q2	\$0.13	\$0.09	\$0.10
Q3	\$0.12	\$0.11	\$0.10
Q4	\$0.10	\$0.10	\$0.11
Fiscal Year EPS	\$0.48	\$0.44	\$0.39
Previous Estimate	-	NE	NE
P/E	19.2x	21.4x	23.7x

Please see the [Important Disclosures Section](#) at the end of this report.

*Earnings Per Share are Pro Forma

NC indicates no change from current estimate. NE indicates no estimate. NM indicates not meaningful.

Sources: WR Hambrecht + Co estimates and company reports

COMPANY PROFILE

Ariba, Inc. is a provider of spend management services and solutions, which help its customers optimize their business processes and reduce costs. Utilizing Ariba's Internet-based Supplier Network, (a network of over 145,000 registered suppliers), the company matches buyers with the ideal suppliers and provides an ordering system based on a standardized protocol. Ariba has offices in 25 countries and has over 1,600 employees, based primarily in the United States. Incorporated in 1996, Ariba is headquartered in Sunnyvale, California.

INVESTMENT POSITIVES

Web 2.0, New Markets, New Opportunities. Ariba Spend Management solutions allow enterprises to efficiently manage the purchase of non-payroll goods and services to run their business. Ariba Spend Management solutions are organized around six key functions: (1) spend visibility, (2) sourcing, (3) contract management, (4) procurement and expense, (5) and (6) supplier management. The company's traditional license model was based on software that was highly configurable and deployed primarily behind the firewall (client server). We believe that as corporate clients migrate their spend management solutions towards Internet-based solutions, it provides Ariba with a new market opportunity. Offering these software products and solutions as a Web-based service provides for easier connectivity between buyers and suppliers.

Compares Getting Easier; Accounting Changes to Deferred Revenue Model Mostly Complete. In fiscal year 2006, the company shifted from a perpetual license model, with upfront revenue recognition, to more subscription or term licenses (recurring revenues), with revenue recognition spread out over time. This change in accounting led to difficult compares as license revenues continued to decline exiting FY:06. However, the company's backlog and deferred revenues ticked up in FQ1:07, which may lead to easier compares going forward.

Corporate Cost Savings Driver for Business. Our investment thesis is predicated on the fact that software companies must offer solutions that provide the purchaser with tremendous ROI potential or enhanced functionality driving a competitive advantage in the marketplace. We believe Ariba's platform offers these opportunities.

Supplier Network Ecosystem Worth Watching. Ariba's supplier solutions allow businesses to streamline the prospecting to payment cycle and support over \$120 billion in annual sourcing volumes per year and allow for access to the world's leading buying organization. With Ariba's Supplier Network (ASN), clients can leverage this large infrastructure to interact with suppliers. The network supports over \$90 billion in annual order volume and drives 16 million purchase orders each year while offering flexibility in routing formats and interface customization. This supplier Ecosystem creates an enormous barrier to entry for other incumbents in the space.

Strong Balance Sheet and Cash Position. Ariba exited FY:06 with roughly \$174 million in cash and equivalents on the balance sheet, with no outstanding debt. This equates to a net cash position of roughly \$2.39 per share. Given the strong balance sheet and lack of debt, we believe the company could pursue small strategic acquisitions and/or initiate a share repurchase program that could drive earnings accretion.

INVESTMENT RISKS

Competitive Landscape; New Entrants. The market for supplier network solutions is extremely competitive and subject to rapid technology changes resulting in future pricing pressures. Ariba competes with the major fully integrated software vendors like SAP and

Oracle (ORCL: Hold). Also IT Services integrators like McKinsey and AT Kearney have major practices in these areas. More important, we believe that smaller niche players like Emptoris, Ketera, Perfect Commerce, Procuri, and Verticalnet have made significant progress into the space of late. Investors should notes that Ariba's solutions focus on cXML, EDI, HTML, email or fax while some of the other new entrants are built on a Web 2.0 platform. This technology shift is a trend worth noting, in our view.

Standalone Solution; Vertical Integration into Back End ERP Systems Lacking. The recent rash of acquisitions indicates to us that the overall software and solutions landscape is consolidating. Clients are demanding end-to-end integration software solutions addressing specific vertical needs and related applications. With Ariba playing "Switzerland" this integration may be difficult to achieve, in our view.

Results Hard to Forecast; Dependant on Success of Numerous End Markets. Ariba's supply chain infrastructure addresses a variety of end markets that are subject to numerous variables, which makes analysis and forecasting of quarterly results difficult, especially in light of the ongoing product transition. That said, we believe investors should prepare themselves for choppy quarters which will more than likely keep a lid on multiple expansion until the business model matures to a more normalized state.

Unresolved Issues. The company has roughly 716,000 square feet of office space consisting of a five building office park. Currently, Ariba only occupies roughly 200,000 square feet of the space and 442,600 square feet are subleased to a 3rd party. These subleases expire in July 2007, May 2008 and August 2008. These lease commitments do not expire until January 2013 resulting in an annual lease expense of roughly \$35-40 million per year. Additionally, other income currently includes deferred income recorded upon the settlement with Softbank that started in January 2005 and is expected to terminate in October 2007. We estimate that this settlement will contribute roughly \$0.15-0.20 to EPS in FY:07. The loss of this non cash revenue will not make for easy compares, in our view. Furthermore, the company has not reserved for any potential legal issues which are still pending, as it believes these potential losses are not probable or estimable.

VALUATION

Clearly to us, Ariba is in the midst of a product transition, and current revenue and earnings growth estimates may prove to be conservative. That said, until clearer catalysts emerge, we believe current valuation is reasonable and limits upside potential in the near-term. Ariba shares are currently trading at 23x our C2007E and C2008E non-GAAP EPS estimates of \$0.40 and \$0.41, respectively. This is roughly in line with the CY:07 median multiples of 24x and slightly above the CY:08E median multiple of 20x for a group of similar companies, while Ariba's CY:07E/CY:08E EPS growth of 3% trails the group median of 25%. In addition, although Ariba trades at a sizeable discount on an EV/Revenue basis (1.5x and 1.4x CY:07E and CY:08E revenues versus the group medians of 4.0x and 3.1x, respectively), Ariba's CY:07E/CY:08E revenue growth of 8% significantly trails the group median of 24%.

On an EV/FCF basis, Ariba shares are trading at 21x and 14x our CY:07 and CY:08 FCF estimates, respectively. We believe that cash flow is a better measure of the firm's success, but with the shares already trading at 14x our CY:08 estimate, while overall top-line growth trails the broader group, we believe the multiple may be capped in the near-term.

EXHIBIT 1: COMPARABLE VALUATION TABLE

Company	Ticker	Rating	Price	Price	EV	Mkt. Cap.	Revenue (\$M)			Rev Growth		EV / Rev			EPS			EPS Growth		Price / Earnings			5 YR		PEG	
			Target	04/02/07			(\$MM)	(\$M)	CY06A	CY07E	CY08E	06-07	07-08	'06A	'07E	'08E	CY06A	CY07E	CY08E	06-07	07-08	'06A	'07E	'08E	Gr. (%)	'07
Salesforce.com	CRM			\$43.44	4,661	4,930	496	721	979	46%	36%	9.4x	6.5x	4.8x	\$ 0.23	\$ 0.42	\$ 0.68	81%	63%	189x	104x	64x	46%	2.3x	1.4x	
Omniiture Inc.	OMTR			\$17.67	793	866	80	135	205	69%	52%	10.0x	5.9x	3.9x	\$(0.08)	\$ -	\$ -	NM	NM	NM	NM	NM	47%	NM	NM	
Kenexa Corp.	KNXA			\$30.17	790	762	110	187	232	70%	24%	7.2x	4.2x	3.4x	\$ 0.96	\$ 1.22	\$ 1.53	27%	25%	31x	25x	20x	23%	1.1x	0.9x	
Concur Technologies, ICNQR				\$17.21	608	623	105	131	171	25%	30%	5.8x	4.6x	3.6x	\$ 0.33	\$ 0.32	\$ 0.49	-3%	52%	52x	54x	35x	25%	2.1x	1.4x	
Ultimate Software GroupULTI				\$25.84	608	649	113	147	179	30%	22%	5.4x	4.1x	3.4x	\$ 0.38	\$ 0.68	\$ 0.72	78%	6%	68x	38x	36x	26%	1.5x	1.4x	
Global Sources Ltd. GSOL				\$14.59	452	617	155	184	214	19%	17%	2.9x	2.5x	2.1x	\$ 0.46	\$ 0.63	\$ 0.92	36%	46%	31x	23x	16x	25%	0.9x	0.6x	
Rightnow TechnologiesRNOW				\$16.12	448	530	110	118	156	7%	33%	4.1x	3.8x	2.9x	\$(0.01)	\$(0.41)	\$ 0.17	NM	NM	NM	NM	97x	31%	NM	3.2x	
I2 Technologies, Inc. ITWO				\$23.50	590	496	272	292	318	8%	9%	2.2x	2.0x	1.9x	\$ 1.27	\$ 1.37	\$ 1.67	8%	22%	19x	17x	14x	10%	1.7x	1.4x	
JDA Software Group InJDAS				\$14.92	568	440	278	360	378	30%	5%	2.0x	1.6x	1.5x	\$ 0.55	\$ 1.01	\$ 1.14	83%	13%	27x	15x	13x	16%	0.9x	0.8x	
Websidestory Inc. WSSI				\$12.56	249	254	69	90	112	<u>30%</u>	<u>24%</u>	<u>3.6x</u>	<u>2.8x</u>	<u>2.2x</u>	\$ 0.55	\$ 0.72	\$ 0.90	<u>30%</u>	<u>25%</u>	<u>23x</u>	<u>18x</u>	<u>14x</u>	34%	0.5x	0.4x	
												Median: 30%	24%	4.7x	4.0x	3.1x			33%	25%	31x	24x	20x			
												Average: 33%	25%	5.2x	3.8x	3.0x			43%	32%	55x	37x	34x			
Ariba Inc.	ARBA	\$0.00	\$0.00	\$9.29	469	700	297	310	334	4%	8%	1.6x	1.5x	1.4x	\$0.47	\$0.40	\$0.41	-15%	3%	20x	23x	23x	11%	2.1x	2.0x	

Source: CapitalIQ, WR Hambrecht + Co estimates

On a DCF basis, we are assuming a 15x terminal multiple and 15.4% discount rate, which equates to a total equity value of \$718 million, or \$9.85 per share, as shown below. Given that the stock is already trading at \$9.30, we believe upside is limited at this time, barring any additional catalysts.

EXHIBIT 2: DCF ANALYSIS

Assumed Range						
Terminal Multiple	15.0	15.0	15.0	15.0	15.0	15.0
Discount Rate	17.0%	16.0%	15.4%	14.0%	13.0%	12.0%
Terminal FCF	82	82	82	82	82	82
Terminal Value	1,236	1,236	1,236	1,236	1,236	1,236
Discounted TV	257	280	295	333	364	398
CDCF	249	249	249	249	249	249
Enterprise Value	506	529	544	582	613	647
Plus Excess Cash	174	174	174	174	174	174
Equity Value	680	703	718	756	787	821
Shs. Outstanding	73	73	73	73	73	73
Equity Value/Share	\$9.33	\$9.65	\$9.85	\$10.38	\$10.80	\$11.26

Total Value	Discount Rate		10-yr FCF Terminal Multiple			
	12x	14x	15x	16x	18x	
13.0%	743	791	816	840	888	
14.0%	706	750	773	795	839	
15.4%	659	698	718	738	777	
16.0%	641	678	697	715	753	
17.0%	612	646	664	681	715	

Per Share Value	Discount Rate		10-yr FCF Terminal Multiple			
	12x	14x	15x	16x	18x	
13.0%	\$10.19	\$10.86	\$11.19	\$11.52	\$12.19	
14.0%	\$9.68	\$10.29	\$10.60	\$10.90	\$11.51	
15.4%	\$9.04	\$9.58	\$9.85	\$10.12	\$10.66	
16.0%	\$8.79	\$9.30	\$9.56	\$9.82	\$10.33	
17.0%	\$8.40	\$8.87	\$9.10	\$9.34	\$9.81	

Source: WR Hambrecht + Co estimates

BUSINESS BACKGROUND

Ariba has incorporated significant additions and enhancements to its solutions platform since the company's inception in 1996. Its initial product, Ariba Buyer, was introduced in 1997, and was the precursor to the spend management solutions that Ariba offers today. In 1999, Ariba introduced the Ariba Supplier Network, bolstered by Ariba Sourcing in 2001. In July of 2004, Ariba acquired FreeMarkets for \$479 million, and incorporated its technology into the Ariba product stack.

Ariba's current business is aligned to offer six key Spend Management solutions, which include Visibility, Sourcing, Contract Management, Procurement & Expense, Invoice & Payment, and Supplier Management solutions. These six solutions utilize the Internet-based Ariba Supplier Network, which is a network of over 145,000 suppliers matching buyers with the ideal suppliers and offering an ordering system based on a standardized protocol.

Ariba competes against a wide variety of players in a range of industries. In the service provider space, Ariba competes against firms like AT Kearney and McKinsey. In the enterprise software space, Ariba competes with Oracle and SAP, and at a smaller scale, with companies like Katera, Perfect Commerce, Emptoris, and Verticalnet. Currently, Ariba utilizes third party system integrators such as Accenture, BearingPoint, Deloitte Consulting, and IBM to implement Ariba solutions.

Historically, Ariba operated under a perpetual licensing model. However, due to the choppy nature of perpetual licensing, between three and seven large customers often represented over 50% of license revenues for each quarter throughout FY:06 and FY:05, and deals typically closed at the end of each quarter. Accordingly, average sales price (ASPs) were similarly choppy, as price discounts at the end of each quarter designed to incentivize customers to sign licensing deals would adversely impact ASPs.

In November of 2005, Ariba announced a significant change to its long-term strategic vision. Similar to many companies in the enterprise software space, Ariba announced its plans to transition away from a perpetual licensing model to a term licensing and subscription model, or On-Demand model. Accordingly, the company stopped reporting license revenues as a separate line item in FQ1:07, as perpetual licensing revenues continue to decline as a meaningful percentage of overall revenues.

With this transition to an On-Demand model, the company now offers a more flexible solution platform, offering both traditional perpetual licenses and term/subscription licenses. In addition, Ariba offers both On-Demand solutions and non-hosted solutions. This transition from a pure perpetual licensing model has affected margins, and will continue to do so until the revenue mix between perpetual and subscription revenues reaches a normalized state.

The company has noted that traditional license gross margins are greater than 90%, while subscription/maintenance gross margins are in the 75% range. Labor-intensive services gross margins are in the 10-30% range. The transition to higher subscription revenues as license revenues roll off led to an overall gross margin decline of roughly 500 bps in FY:06 on a y/y basis. Going forward, the company's strategic plan is to offset the continuing decline in license revenues with subscription sales while bolstering ASPs during the product transition.

KEY FINANCIAL ASSUMPTIONS

For upcoming FQ2:07 results, we are forecasting revenue of \$75.4 million (+2%) and non-GAAP EPS of \$0.09, more or less in line with Street consensus estimates of \$75.1 million and \$0.09, respectively. These estimates reflect a 51.8% gross margin and 1.9% operating margin, due to a typical q/q seasonal decline. Our full year FY:07 estimates are for revenues of \$306.8 million (+4%) and non-GAAP EPS of \$0.44, slightly below Street consensus of \$307.4 million and \$0.45, respectively. Our full year FY:08 estimates are for revenues of \$328.6 million (+7%) and non-GAAP EPS of \$0.39 (-10%), versus Street consensus of \$330.4 million and \$0.49, respectively. Investors should note that in FY:08, non-GAAP EPS results are negatively affected by the expected loss of roughly \$3.4 million in other income from the Softbank settlement, which rolls off in October of 2007. Looking ahead, our FY:09 estimates are for revenues of \$355.2 million (+8%) and non-GAAP EPS of \$0.49 (+25%), versus Street consensus of \$361.0 million and \$0.65, respectively.

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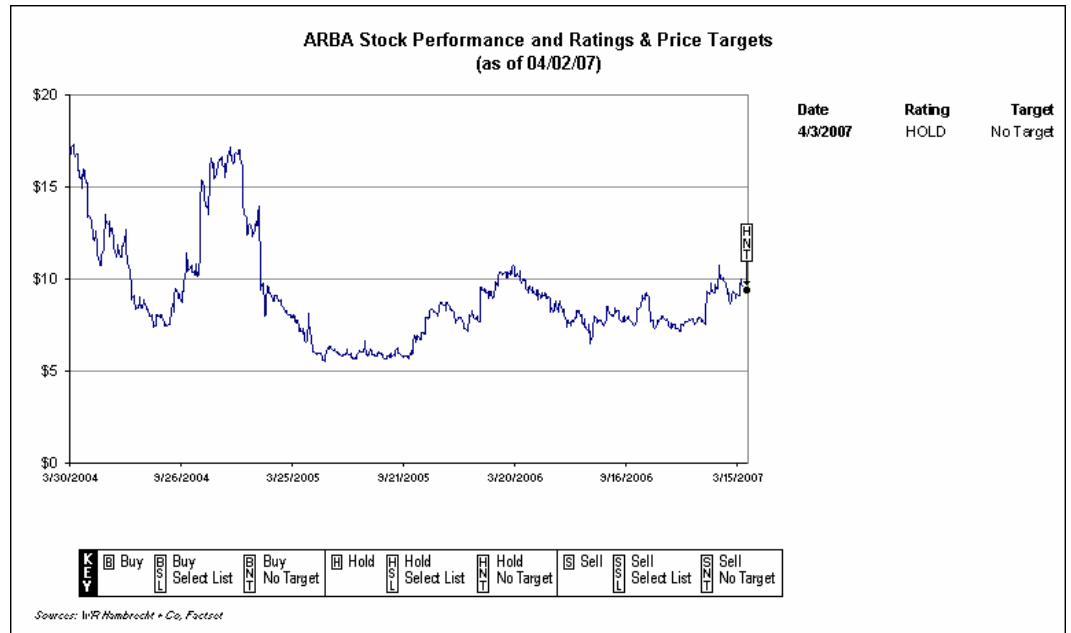
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BUY	Stocks rated Buy are those we recommend actively buying; these stocks are expected in absolute dollar terms to appreciate at least 10% over the next 6 months.	59	11
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SELL	Stocks rated Sell are those we would be actively selling; these stocks are expected to depreciate in absolute dollar terms at least 10% over the next 6 months.	4	0

PRICE TARGET RISKS

Investment risks associated with the achievement of the price target include, but are not limited to, the company's failure to achieve our earnings and revenue estimates, unforeseen macroeconomic and/or industry events that adversely impact demand for the company's products or services, product obsolescence, changes in investor sentiment regarding the specific company or industry, intense and rapidly changing competitive pressures, the continuing development of industry standards, the company's ability to recruit and retain competent personnel, and adverse market conditions. For a complete discussion of the risk factors that could affect the market price of the company's shares, refer to the most recent form 10-Q or 10-K that the company has filed with the SEC.

VALUATION METHODS TO DETERMINE PRICE TARGET

NA

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