



pip coburn's
waypoints – a journey through technology and change

Apple's Retail Conduits ...

*Waypoints Release 3.0
September 23, 2005*

Reminder: We'll be hosting a conference call on Monday, September 26th at 11am. Dial in: (866) 238-1641, (703) 639-1162 PIN: 772094

- **Focus Stock: The importance of Apple's Retail Stores**
- **Focus Stock: Microsoft's New Product Hype ... and R&D strategy...**
- **Change → Top 20 Global Tech Stocks: How are they adapting to change?**
- **Always On → Thoughts on Oracle/Siebel and eBay/Skype**

Thanks for joining us!

We hope to have you with us every two weeks as we journey together through the changing tech universe. This is the second of four planned Beta releases of Waypoints. After issue four, we'll be moving to a paid subscription basis.

We aim to help make sense of the sometimes overwhelming and confusing world of global tech, telecom and media ...and perhaps help increase the clarity and conviction around the investment decisions you make and save you time in clearing though the muck.

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Waypoints Release 3.0 ... September 23, 2005

Global tech stocks – Our “Buys”

Big two weeks for CRM ...

Buys	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
Corning Inc	\$29,574	1	4	22	75	1.03	1.36	19%	18%	25	20
Research In Motion Limited	\$14,397	-4	-2	2	-1	1.04	1.03	128%	53%	38	30
Motorola Inc	\$55,949	4	7	24	27	1.04	1.26	15%	8%	20	18
XM Satellite Radio Holdings Inc	\$7,873	1	6	7	17	1.02	1.07	126%	79%	nmf	nmf
Apple Computer Inc	\$44,139	13	16	40	180	1.14	1.31	68%	19%	37	32
Cognizant Technology Solutions Corp	\$6,225	0	2	-4	57	0.94	0.99	50%	41%	43	32
Infosys Technologies Ltd	\$19,849	3	8	-2	27	0.99	1.02	50%	33%	47	36
Tata Consultancy Services Ltd	\$16,103	5	12	13	41	1.09	1.11	34%	31%	nmf	nmf
Texas Instruments Inc	\$3,074	0	2	17	43	1.00	1.19	6%	13%	24	20
Qualcomm Inc	\$70,793	9	8	24	10	1.10	1.15	15%	21%	38	31
Salesforce.com Inc	\$2,540	22	18	18	44	1.04	1.29	81%	75%	nmf	135
Dell Inc	\$81,033	-5	-5	-16	-6	0.88	0.85	19%	15%	26	21
Accenture Ltd	\$23,006	6	4	8	-5	1.02	1.04	4%	10%	18	16
NVIDIA Corp	\$5,638	9	15	21	122	1.13	1.28	10%	18%	64	22
Hyperion Solutions Corp	\$1,834	6	8	15	26	1.01	1.01	13%	7%	24	21
Activision Inc	\$4,227	-7	2	17	103	0.96	1.16	43%	9%	30	28
	\$27,266	4	7	13	47	1.03	1.13	43%	28%	33	33

Still playing three Indian names...

Global tech stocks – Our Buy “candidates”

Logitech – a long-time User Experience play...

Buy candidates	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
SAP AG	\$13,370	1	2	2	7	0.98	1.02	2%	9%	27	24
Oracle Corp	\$69,227	3	2	7	17	0.99	1.02	17%	21%	21	17
Adobe Systems Inc	\$13,637	3	3	-10	10	1.00	0.93	18%	14%	25	23
Cognos Inc	\$3,605	10	10	8	15	1.03	0.98	19%	14%	29	25
Juniper Networks Inc	\$12,971	2	-2	-15	-10	0.95	0.94	52%	21%	32	26
Caci International Inc	\$2,301	-3	-2	-4	14	0.94	0.98	41%	12%	22	20
Computer Sciences Corp.	\$8,500	3	4	5	-5	1.01	0.97	11%	1%	14	14
Microsoft Corp	\$276,816	-6	-4	3	-5	0.96	0.99	8%	11%	23	20
Logitech International SA	\$3,879	11	6	33	79	1.08	1.30	15%	19%	33	28
Marvell Technology Group Ltd	\$12,899	-4	-3	15	67	1.01	1.18	49%	33%	55	35
Tietoator Corp	\$2,765	6	8	16	26	1.04	1.11	-1%	7%	15	13
Agilent Technologies Inc	\$16,817	6	13	38	46	1.16	1.37	-4%	-4%	32	24
ATI Technologies Inc	\$3,360	9	15	2	-19	1.07	0.87	11%	1%	47	36
	\$29,426	3	3	5	18	1.01	1.03	18%	13%	29	23

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Global tech stocks – Our “Sells”

We don't like the Lenovo long-term story; but suspect the “restructuring” story may linger for a few quarters...

Sells	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
BMC Software Inc	\$4,522	4	2	16	36	1.01	1.16	3%	3%	33	22
Via Technologies Inc	\$812	13	-13	-6	14	0.93	1.13	-19%	17%	nmf	nmf
Affiliated Computer Services Inc	\$6,719	3	5	3	-6	1.03	1.01	5%	26%	17	15
Advanced Micro Devices Inc	\$8,899	11	8	29	75	1.05	1.21	7%	12%	102	34
Lenovo Group Ltd	\$3,371	14	15	59	35	1.23	1.44	4%	296%	185	169
Ciena Corp	\$1,231	0	1	-4	11	1.02	0.97	42%	18%	nmf	nmf
3Com Corp	\$1,373	7	4	-2	-17	1.06	1.03	-7%	14%	nmf	nmf
Electronic Data Systems Corp	\$11,687	-1	3	12	14	1.01	1.05	-2%	0%	40	22
Extreme Networks Inc	\$567	4	6	3	-2	0.96	0.84	9%	7%	42	25
Foundry Networks Inc	\$1,679	7	2	34	12	1.09	1.18	-7%	13%	39	30
RSA Security Inc	\$948	2	6	3	-29	1.03	0.91	1%	8%	26	21
Sanmina-SCI Corp	\$2,302	-15	-7	-24	-38	0.84	0.74	-4%	1%	17	13
Siebel Systems Inc	\$5,364	25	23	18	29	1.18	1.14	-5%	4%	103	54
SonicWall Inc	\$414	9	13	11	-4	1.06	1.07	7%	11%	33	27
Utstarcom Inc	\$964	8	1	12	-41	1.00	0.71	17%	3%	nmf	14
Webmethods Inc	\$361	-3	0	24	35	0.98	1.09	6%	3%	nmf	45
Sun Microsystems Inc	\$13,777	5	12	3	3	1.04	0.96	-1%	8%	nmf	131
	\$3,823	5	5	11	7	1.03	1.04	3%	26%	58	44

Global tech stocks – Our “Sell candidates”

Room for NTAP estimates and valuation to come a bit more??? We address within...

Sell candidates	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
JDS Uniphase Corp	\$2,592	15	19	14	-49	1.13	0.96	11%	60%	nmf	nmf
Unisys Corp	\$2,350	3	3	5	-34	1.02	0.92	2%	3%	nmf	30
Novell Inc	\$2,716	8	15	15	5	1.09	1.14	1%	4%	78	49
Red Hat Inc	\$2,860	19	22	33	28	1.09	1.27	56%	38%	68	54
Marconi Corporation PLC	\$1,092	2	-2	-4	-53	1.26	68.06	-18%	-4%	nmf	nmf
Realtek Semiconductor Corp	\$915	15	8	15	7	1.06	1.16	2%	12%	nmf	nmf
Minebea Co Ltd	\$1,674	3	-2	6	1	1.02	1.05	3%	0%	nmf	nmf
Business Objects SA	\$3,266	7	5	28	58	1.07	1.29	1%	9%	23	20
Keane Inc	\$720	3	0	-14	-22	0.94	0.88	7%	7%	21	17
Lucent Technologies Inc	\$13,468	-3	0	-3	-11	1.02	1.00	5%	6%	17	16
Lexmark International Inc	\$7,621	2	3	-4	-24	0.98	0.84	4%	6%	15	13
SMIC	\$175,897	-4	-5	-9	-8	0.91	0.93	24%	38%	nmf	32
SSA Global Technologies Inc	\$1,088	-1	4	30	#N/A	#N/A	#N/A	11%	6%	16	14
Viisage Technology Inc	\$205	-1	-6	-6	-38	0.86	0.80	14%	15%	nmf	nmf
Gateway Inc	\$1,024	-10	-11	-23	-42	0.77	0.64	8%	11%	20	13
Atari Inc	\$159	7	0	-52	-11	0.72	0.54	6%	-35%	17	nmf
Brocade Communications System	\$1,050	5	6	7	-25	1.00	0.79	-4%	7%	18	18
Midway Games Inc	\$1,309	-2	-11	35	38	0.98	1.27	22%	25%	nmf	nmf
Kemet Corp	\$692	-1	-2	18	-5	0.99	1.02	-3%	10%	nmf	69
Jda Software Group	\$439	7	8	23	42	1.04	1.14	-1%	8%	27	22
Network Appliance Inc	\$8,893	2	2	-19	4	0.95	0.83	36%	26%	38	31
Palm Inc	nmf	5	4	24	14	1.08	1.21	34%	20%	23	20
Altiris Inc	\$398	9	9	-14	-53	1.01	0.65	13%	6%	30	24
Epcos AG	\$826	5	3	2	-16	0.96	0.99	-12%	9%	nmf	20
Mercury Interactive Corp	\$3,244	3	3	-4	4	0.98	0.88	25%	16%	25	21
Avaya Inc	\$4,660	-5	-6	15	-34	0.95	0.81	20%	7%	17	14
	\$9,042	3	2	3	#N/A	#N/A	#N/A	9%	14%	30	27

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Tech Safari: Growth **Avg 2006 Rev Growth: 29%**

Communication	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
Broadcom Corporation	\$15,130	3	5	23	53	1.04	1.27	5%	21%	34	28
F5 Networks Inc	\$1,616	4	13	-9	43	1.06	0.94	63%	27%	34	27
Juniper Networks Inc	\$12,971	2	-2	-15	-10	0.95	0.94	52%	21%	32	26
Marvell Technology Group Ltd	\$12,899	-4	-3	15	67	1.01	1.18	49%	33%	55	35
Netgear Inc	\$787	9	9	21	86	1.09	1.33	19%	14%	23	20
NetLogic Microsystems Inc	\$392	6	6	26	192	1.01	1.41	68%	15%	25	24
Sonus Networks Inc	\$1,219	4	0	-2	-14	1.08	1.09	14%	27%	86	33
Audiocodes LTD	\$420	7	7	-4	-19	1.04	0.87	40%	23%	34	24
Content / Dig Home	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
XM Satellite Radio Holdings Inc	\$7,873	1	6	7	17	1.02	1.07	126%	79%	nmf	nmf
Avid Technology Inc	\$1,495	13	12	-24	-11	1.00	0.77	31%	33%	19	15
Creative Technology Ltd	\$642	-9	6	1	-30	1.00	0.76	nmf	nmf	nmf	nmf
MediaTek Incorporation	\$8,144	15	8	26	47	1.07	1.36	0%	23%	nmf	nmf
Scientific-Atlanta Inc.	\$5,756	-2	1	13	41	0.97	1.11	11%	14%	23	20
Sirius Satellite Radio Inc	\$8,871	-3	2	12	134	0.96	1.05	250%	141%	nmf	nmf
Tessera Technologies Inc	\$1,368	-8	-5	-8	28	0.91	0.85	31%	30%	32	20
Trident Microsystems Inc	\$846	-7	1	42	222	0.95	1.39	32%	93%	163	34
Integration	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
Autodesk Inc	\$9,627	-2	4	14	74	1.07	1.20	28%	24%	48	33
Autonomy Corporation PLC	\$755	1	14	57	85			42%	31%	nmf	nmf
Cognos Inc	\$3,605	10	10	8	15	1.03	0.98	19%	14%	29	25
Hyperion Solutions Corp	\$1,834	6	8	15	26	1.01	1.01	13%	7%	24	21
Business Objects SA	\$3,231	4	4	26	53	1.06	1.24	13%	8%	28	24
Mercury Interactive Corp	\$3,268	3	3	-4	4	0.98	0.88	25%	16%	25	21
Network Appliance Inc	\$8,886	2	2	-19	4	0.95	0.83	36%	26%	38	31
Trend Micro Inc	\$4,594	-2	-3	0	-24	0.96	0.83	nmf	nmf	nmf	nmf
Google Inc	\$85,982	8	10	7	161	1.06	1.33	81%	42%	55	42
Wind River Systems Inc	\$1,102	-2	-18	-18	12	0.82	0.87	15%	15%	108	43
Mobility	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
Research In Motion Limited	\$14,397	-4	-2	2	-1	1.04	1.03	128%	53%	38	30
Qualcomm Inc	\$70,793	9	8	24	10	1.10	1.15	15%	21%	38	31
ARM Holdings PLC	\$8,299	-2	-5	-6	28	0.95	1.00	43%	19%	28	22
GameLoft	\$417	-6	1	36	115	0.99	1.35	68%	59%	37	18
Garmin Ltd	\$7,136	14	17	53	62	1.12	1.24	27%	18%	25	22
Hittite Microwave Corp		4	6			1.05	1.05	27%	19%	33	31
High Tech Computer Corp	\$4,069	10	22	72	278	1.11	1.77	74%	34%	nmf	nmf
Jamdat Mobile Inc	\$565	0	7	-15		0.89	1.02	119%	53%	30	23
Naveq Corp	\$4,287	2	9	32	35	1.09	1.14	25%	20%	49	39
TomTom NV	\$4,252	12	26	102		1.23	1.43	185%	64%	31	21
User Experience	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
Amazon.Com Inc	\$17,247	-2	-4	18	-3	0.97	1.09	24%	18%	55	41
Apple Computer Inc	\$44,139	13	16	40	180	1.14	1.31	68%	19%	37	32
Corning Inc	\$29,574	1	4	22	75	1.03	1.36	19%	18%	25	20
Ebay Inc	\$49,701	-9	-6	-1	-19	0.93	0.91	35%	29%	44	36
Logitech International SA	\$3,548	7	5	31	72	1.06	1.24	15%	17%	26	22
NVIDIA Corp	\$5,638	9	15	21	122	1.13	1.28	10%	18%	64	22
Cree Inc	\$1,820	-6	-1	-12	-19	0.89	0.88	27%	13%	20	21
Genesis Microchip Inc	\$780	-13	-7	21	70	0.88	1.21	-6%	37%	93	29
Virtual	Mkt Cap	2wk %	1mo %	3mo %	12mo %	vs 50day	vs 200day	Rev's 05	Rev's 06	PE 05	PE 06
Citrix Systems Inc	\$4,200	4	5	11	37	1.02	1.04	18%	14%	23	20
Infosys Technologies Ltd	\$19,849	3	8	-2	27	0.99	1.02	50%	33%	47	36
Tata Consultancy Services Ltd	\$16,103	5	12	13	41	1.09	1.11	34%	31%	nmf	nmf
Cognizant Technology Solutions C	\$6,225	0	2	-4	57	0.94	0.99	50%	41%	43	32
HCL Technologies Ltd	\$3,230	5	10	20	33	1.10	1.26	14%	30%	nmf	nmf
Salesforce.com Inc	\$2,540	22	18	18	44	1.04	1.29	81%	75%	nmf	135
Rightnow Technologies Inc	\$443	26	24	26	23	1.22	1.19	37%	29%	88	57
Satyam Computer Services Ltd	\$9,243	6	9	10	20	1.03	1.16	39%	34%	31	23
Wipro Ltd	\$14,285	3	8	-7	13	1.00	0.96	35%	29%	40	32
Average of All	\$10,122	3	5	14	49	2.86	3.63	38%	29%	43	31

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Waypoints Release 3.0 ... September 23, 2005

Waypoints Release 3.0: short questions ...short answers

“It’s not coming back. There’s this childlike notion that the IT industry is different than the auto industry or the railroad industry. That IT will always be immature, it will always be run by venture capitalists up on Sand Hill Road, by clever entrepreneurs with the Next Great Thing. And if you dare not agree with them, they say you just don’t get it. Get what? The industry is maturing. The valley will never be what it was....” ... Larry Ellison

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Q: What do you make of Oracle / Siebel?

... we “get it.” What happens when maturity finally comes to an industry? Consolidation. What is Larry Ellison doing? Consolidating. What are many many small cap software companies doing? Looking for exit strategies. We suspect the take-out premiums will remain low ... 17% for SEBL, BEA / Plumtree and SSA / EPNY in the 10-15% range...

Q: How ‘bout eBay / Skype?

...don’t get it. Lots more in Always On ... page 27 ...

Q: What do you make of Microsoft’s re-org?

... don’t get it. A “more nimble” Microsoft sounds good in theory. But it’s not clear to us how this particular restructuring will help. This week, we discuss that cutting R&D more aggressively would be a better signal to us that Microsoft truly “gets it”. If MSFT had spent ... say ... 12% of revenues on R&D in FY05 instead of the 16% they did spend, they’d tack on an extra \$0.15 in EPS and still have a \$4.6b R&D budget. More on page 16...

Q: Who else among the large caps don’t seem to “get” that tech is mature and that process innovation, not product innovation is warranted ...?

Intel, Cisco, Nokia, Lenovo ... Those who **do** get it → AAPL, IBM, QCOM, ORCL, ERICY, DELL, MOT... more on page 29 ...

Q: What themes are you watching MOST closely at Apple? Tiger sales ...iPod sales ... iMac sales ...?

None of the above. We are extremely interested in Apple’s retail stores – which we view as conduits where analogists can go to comfortably migrate to the digital world. This week, we dig into Apple’s model to examine how big a role retail stores play ... page 7...

Q: What events do you care most about in the next 3-4 weeks?

... Sept 28th: RIMM Earnings ... Sept 28th: Garmin Analyst Day ...October 5-7th → Web 2.0 Conference ... October 6th: Accenture Earnings ...more on page 18...

Yi Tan Technology Call:

Date: Monday, Sept 19th

Time: 10:30 PDT, 1:30 EDT

*Dial-in: 1-800-615-2900
1-661-705-2005*

Passcode: 778778

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Waypoints Release 3.0 ... September 23, 2005

Waypoints 3.0: Apple's Retail Conduits

*What we really do for a living is aim to understand all we can about **change** and then apply our insights toward investing in our area of domain expertise -- tech, telecom and media. We want to identify changes important enough to change valuation → situations where major positive or negative fundamental change significantly alters the relation of money going into the "box" to money out.*

*Our **Change Function** focuses on **user experience** when assessing one critical type of change – the likely adoption of new technologies. Inside our Change Function, we assess a user's current pain versus their perceived pain of adopting a solution. We think the **supply** of new technologies is a necessary but not sufficient part of the adoption process. We focus **our** energy on the users...*

Now... let's pick up where we left off two weeks ago ... on **user experience**.

Quick refresher of what we hit on in *Waypoints 2.0*...

- **Point 1:** Our view on technology adoption and whether new products will succeed or fail is founded on the Change Framework... which considers the **user's** needs and barriers to adoption ... not the **supplier's** need to push a product...

Our Change Framework: Change = f
(user's crisis v user's perceived pain of adoption)

- **Point 2:** Most tech companies either don't truly "get" the user's vital role in a buying process or don't truly know how to lower a user's perceived pain of adoption.
- **Point 3:** This creates an opportunity for those companies that do "get it" ... and an investment opportunity for us if we can identify good "user experience" stories...

We then wrapped up our stock discussion by digging into the models of two "user experience" plays – RIMM and Salesforce.com. However, we didn't spend much time on the company that best exemplifies "user experience" → Apple.

Why not?

... well ... partly 'cuz our "**Stocks**" section was already approaching 10 pages ...so we thought much more discussion about **user experience** just might have compromised ... *your user experience*. And ... partly 'cuz we wanted to spend another week or so getting our arms around a key key key part of the Apple story → their retail stores.

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Waypoints Release 3.0 ... September 23, 2005

“Key key key”? At just 15% of overall Apple revenues????

Yep, “key key key”... Over the past couple years, we’ve heard plenty of debates about what lies at the heart of Apple’s success – the iPod’s hardware ... no, wait, the iPods software ... or security woes driving PC share gains ... or Apple’s “cool” factor ... but ... our take →

... our take → it’s about the stores!!!

Looking ahead, here’s our thinking ... which we suspect is sliiiiiightly different than most ‘cuz of our obsession with change and that whole user experience / pain of adoption thingamajiggy...

Conventional thinking – at least among the bulls – **zooms in** and suggests that things like the iPod and the iPod Halo Effect will continue to drive growth at Apple.

No disagreement there ...

...but ... let’s **zoom out** and offer another angle from the *Change Framework* perspective.

Our take: Key theme for the next 3-5 years: Apple is the place analogists can go to become digital immigrants - where those who are terrified of technology feel comfortable about trying their hand with this “digital” stuff.

How does Apple create this comfort zone?

Well ... a lot of ways. For one, their culture is based on the user experience -- from the simplicity of the iPod to the packaging of their products. But another key key key way is with their hip, yet warm and inviting, retail stores.

The point: Apple’s retail stores are a conduit for analogists to migrate to the digital world

... we’re believing this more and more with each new Apple product intro and each visit we take to an Apple store...

“So are the analysts right that the sun will soon set on the iPod Age? The truth is, the iPod has faced stiff competition from some of the industry’s best-known companies since the day it was introduced. Yet even after four years, all of Dell’s horses and all Sony’s men haven’t made a dent in the iPod’s dominance. And with the introduction of gorgeous, functional and elegant iPod Nano, that’s not about to change.” David Pogue, New York Times review of the new iPod Nano.

Is this “retail / analogist” big picture theme enough to ... say ... help Apple blow out their September quarter?

Eh ... not likely ... -- the Nano might help there, tho’ ... ☺

But is it enough to make us very excited about the story over the next 5-10 years?

You bet.

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Retail stores and Apple's model

"Apple Computer, of course, is often mentioned as the ultimate aspirational technology company. It isn't simply that the iPod or the PowerBook is 'well-designed'; it is that Apple realizes the extent to which people buying its products are making a statement about their good taste. Even if a Dell Windows machine does all the same things - and is less expensive and faster to boot -- it still doesn't matter." ... Lee Gomes, WSJ...

We view Apple's retail stores as a conduit for analogists to migrate to the digital world

OK ...now ... just how important are retail stores to Apple's financial model?

Before we get started, probably worth mentioning that ... well ...there are a ton of different levers in Apple's model and ...yeah ... someday we'll probably examine – generally speaking – just how likely it is that a company this large can grow revenues north of 20% for **three** consecutive years – into 2006 – as expected. **Remarkable.** And we'll want to scrutinize whether they can grow desktops 15% in 2006 ... or notebooks 10% ... or iPods another 25-30% after two consecutive years north of 250% ...as expected. **All sounds reasonable to us ... btw...**

But today ... we're really keen on talking about the retail stores and their importance to Apple's financial model... so let's get at it. Lots of little angles. First ... some good-to-know fun facts...

	2002	2003	2004	2005e
Total Stores (at fiscal yr end)	40	65	86	125e
Total Store Visitors	2.25m	13.9m	25.2m	50m
Retail Segment Revenues	\$283m	\$621m	\$1,185m	\$2,300m

Second ... retail stores as a % of overall revenues...

	2002	2003	2004	2005e
Total Apple revenues	5,742	6,207	8,279	14,200
Retail Segment revenues	283	621	1,185	2,300
Stores as % of Revs	5%	10%	14%	16%

OK ... now let's look at retail stores as a % of overall **profits**. Here's where it gets a bit tricky, because there are two types of profit to consider for Apple's retail stores:

- **Retail Profits** → the profit that each Apple store makes after paying Apple for the products it sells. Here, Apple treats a retail store like any other reseller → the parent company marks up the products before “selling” them to its own retail stores, so a product's cost base is higher on the retail store's P&L. The difference between the cost base and what I buy my iPod for in SoHo is falls into this category...
- **Retail Manufacturing Profits** → Most simply, this is the amount of profit Apple – the parent company – makes when it sells an item to its retail store. Here, the retail stores effectively play the part of just another retail channel partner. The figure is not officially recorded as Retail Store Profit, but the profit is generated when Apple products are sold at a retail store...

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Our point → if we look at Apple's financial statements, the retail stores' % of overall *revenues* are ho-hum ... ~15% ... and the retail stores' % of overall *profits* is kinda boring ... again, around 10-15%

However, if we include the “retail manufacturing profits” ... the income Apple receives for products sold through the retail stores, then we see that Apple's retail stores ... *matter*.

	2003	2004	2005e
Retail store profits	(5)	39	150
Retail store mfg profit	105	213	425
Overall Retail Profits: Store + Mfg	100	252	575
Approx EBIT for Apple overall	–	326	1,650

How much do they matter?

We estimate that in FY05, Apple's retail stores – through a combination of “retail store profits” and “manufacturing profits” – will generate roughly \$575m in profits of a total EBIT number of \$1.6b for Apple.

Of course, playing devil's advocate, we can suggest that much of this “manufacturing profit” would have been realized anyway if Apple stores did not exist -- folks could instead simply buy their iMacs through a different reseller. But we sense the stores themselves ...the conduits ... are a real driver.

Nothing against CompUSA, but isn't it just a tad better experience to go to an Apple store??

Sensitivity analysis...

OK ... so what now?

Well, we're going to run a sensitivity out to 2007 to see what kind of contribution retail stores can have on Apple's overall numbers? How much revenue and profitability growth can they drive from here?

Best place to start might be to ask how many stores we think Apple can ramp...

Question: If Apple is currently at 125 stores, how many more stores can Apple open before the market is saturated?

Well, there are roughly 700 Best Buys in the US and Canada ...and there are roughly 3000 Gaps in the world. So ... well ... yeah, we know this is about as non-apples-to-apples as we can get, but as far as reference points go, if there are 700 Best Buys, we think Apple can one day get to 300... one day. They are at 125 now... plenty of room to grow...

There are 700 Best Buy stores in North America ... how many can Apple grow to?

Question: Can they continue to grow revenues and profits per store?

Hmm... well, we're aware that theoretically... with each new store, the average rev's and profits of their old stores might be compromised. But, this certainly hasn't happened yet – as the stores have matured and attract more traffic, *annual sales per store have increased from under \$10m in 2003 to over \$20m in 2005*. Additionally, if our “analogue

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conduit” theory holds up, we think Apple stores have a long way to go before they start cannibalizing with one another...

So, now that we have rough assumptions for # of stores and avg sales per store, how big can retail’s contribution get? Well ...using 160 stores in 2007 and \$24m per store...

→ to 18% of sales by FY07 ... growing into a \$3.8b business...

	2003	2004	2005e	2006e	2007e
Average # of stores during year	55	75	105	135	160
Average revenues per store	9	16	22	23	24
Retail Store Revenues	621	1,185	2,300	3,105	3,840
Rough Revenue Ests for Apple	6,207	8,279	14,200	17,000	21,500
Retail as % of overall revenues	10%	14%	16%	18%	18%

How ‘bout profits?

Well, again, in and of themselves, the retail stores have not been a large contributor to Apple’s profitability. But if we also consider the *manufacturing profit* Apple makes on a sale through a retail store, then the contribution becomes very significant.

Running a similar, crude, sensitivity analysis

... we notice that in FY05, the average Apple retail store generated \$5.5m in profits ... up from FY04’s \$3.4b. If we project to 160 stores in 2007e and use an average store profit average of \$6.5m, we see that after generating about \$575m in profits in FY05, the retail stores can grow profits by another \$425m or so ... to reach \$1.0b in FY07.

That’s all well and good, but when we realize that current Street estimates for Apple’s overall EBIT are only slated to grow by \$400-500m from FY05 to FY07 – from \$1.7b to \$2.1b – we stop to take notice.

	2003	2004	2005e	2006e	2007e
Average # of stores during year	55	75	105	135	160
Overall Retail Profits: Store + Mfg	100	252	575	810	1,040
Average Profits per store	1.8	3.4	5.5	6.0	6.5
Approx EBIT for Apple overall	-	326	1,650	1,950	2,106
Retail stores as % of overall profit	NA	77%	35%	42%	49%

This means that if our sensitivity analysis’ assumptions are even in the right ballpark – a big if, mind you – then Apple’s retail stores can account for nearly all of Apple’s total estimated EBIT growth over the next two years ...with minimal contribution from other sales channels...

So what?? ... there’s a lot here ...what are our takeaways?

Are we 100% confident Apple’s retail stores are gonna exactly generate \$1.0b in profits in 2 yrs time?

No. This is a verrrrrry rough sensitivity analysis. This is not a forecast ... it’s a reference point...

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But, does our reference point give us increased conviction that – as long as Apple's retail stores continue to flourish – that there is still plenty of earnings growth to be had at Apple?

Yep.

Maybe more than folks currently expect?

Yep.

... so ... going forward, we're gonna look more and more closely at the store count ... revenues per store ... and profitability per store to see how they're tracking with our sensitivity assumptions above...

Stock Screen – Searching for Sell ideas

We're going to examine another model – MSFT – in just a bit ... but first, we asked Pam to run a stock screen before she jetted off to Australia. *The screen: we identified which tech stocks had >20% expected revenue growth in 2006 and PEs above 25x 2006 EPS.*

What were we thinking?

Well ... we were looking for Sell ideas. Now, there are several different ways to identify a good "Sell" ...

- #1 → Identify companies that will someday disappoint on the earnings front and miss lofty growth expectations ...
- #2 → Identify companies that will someday experience multiple contraction ...
- #3 → Identify companies that will experience both estimate reductions and multiple contraction...

Using #1 and #2 to find Sell ideas certainly has its merits, but today we're looking at #3 ... so we ran a screen to find companies that had both high growth expectations and high valuations.

What'd we find?

Well ... frankly ... we didn't find that many good sell ideas – bummer – likely a function of the fact that tech estimates having come down over the past 5 years.

Generally speaking, estimates across broader tech are OK ... which is one of the reasons why we're spending more time nowadays looking at stocks, not sectors, and not making macro calls on "tech". From 2000 thru 2002, as estimates were falling across the entire tech landscape, we were more inclined to make broader bets. These days, it's about stocks ...

"The aging of America isn't a temporary event ... Where we had 35.5m people age 65 and older in 2000, we'll have 69.4m in 2030." ...

... The Coming Generational Storm, Laurence J Kotlikoff and Scott Burns ... who also provide these stat → Population age 65 and over: 1900 4.1%, 2000 12.4%... and rising.

The point → there are lotsa analogists for Apple to tap into...

We screen global tech stocks to find names that are both expensive and have high 2006 growth estimates...

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What we *did* find was a lot of *Safari* names ... names that are exposed to trends that we are kinda excited about and that do merit some scarcity value... names like Salesforce.com ... RIMM ... Cognizant ... Infosys ... Wipro ... flat panel plays like Genesis Micro and Trident ...

Company Name	Mkt Cap	06E Rev Gr	06E P/E	Company Name	Mkt Cap	06E Rev Gr	06E P/E
Google Inc.	\$159,122	45%	39	Cognex Corp.	\$1,403	21%	28
QUALCOMM Inc.	\$65,217	22%	28	SiRF Tech	\$1,327	41%	38
Yahoo! Inc.	\$46,834	28%	45	Ixia	\$1,189	20%	27
Infosys	\$19,312	31%	30	Sonus	\$1,166	27%	32
Cognizant	\$18,688	41%	34	Websense Inc.	\$1,165	23%	27
RIMM	\$15,362	31%	25	Equinix Inc.	\$916	25%	86
Broadcom Corp.	\$14,422	21%	27	Genesis Micro	\$891	21%	30
Wipro Ltd.	\$13,780	25%	26	SS&C Tech	\$858	23%	25
Marvell	\$12,997	23%	31	Trident Micro	\$855	41%	31
Juniper	\$12,909	22%	26	GSI Commerce	\$783	23%	30
NTAP	\$8,631	26%	26	Conexant	\$776	25%	35
livedoor Co. Ltd.	\$4,661	47%	49	Autonomy	\$759	32%	41
TomTom B.V.	\$4,347	64%	25	Sify Ltd.	\$716	33%	184
SMIC	\$3,661	35%	29	OpenTV Corp.	\$688	24%	36
Red Hat Inc.	\$2,519	29%	42	Exar Corp.	\$667	22%	47
Cogent Inc.	\$2,420	42%	31	Aplix Corp.	\$647	57%	386
Cypress	\$2,086	20%	28	O2Micro	\$637	24%	25
Salesforce.com	\$2,038	48%	64	Marchex Inc.	\$538	38%	26

Did we find any Sell candidates at all?

Yeah.

NTAP – Adding to Sell Candidate list

NTAP stands out. Competition is heating up in the storage space ... especially as EMC and NTAP collide in the NAS market ... and folks are still expecting 26% revenue growth – that's a lot – and it's trading at a 26x multiple ... which doesn't seem crazy given NTAP has traded well into the 30-40x range for a long time. But ... maybe, just maybe, with that 30-40x range came a presumption that NTAP was gonna keep taking #'s higher.

Last qtr, #s came down for the first time in awhile.

An anomaly or a trend? And is there more room for NTAP's multiple to come down?

If competition heats up and #s have to come down more, absolutely...

“HP is not out of the woods yet – as the company itself fully admits – but the signs are that it's making progress in turning around its storage business. ... For the first time in a long time, we're starting to see HP get aggressive from a competitive perspective, especially against the two industry fire starters: Network Appliance and EMC.”...the451 Group

Comm ICs Still Expensive

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There are also a handful of comm IC plays that made the list. Broadcom, Marvell, Conexant ... Cypress ... Exar ... and if we took the mkt cap minimum down to \$400m, Vitesse. Now, before we jump to conclusions, we'll want to see what's behind those growth estimates ... but our initial hunch is that the Street might still be living in Denial when it comes to the comm. IC names – *Are there **that** many growth opps in comm. Equip? Are any of these companies counting on stories like WiMax or FTTX? And do they deserve 30-40x multiples? Hmmm...*

So what? What are we doing with all this?

We are adding **NTAP** on our Sell candidate list. But, for more Sell ideas, we're gonna look to a different basket of companies ... companies that did not qualify for today's screen because ... well ... they don't have PEs. They are not profitable... and, in many cases, the sell-side's ever optimistic outlook has some of these companies restructuring successfully ... and in many cases ... well, they won't succeed.

*So, our Sell list is littered with non-profitable, broken companies like **Ciena, 3Com, WebMethods, Sun**. Other loss makers on our Sell Candidates list → **JDSU, Unisys, Novell, Viisage, Kemet, Midway...***

Microsoft – New products driving growth?

A nugget from Microsoft's Professional Developers Conference a couple week's back:

"When these products come out in late 2006...it will be the largest marketing event we've ever had," Microsoft Chairman Bill Gates said in his keynote speech Tuesday, referring to the new versions of Office and Vista.

Hmmm... if by "largest marketing event", Microsoft means "most hype", then ... well ... yeah, might be hard to argue.

But, are Microsoft's upcoming product releases the company's most important product releases ever, as some are suggesting?

No way. Nothing against Microsoft ... in fact, as Pip talks about in our Change section, we think the company – in some ways – is adapting well to the change occurring around them – tech's slowing growth, that is.

... but really, how much impact can Vista ... or Office ... or even X-Box have on Microsoft's overall top line growth?

To find out, we examined Microsoft's model more deeply... Here's what we found out...

Point 1 → There's a big variance in "out" numbers on the Street

What do they do? Overly aggressive estimates? Or exciting names in hot spaces?

*livedoor Co. Ltd.
Software for Skype*

*TomTom B.V.
GPS car navigation*

*SiRF Tech
Location technology ICs*

*Ixia
Network performance test*

*Websense Inc.
Web filtering -- security*

*Equinix Inc
Data ctrs/ internet
Xchange*

*SS&C Tech.
Software - financial
institutions/ hedge funds*

*GSI Commerce
Outsourced e-commerce
solutions.*

*Sify Ltd.
India Internet, e-commerce*

*Aplix Corp .
Japan software - java for
mobile phones*

*Marchex Inc.
Advertising and search
marketing*

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From a bottoms up revenue perspective, there's not much "consensus" about what growth to expect from MSFT's new products. We found some models with FY07 "Home and Entertainment" revenues well north of \$8b with others well south of \$6b. Some with "Servers" growing mid-single digits in 07 with other models well into the teens.

*Vista ... SQL Server
 ... X-Box ... IPTV...*

*Earnings drivers?
 Or multiple
 stimulants...??*

So what?

Well, funny thing is, despite the bottoms-up discrepancies, there isn't a whole lot of variance in the Street's growth estimates for Microsoft as a whole in FY06 and FY07.

The point → for a company this large, it's going to be difficult for any single segment to move the overall company's needle a whole heckuva lot.

At any rate ... we dug under the weeds and looked at growth expectations for each of MSFT's segments to see if we could find some insights... Couple quick observations:

		FY02	FY03	FY04	FY05		FY02	FY03	FY04	FY05
Client	Revenue	9,350	10,287	11,241	11,996	Op income	7,000	8,400	9,000	9,300
	Y/Y growth %		10%	9%	7%	Op margin %	75%	81%	80%	78%
	% of overall revs	33%	32%	31%	30%	% of overall op income	79%	80%	78%	56%
Servers	Revenue	5,632	6,692	7,881	9,321	Op income	110	1,840	2,170	3,000
	Y/Y growth %		19%	18%	18%	Op margin %	2%	28%	28%	32%
	% of overall revs	20%	21%	21%	23%	% of overall op income	1%	18%	19%	18%
Info Worker	Revenue	8,328	9,695	10,924	11,331	Op income	5,900	7,500	8,070	8,400
	Y/Y growth %		16%	13%	4%	Op margin %	71%	77%	74%	74%
	% of overall revs	29%	30%	30%	28%	% of overall op income	66%	71%	70%	51%
Biz Solutions	Revenue	308	577	660	796	Op income	(320)	(200)	(180)	(165)
	Y/Y growth %		87%	14%	21%	Op margin %	-104%	-35%	-27%	-21%
	% of overall revs	1%	2%	2%	2%	% of overall op income	-4%	-2%	-2%	-1%
MSN	Revenue	1,924	2,396	2,444	2,365	Op income	(1,015)	(380)	400	465
	Y/Y growth %		25%	2%	-3%	Op margin %	-53%	-16%	16%	20%
	% of overall revs	7%	7%	7%	6%	% of overall op income	-11%	-4%	3%	3%
Mobile/Embed.	Revenue	124	153	239	334	Op income	(360)	(160)	(100)	(20)
	Y/Y growth %		23%	56%	40%	Op margin %	-289%	-106%	-43%	-6%
	% of overall revs	0%	0%	1%	1%	% of overall op income	-4%	-2%	-1%	0%
Home / Entertain.	Revenue	2,411	2,779	2,870	3,209	Op income	(1,130)	(940)	(890)	(340)
	Y/Y growth %		15%	3%	12%	Op margin %	-47%	-34%	-31%	-11%
	% of overall revs	8%	9%	8%	8%	% of overall op income	13%	-9%	-8%	-2%
Total	Y/Y growth %		13%	14%	8%	Op margin %	31%	33%	31%	42%

- **Microsoft's Client division** – Windows – makes up 30% of revenues and 55-60% of profits but as the company expands its product line, it has become less of a contributor over the past couple years. This is where Vista will show up first btw...
- **Info Worker – Office Suite** – is similar to Windows – roughly 30% of revs and 50% of profits ... and declining.
- **Servers – SQL Server** – 20-25% of revenues but lower margins ... roughly 18% of profits...

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→ **Home and Entertainment – IPTV and Xbox** – becoming a bigger part of revenues but still not profitable. Our take → Xbox should take this segment north of 10% of total revenues by 2007 but we're not jazzed about IPTV's prospects any time soon...

Sensitivity Analysis → Vista's effect on sales and earnings

Let's run a sensitivity analysis. For the sake of time and space, we'll limit this analysis to Vista.

Our aim? NOT to perfectly forecast Microsoft's revenues and earnings accurately. We realize this sensitivity is over-simplified ... but our goal is merely to find out how much impact Microsoft's new products will have on Microsoft's overall needle...

	FY04	FY05	FY06E	FY07E	FY08	
					Client @ 10%	Client @ 20%
MSFT Revs	36,850	39,800	44,178	49,258	54,047	55,400
Revenue Gr%	14%	8%	11%	12%	10%	12%

What do we find out?

Sensitivity analysis → base case: We assume Vista drives 15% growth in Microsoft's Client division in FY08 and that Microsoft as a whole grows 11% in FY06, 12% in FY07 and 11% in FY08 – numbers roughly in line with the Street.

Now, our base 15% growth for the "Client" segment might not seem like a huge number ... until we realize that by FY08, the Client division will likely be a \$15-16b business. Tough to grow \$15b by 15% in one year...

Also, it's important to note that in FY08, even though Vista will be over a year old, it will still not account for *all* of the Client segment's revenues. In fact, our old friend Heather Bellini at UBS expects Vista to comprise a mere 40% of Client revenues in FY08... driving 8% y/y growth in that segment...

Now, let's see how different growth rates in the Client segment affect overall revenues...

Conclusion → Microsoft's new products might actually be more of a stimulus on multiples than they are on earnings. We suspect "successful" ramps of X-Box ...or ...Vista ... or ... SQL Server might mean the difference between ... say ... 10% top line growth and 12% ... not 9% and 25% ...

- **Scenario 1: 20%** Client growth → all other things being equal → generates **12%** overall growth for Microsoft.
- **Scenario 2: 10%** Client growth → all other things being equal → generates **10%** overall growth for Microsoft.

As far as operating income goes, using historical margin assumptions of 80%, the extra 10% top line growth in Microsoft's Client segment would generate an extra \$1.0b in operating income ... \$700m post taxes ... or roughly \$0.10 EPS off a base of \$1.80 or so in FY08.

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So ...are new products like Vista worth “noting”?

Absolutely.

Worth all the hype?

Eh ... not really.

Maybe they should slash R&D ...

Next topic on Microsoft → This week, Microsoft announced a restructuring to “streamline” its organization ... push “decision making” capability further down so the company can better compete with smaller, more nimble competitors like Google, Yahoo, Apple...

Our take? More nimble sounds good in theory. But it’s not clear to us how this particular restructuring will help. Will the formation of a new “Entertainment and Devices” platform really help Microsoft stop Apple in its tracks? Nah.

So what would we like to see from Microsoft’s management instead?

Well, this is all gonna sound counterintuitive... but, our starting point is that, well, Microsoft isn’t that innovative anymore.

So ... the intuitive response might be → then they should spend more on R&D!!!

But ... our response is → please cut R&D!!!!

We don’t want to see *more* R&D. We want to see *more efficient* R&D. From Fred Brooks, the father of the IBM System/360 in The Mythical Man Month →

“Adding manpower to a late software project makes it later”

So, hmmm, maybe Microsoft needs to have fewer people creating things ...but greater efficiency. Since Ed Zander has been at MOT, we sense a greater efficiency and effectiveness ... and heck, Apple does pretty well with their 4% in R&D as a % of sales

A quick and dirty sensitivity shows that if MSFT had spent ... say ... 12% of revenues on R&D in FY05 instead of the 16% they did spend – \$4.6b in absolute dollars instead of \$6.1b – they’d squeeze out another \$0.15 in earnings and EPS would have been closer to \$1.27 than the \$1.12 they reported ... and, well, they’d *still* have a massive \$4.6b R&D budget.

So ... can MSFT “get by” with spending \$1.5b less?

Well, we’ve never run a \$40b company, but our guess is yes...

*An add’l 10%
growth in Client
revenues equates to
an add’l \$1.4b in
revs ...or roughly
2% ...*

*... \$1.0b in op
income ... and
about \$0.10 in EPS
all the way out in
2008*

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... now the good news → Microsoft *has* cut its R&D budget from the 20% just 2-3 years ago to 16% in FY05. Much of this can be attributed to stock based compensation coming down, but ...yeah ... they are moving in the right direction.

	FY2003	FY2004	FY2005
R&D % incl stock based comp	20.5%	21.1%	15.5%
Stock based comp in R&D	\$1,964m	\$3,117m	\$1,241m
R&D % excl stock based comp	14.4%	12.7%	12.4%

If Microsoft spent about \$1.5b less in R&D in 2005, EPS would have been \$1.27 instead of \$1.12...

So ... how much more aggressive is management willing to get???

...and, is management willing to take the wrath of investors saying they're no longer committed to growth if they cut R&D?

Tough one, politically ...

... more on Microsoft and other large cap tech in the Change section later in the program...

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Upcoming Catalysts

Events we care about:

- Sept 28th: RIMM Earnings
- Sept 28th: Garmin Analyst Day
- October 5-7th: Web 2.0 Conference
- October 6th: Accenture Earnings

Warning: this is going to be one long run on sentence about how Jabil, Micron, Solectron, ATI will all report earnings in the next couple of weeks ... and how SAP will and BEA will both host user/tech teach ins ... and how Intuit, Nat Semi will host analyst days ...

Events we care about:

- 9/28: RIMM Earnings
- 9/28: Garmin Analyst Day
- 10/5-7: Web 2.0
- 10/6: Accenture Earnings

... but we're not really going to talk about them 'cuz we think they are pretty well previewed by Wall Street and we don't see much value to regurgitating a bunch of consensus factoids...

... so having said that, what will we care about?

Conferences and Trade Shows

The two industry events we'll be watching, but unfortunately won't be participating in this year, are Web 2.0 out in San Fran and the Gartner IT Expo in Orlando.

Web 2.0 this year will be pretty exciting...the eBay/Skype deal has the VC community buzzing again that – hey, the sky REALLY is the limit. Uh huh... delusions of grandeur about this second wave of the internet aside, people *are* using the Internet more – just ask our cohort at Coburn Ventures about the wide eye panic if we can't get a connection – and we see this deal is another sign of the convergence / collision course that the wireline and wireless telcos, media, eCommerce, and search companies as well as Intel and Cisco are all on together ... ☺

<u>Date</u>	<u>Conference</u>	<u>Location</u>	<u>What's important?</u>
Sep. 27-29	SAP TechEd	Boston, MA	
Sep. 27 -29	BEA eWorld	Santa Clara, CA	
Sep. 27-29	CTIA Wireless IT & Entertainment Conference	San Fran, CA	
Sep. 28	Intuit Analyst Day		
Sep. 29	Garmin Analyst Meeting	Webcast	Making sense of Garmin, Tom Tom and Navteq
Oct. 5	Nat Semi Analyst Day		
Oct. 5-7	Web 2.0 Conference	San Fran, CA	eBay/Skype, convergence, the second wave of the internet

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Oct. 16-21

Gartner IT Expo

Orlando, FL

SOA, the future of packaged apps, what do users really think of the recent consolidation?

The Gartner IT Expo in Orlando is a major orgy of 4,000 techies. Something like 19 of the 30 hotels inside Disney are filled with conference attendees... this is big and this is also fairly mainstream, with representation from pretty much every industry and both the public and private sector.

So, it's a great place to take the pulse of the current challenges inside the IT industry from the folks that are actually doing the work. Given the recent batch of M&A activity, questions we'd love to get a handle on would be:

- What is the future of packaged software?
- What do customers REALLY think of the recent slate of consolidation?
- How do they think ORCL/SEBL stack up against Salesforce.com?
- What are the trends in SOA (service oriented architectures)?

The **Garmin analyst meeting** on the 29th will be an information gathering session for us to get a handle on the GPS industry. Lehman recently ratcheted up rival Tom Tom's numbers and suggested even that might be too low – a growth investor's dream. The key thing we want to figure out here is – how much of the growth is banking on the ramp in handheld devices.

Earnings and such...

Of the half dozen or so earnings reports over the next two weeks, the two that we really care about are RIM on Sep. 28 and Accenture on Oct. 6.

On RIM, the questions we ask ourselves as we watched the stock run from \$70 to \$80, then back down to the mid \$70s in the past month are:

- ◆ Do we expect RIM to say something that would alter our long term investment thesis? Answer: no. We don't think Nokia and Palm's Blackberry initiatives will pose any threat, any near term blip in the stock is just noise.
- ◆ Do we expect earnings to be a catalyst that would bump RIM out of the recent trading range? Answer: not likely. Progress on the NTP patent suit could be a bonus, but doesn't really impact fundamentals.
 - **Aug. Quarter Consensus** → revs of \$487 million, +57% y/y, EPS of \$0.61. Handset unit shipments ~900k, new subs ~600k. Current subscriber base (end of May) 3 million.
 - **Nov. Quarter Benchmark** → revs of \$543 million, +48% y/y, EPS of \$0.66.

Earnings in September:

Sep. 26 – Jabil

Sep. 26 – Micron

Sep. 28 – RedHat

Sep. 28 – RIM

Oct. 6 – Accenture

*Oct. 6 – ATI
Technologies*

On Accenture, we like their consulting exposure and their market position... but we want a simpler user experience for this stock – we want to see a “clean” quarter, as overused as the term might be... where there's nothing controversial, where we can get a clear set of metrics with which to gauge the progress of the company – that doesn't change from quarter to quarter.

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About Change ...

The Change Framework meets Large Caps

Imagine doing a survey course of the *Change Function* meeting some of the largest cap tech stocks... that's what we are up to this week...

About ten days ago I hosted a panel discussion with three veterans of Apple Mike Homer – now of Kontiki, Brodie Keist – now at TiVo, and Kirk Lovener – now at Epocrates. The discussion centered around the *Change Function* that we have been purporting for some time and these ex Apple folks didn't require much coaxing to get behind the possible merit in our *Change Function*. Apple exemplifies – as Dave mentioned earlier -- the *Change Function* after all. Apple gets whatever "it" is.

So, with my brilliant moderating the four of us bobbed and weaved for an hour on all things change oriented. Pleasure. One disappointment? We didn't get to checking out key large cap names thanks to my mediocre moderating ability. So, today, here is our chance.

Let's get started...

What I am gonna do here is look at a bunch of these folks and say "yea" or "nay" as to whether that company "gets it"...

Well, what does "get it" mean? What do we want people to get?

We want folks to get that the vast bulk of the growth opportunities for the largest cap tech stocks has vanished, that consolidation is a game worth successfully playing, that technology is largely in the process innovation stage as opposed to product innovation a distinction discussed by author James Utterback and that users are in charge of adoption as opposed to sellers.

That's it ...

Just a warning I suppose: we do NOT equate "get it" with exciting and "not get it" with boring. Some companies that you and I might agree are reasonably boring in their older age have managements that do "get it" and apply themselves consistent with the new world. But from an investment point of view, we are typically attracted to highly volatile situations. We hope to take advantage of our change thinking to the greatest extent possible. The more volatility, the greater the opportunity we suspect and so the fast growing Tech Safari names are always alluring. We want an 18-month, 40% upside or downside case in order to jump in. Hard to find that in Microsoft.

OK. So... is Microsoft relatively boring?

Sure.

... books Pip has read on
CHANGE ...

...more at
[www.coburnventures.com/
About_Change/
What's_Pip_Reading.html](http://www.coburnventures.com/About_Change/What's_Pip_Reading.html)

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***The Structure of Scientific
Revolutions***
Thomas S. Kuhn
*My favorite book on
change... published way
back in 1962...*

Unstuck
Keith Yamashita & Sandra
Spataro
*Identifying points when
change is required in
companies and how to
implement*

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Is it likely to rise or fall 40% inside 18-24 months?

Nah!

Do we still find value in applying our *Change Function* thinking to the largest cap companies? You bet. The impact may typically be more subtle but ¾ of the investment world counts in figuring these names out to earn their keep.

Microsoft?

Dave and I are here sitting near the water on a spectacular Wednesday in Boston – Dave with his Nantucket Nectar and me with some Poland Spring water from the great state of Maine – so why not start with MSFT... it is a tough one... but NO they don't get it...

Yikes! Controversy straight away...

First let's ramble a touch about the tremendous evidence that they DO get it at Microsoft... that they do see the world has changed and that users are in charge and that mature companies will need to act mature and that Bill Gates and/or Steve Balmer would want to be remembered as the next Jack Welch...

Here it goes...

Microsoft is working on security, easing toward open source integration in some cases, releasing an amazing second gen Xbox, paying a dividend, throwing out more cash thru a huge one-timer, watching T&E expense, reducing medical, reducing the IT budget, partnering much much better, settling differences with former nemesis Sun Micro, settling numerous litigious events – I like saying litigious occasionally to make up for not having gone to litigant school, the focus on cash flow, making money at the segment level and all sorts of nice things. These are all actions consistent with “getting it”.

So what is our problem?

Well Dave spelled most of them out a tad earlier but I think Microsoft still sees itself as a tech innovator as opposed to a process innovator to, again, use James Utterback's phrases! ***Most folks would benefit from considering themselves process innovators first and foremost with “technology” being the content much in the way “hamburgers” is McDonald's content.*** Dell is a process innovator! Nothing embarrassing about it so long as that stock gets moving before too long!

Well Microsoft is a process innovator that still pretends that it is a product/technology innovator and seems to day-to-day consider itself as such. A week back I endured news reports about MSFT releasing its most impressive array of new products up just ahead but the company. But this company will grow at maybe 12% next year as opposed to the olden days of 40%+. Nothing wrong with 12% but is this product set – aside from volume perhaps – the most awe inspiring release we have seen?

The Innovator's Dilemma

Clayton M. Christensen

Shows that innovative companies are unable to follow on with further success due to cultural problems

The Innovator's Solution

Clayton M. Christensen

Superb sequel to his classic Innovator's Dilemma... focus on focusing on "services" and a tie to a brilliant 1975 article by Ted Levitt

Mastering the dynamics of innovation

James Utterback

The distinction in between product innovation, dominant design and process innovation... think about Dell vs everyone else

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No. Nothing revolutionary.

Nothing that will have the world look much if at all different and unlike the early 90s when MSFT dictated user choice that's no longer the case. People may find that the RSS feeds Vista enables as wonderful but

folks are gonna employ RSS feeds at their own pace without MSFT's prompting.

In 1995, Start Me Up and Windows 95 helped get the world in a fresher faster gear. There is no Microsoft wide effort today – nothing wrong with Xbox 360 but it doesn't move the Microsoft needle.

We would love to see Microsoft start cutting its massive and seemingly ineffective R&D program. Unfortunately we don't see it happening soon.

Why?

Cuz... every time someone claim Microsoft isn't innovative the company points to the six gazillion dollars it spends on R&D in core areas like voice interaction and all so if they started chopping this figure – which makes sense to us -- folks would say "management is not only not innovative but they are also cutting R&D spend as a sign of"

The problem is that tech companies outside of Dell are embarrassed to say that they are not innovative... even Oracle wants to call itself innovative with the project Fusion at the same time it is really providing a consolidating service to their space.

So... if MSFT stops acting day-to-day as if they were largely an innovative company, announced they would start reducing R&D dramatically, set in place a process of getting bigger results for their billions in spend as Motorola now seems to be doing post Chris Galvin and further got behind process innovation that protected its core assets/position we would be more excited!

Was MSFT threatened by Linux and Firefox because those are more technologically innovative as in 10x technological changes?

No.

They are being threatened because MSFT gives people the willies in relationship to security for better or worse. Fixing security is what saves their franchises which allows the franchise to have tack on growth. Something tells me the more money spent on R&D at Microsoft the less likely the odds are of solving the security woes – industry folks might think of this as Brook's Law of Security development.

Does IT Matter?

Nicholas Carr

Nicholas Carr suggested that Information Technology was FULLY commoditized... fails to consider that nearly every company on the planet is either aiming to use technology as a differentiator or aiming to keep up with someone who is... see instead Jim Collins p 144-163 of Good to Great

Blink

Malcolm Gladwell

Very easy read about the power of enhanced awareness... popular hit

Chaos

James Gleick

Great survey of the history of chaos theory development

Complexity

M. Mitchell Waldrop

Chaos and complexity -- Brian Arthur plays the central role

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So do they get it? Close call but No!

Now... we have a bit of a challenge... we are thru 3 pages of say 5-6 and we have covered one company... the pace will pick up a bit here in just a second...

Does IBM get it? Yes

Yes, they are a behemoth and growing much slower than the Microsoft numbers I alluded to but they got behind being a “process innovator” over ten years ago when Lou Gerstner took over. This is a service company continually looking to provide a portfolio of options to its users and de-emphasizing its own products. They are getting rid of unprofitable units at nearly every turn – no, I can’t explain that big and not so new and not so profitable but expensive chip plant in East Fishkill, New York -- and aggressively leading the way in using low cost centers around the globe to shrink costs.

There is little pretense at the executive level that IBM’s center of gravity is around its technology. The center of gravity is clients and services and new ways of growing its business thru additional/new delivery mechanisms like the albeit floundering grid and autonomic messages. The company is largely without technological religion. Do we want to own the stock? Not particularly. It’s boring. We prefer volatility.

Does Lenovo get it? No...

Lenovo facilitated IBM getting out of unprofitable businesses. Lenovo is larger than it was but it is not product innovative contrary to the nice media effort recently that this new entity has mustered up to create a cool company reputation. *Unfortunately, Lenovo is not a good process innovation company.*

I suspect this story will end quite poorly and not quietly at all because of its high profile story -- *“Former China Legend buys former U.S. legend”*. The whole thing feels awful but we also respect that the market has gotten sucked into the vortex that this deal is a cool and great thing. New management controls the power points to date – most folks considering this deal don’t know Lenovo from a whole in the wall and likely don’t even know it was called Legend until not so long ago. Most of the folks meeting with the new management have never been to China. This is a nice “story” but I do not expect it to end well but for the next 2-3 quarters it should be safe if not somewhat positive as the first few quarters post a deal like this are usually easily controlled.

Cisco? No...

Doesn’t get it. Great great great company but not a growth company and it seems like their folks are STILLLLLLLLL looking to find those big new

The Celestine Prophecy: An Adventure James Redfield

a search for an ancient manuscript leads to a review of sorts of major changes in society and possible changes ahead

The Future of Peace Scott Hunt

Scott Hunt interviews a number of world figures to ask them few of what peace is and to understand how their view of peace impacts their view of how change can occur. Psychotics of "change" will love the deep connections and others may fall asleep. I LOVED it!

Good to Great Jim Collins

All about the cultures that create and extend greatness... discussion of commonalities of great leaders

Slack

Tom DeMarco

Tom DeMarco gets at change in the enterprise and about creating necessary pre-conditions

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opportunities to exploit to maintain their status as a growth company.

Is it easy to go from “growth” to “mature”?

No!

Is it necessary at a certain point to fess up?

Yes

Do options issued to employees mean that much to employees anymore?

No.

Why?

Cuz the stock ain't flying north any time soon like in the olden days. Cisco is fighting so much about options but for a non-growth company options don't provide the incentive they did way way way back when. So the employees aren't jazzed as if Cisco was Google. Was Cisco “Google” a long time ago? Yeah. No longer.

	Mkt Cap	2wk %	1mo %	3mo %	12mo %	Rev Growth '05 Y/Y %	Rev Growth '06 Y/Y %	PE 05	PE 06
Microsoft	\$278,530	-5	-3	4	-5	8%	11%	24	20
IBM	\$126,754	-1	-4	4	-7	-4%	2%	16	14
Intel	\$150,375	-4	-5	-8	18	15%	8%	17	15
Cisco Systems	\$114,011	3	3	-7	-6	12%	11%	20	17
Dell	\$82,256	-4	-5	-15	-4	19%	15%	26	21
Siemens	\$68,943	1	0	2	5	-1%	8%	18	13
Nokia	\$72,386	5	5	-4	18	4%	5%	17	15
Oracle	\$68,659	2	2	7	17	17%	21%	21	17
Qualcomm	\$69,635	8	5	21	11	15%	21%	38	30
AMD	\$8,899	8	8	27	75	7%	12%	105	36
HP	\$82,741	4	9	21	57	8%	5%	18	16
SAP	\$13,463	2	2	3	9	2%	9%	28	25
Ericsson	\$563,244	2	2	8	24	0%	6%	18	17
Google	\$84,832	6	11	6	155	81%	42%	55	41
Ebay	\$50,013	-9	-6	-1	-19	35%	29%	44	36
Texas Instruments	\$53,187	0	3	19	44	6%	13%	24	20
Motorola Inc	\$57,430	6	11	28	34	15%	8%	21	18
TSMC	\$202,500	1	-1	-10	14	-2%	17%	16	13
Apple Computer	\$43,682	12	15	40	179	68%	18%	37	33
CANON	\$46,473	3	3	-4	10	-5%	5%	14	13
Average of All	\$ 111,901	2	3	7	31	15%	13%	29	22

Intel? Doesn't get it.

Intel is the home of Moore's Law and a *deep deep* embracer of disruptive technologies and all but the bulk of the work today seems to be about power issues and heat issues. We are done with the speed races in favor of usefulness and that should be the end of the matter with the headline “former technology pusher becomes amazingly efficient company as world goes from product innovation to process innovation.”

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Instead Intel still seems to believe that day in and day out it can take its role as supplier during the PC adoption stage – facilitated first and foremost by the graphical user interface and supported by faster and faster chips – and has a new “platform approach.”

... nice and all but Intel sits at the back of the food chain. They are far away from the end user. There are a number of folks in between Intel and the user who have more say about products.

We are all for hiring anthropologists to go whisper in folks ears how to make technology simpler for the end user but Intel is not the player that actually makes the technology easier to use. Intel is hired help today. The platform approach presupposes greater importance to Intel than is reality here in 2005 especially with the likes of AMD breathing down their technological neck and the likes of many many folks like Qualcomm, Texas Instruments, NVidia, IBM/Sony/Toshiba, Broadcom, Samsung and RIMM to name just a few frankly miles ahead of Intel in important areas.

Intel is a PC/Server company and the takeoff in laptops is a very fortunate thing and someday most laptops will not only have a Centrino-esqe chip but lots of the end users will actually sit at Starbucks and use that capability.

Does it make sense to spend a gazillion dollars to market Centrino in hopes of kick starting a trend?

Sure.

Does it make sense to think you dictate habit to six billion people?

No.

Intel is a manufacturing company and one might think it therefore in a great place to become a “process innovation” company but its heritage and cultural legacy dictates that it keep looking to be more important in the world’s technological decision process than it is.

Qualcomm? Gets it.

Qualcomm qualifies as one of the most self-aware companies in tech. They created an entire market around CDMA by goading others to become part of the CDMA ecosystem and then peeled off the businesses it could not make money in. It is still early early early in enjoying the fruits of the 3G world where its patents extend and royalty streams will pour in from sources previously cordoned off by GSM. Worries over QCOM exposure if 4G takes-off to fast.

Oracle? Gets it.

They are mature and they know it. Fusion is about process innovation not product innovation. Buying PeopleSoft and Siebel and all is about consolidating an industry – more commentary in the AlwaysOn – www.alwayson-network.com piece this week.

Samsung? Gets it.

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his company woke up in the late 90s during the Korean financial meltdown. It recreated and repositioned its brand successful extremely quickly to represent quality. Samsung is the cost effective supplier in DRAM and in displays. Not an accident → they know those businesses are all about process innovation.

Ericsson? Gets it.

After years as an exemplary serial restructurer the company brought in the right management and started quickly hacking out costs and reducing growth expectations. The company got away from the siren's call for growth growth growth. Congratulations.

Dell? Gets it

Perhaps the best process innovation

HP? Finally gets it???

HP? On the way to getting the new world for us...Gets it now... less talk about innovation! More about making money! Will there be an interesting story after Mark Hurd settles in and investors also are forced to examine the playing field? Too early to tell. Mark Hurd deserves the honeymoon period.

Motorola? Gets it.

While Motorola found a hit with the RAZR phone – as well as likely a big ole clunker in the ROKR – what Ed Zander has really brought is discipline, order and intensity to the corporate culture. These qualities had been sorely missing. In the past an ineffective R&D effort might be excused by the “ever coming” growth that might be tapped. Ineffective divisions seemed content to be ineffective since the threat of a spinout – with the accompanying layoffs – ran contrary to the idea of Motorola management perhaps enjoying the association with managing more and more as opposed to less. The recent spinoffs and discussion of additional spinoffs is a classic sign of a company that understands the world has changed. The focus has been on operating expenses and process.

Nokia? Doesn't get it.

This is a very tough one to call. Certainly Nokia has focused well on the emerging markets opportunities but R&D is high and sticky in coming down. Perhaps the Engage fiasco of a couple years ago is sticking in my mind too much but the recent hi-end handset release looks like another case of a smart phone gone awry.

More soon if I missed your favorite.

Always On

SKYPE'S OUT, SO IS SIEBEL

In an article in Barron's over two years ago, Larry Ellison was quoted as saying,

"It's not coming back. There's this childlike notion that the IT industry is different than the auto industry or the railroad industry. That IT will always be immature, it will always be run by venture capitalists up on Sand Hill Road, by clever entrepreneurs with the Next Great Thing. And if you dare not agree with them, they say you just don't get it. Get what? The industry is maturing. The valley will never be what it was...."

Fast forward to last week ...

In one day we had two deals.

One deal was about tech's maturity, and one was about the idea that tech will always be immature....

One of these deals makes sense, and we can't see the sense in the other.

It is now a few years gone by, since Larry Ellison generated his famous quote about the valley never again being the same. But for VCs out there, the Skype deal was further confirmation that the Valley will always be the Valley. The rejuvenation is the consequence of the latest architectural shift in technology, from an end-to-end network in Web 1.0 to a ubiquitous never-ending cloud around the corner in Web 3.0. If you can plug into it and add value, you can make \$4 billion — and you may still make \$4 billion even if you can't.

Euphoria.

Exhilaration.

Now, back to **non-euphoria, non-exhilaration.**

"Oracle's strategy is simple. Instead of innovating, buy as much installed base as possible, call it Oracle Fusion, and make sure it all uses Oracle database. Now, the same thing that happened to PeopleSoft will happen to Siebel, it will die...." ... Marc Benioff ... Salesforce.com

Larry Ellison is a multi-billionaire. He is also gearing his company and driving the software industry to act in concert with his personal acceptance of the cold tech world. This is the world where new technologies – including Skype – shrink the revenue pie for the industry as a whole.

"What might one expect when maturity finally comes to this or any industry?"

Consolidation.

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“What is Larry Ellison doing?”

Consolidating.

“Why are the premiums so low in virtually all the software deals going around?”

Sellers are desperate not to be one of the many, many, many companies that will be left unfortunately alone as the consolidation wave circles the planet. If you don't get bought you may become irrelevant soon enough anyway, so an extra 10-16% might sound good to a desperate board, but not at all to the investor typically expecting a 35% uptick.

Remember when the DOJ and a whole lot of other folks wanted to block the PeopleSoft deal? It was a little bizarre to us, in that the notion that the poor little buyers of technology would be defenseless against these mammoth almighty sellers of tech was laughable.

But ... software faces the following challenges to name just a few → *web services*, and the various combinations and permutations of all of these forces. Additionally, those so-called “*steady*” *maintenance streams* upon which many software deals are being priced aren't so steady at all in an absolute sense — though, yes, they are steady compared to new software licenses! CIOs have now been pushing back on maintenance for several years. Long long ago, such as in 1999, discussing a downward adjustment in maintenance pricing was virtually unheard of.

Poor defenseless buyers of software?!

Hah!

So now Larry Ellison is picking up the pace of consolidation with more and more, and we don't blame him. Not sure if there is any choice but to become a mammoth, less-innovating but more cost-conscious purveyor.

IT is mature.

Not sure if Oracle will come out of this better than today, but Oracle will be better than it would be otherwise. Siebel has kept R&D spend at a luxurious 20% of sales. That will drop. Oracle erased the PeopleSoft salesforce. Let's see what happens this go-round.... More of the same?

Marc Benioff's quote above is pretty much on target, and I suspect that if Larry Ellison didn't learn his lessons on public communication of intent during the PeopleSoft journey he would tell you directly himself. Because Larry Ellison – the multi-billionaire —thinks the industry *is* dead, and the playbook in such circumstances is straightforward.

Now there are other billionaires to talk of.

eBay and Skype

In the day of asynchronous communications, the eBay folks decided to get real time. But as our favorite telecom analyst on Wall Street, John Hodulik at UBS, points out “*eBay is not buying Skype because it is*

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longing to get in the long distance business. eBay is in the business of matching buyers and sellers and believes it could facilitate more transactions if it had the ability to allow people to speak.”

I fess up: I don't get this deal.

I know it has something to do with PayPal and pay-per-click and something to do with selling cars and communications and all sorts of stuff – so I am told – but I don't really really really get it and the \$4 billion “winning bid.” Hopefully I will.... I have been told by some that Meg Whitman is really smart and that she must have it figured out, but lots of smart people were doing things that we couldn't understand in 1998 and 1999 and it didn't end up well:

- *Remember the smart people who spent over \$100 billion on 3G spectrum in Europe?*
- *Remember the smart folks at JDS Uniphase paying \$41 billion for who-was-it?*
- *Remember when Steve Case was smart, then not smart, then smart, and then did the Time Warner deal?*
- *Bernard Schwartz and Globalstar? Benchmark and Webvan?*
- *Pip Coburn thinking the Cleveland Indians would one day win the World Series?*

What I see is folks – including us – dwelling on \$4.1 billion – a lot of money. In sales school – and this is a sales situation with the eBay investors as the audience – we all learn that when a potential client talks about price, we are to help bring them back to value. But in this case the “dwelling on” hasn't stopped.

For fun, just say “*eBay buys Skype*” to someone. Bet they mention the price tag inside the next 10 seconds.

So what was eBay thinking?

Here are some options:

- **Option 1:** eBay was goaded into the Skype deal, and more and more folks will certainly use Skype for international calls, but eventually Skype will be seen as valueless in its own right, but nonetheless as an important piece to control on the board....
- **Option 2:** eBay is a bit confused at the moment, and is looking for a new spark to their enterprise and cost became a secondary consideration to excitement....
- **Option 3:** eBay felt forced to respond to the VoIP positioning of the other major internet players... and didn't think it could develop its own quickly, and didn't want to pay just a little money as Microsoft did for Teleo but preferred to pay a lot for the headline-grabber Skype.
- **Option 4:** eBay was on the wrong end of a trade crafted thru a monumental campaign — by a company that is “not for sale” but was seemingly being shopped around to everyone on the block if the leaks in the general press were on target — and therefore no one really really knows why in the world the price tag is \$4.1 billion as opposed to some other number, since no metric

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allowed you to get much north of zero in and of itself as far as my small eyes can see. Sorry for the run-on sentence.

- **Option 5:** The deal was just plain brilliant.... and I just don't "get it."
- **Option 6:** The Cleveland Indians will win the World Series.

Wonder what Larry Ellison thinks....

"If greed and optimism fueled the first tech bubble, fear and pessimism are the drivers for this one...."
Eric Nee, CIO Insight