Issue 344: Wednesday, November 12, 2008

In This Issue

Telecom Overview: Another Earnings Cycle Winds Down

This week's edition of *The Telecom Connection* covers the last major block of model portfolio earnings from **Cisco** (CSCO), **Clearwire** (CLWR), **Netlist** (NLST) and **Qualcomm** (QCOM). For the most part, the results were disappointing, particularly when it came to the companies' respective outlooks for December. However, the oversold levels tended to produce some positive reactions in the stocks.

Last week, I referenced an improvement in new wireless subscriber growth in India. I have updated the data with September numbers for both India and China and included some comments on each.

As our inventory monitoring process winds down for another earnings cycle, there was no change in any of the numbers from last week. At this point, I believe it is unlikely that we will see any increases, but there's a good chance that it may fall another day or two as we close out November.

Lastly, as always, I've updated the model portfolio reporting schedule with the latest data at the end of the newsletter.

Now, let's take a look at the earnings results.

Model Portfolio Earnings Reviews

A handful of companies reported over the last week and, while they were generally bad, the reactions of the stocks were mostly positive.

• Cisco is indeed a bellwether for the technology and telecommunications industries and the cloud it cast over this market sector following its call was quite negative. While the results from its fiscal first quarter were essentially in line with expectations, the outlook created a knot in the pit of my stomach.

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From a product perspective, going by division, revenue from Routers increased 1% from last year while revenue from Switches rose 8% over the same time frame. As usual, Advanced Technologies was the strong point with total revenue up 15% year over year, led by Unified Communications (up 22%), Wireless (up 21%) and Security (up 19%). The Emerging Technologies division (i.e., the second generation of Advanced Technologies) experienced revenue growth of 25%, led by Applications Network Services (up 25%) and Video (up 21%).

Last quarter's book-to-bill ratio was characterized as "comfortably above one" but that was anything but the case this quarter. Product bookings were down 3% in the quarter and deteriorated throughout. August bookings were up 7% whereas October bookings were down 9% as customers worldwide warned that their business was deteriorating. I noted in the preview that management commented last time around that its service provider customers were very "mixed." That concern translated into weak service provider orders in almost every area of the world with Japan being the exception.

Management used its October experience as the basis for its guidance. As a result, the outlook for the fiscal second quarter was dramatically below the current consensus. Revenue is expected to be down 5%-10% year over year or between $8.85 billion and $9.34 billion. Gross margin is targeted to be 64% with operating expenses expected to come in between 39% and 41% of revenue with $130 million from other income. The tax rate should be 22% and the share count should decline by $50 million-$100 million. All together, this should deliver pro forma EPS between $0.05 and $0.08. This compares with Street consensus going into the call for revenue of $10.49 billion and pro forma EPS of $0.40.

My concerns relative to vendor financing did not come up specifically, but it was apparent that Cisco has no plans to spur demand by providing financing. In fact, management commented on the financial stability of its customer base as compared to the conditions in the market in 2001.The company is being proactive in addressing the current market conditions.

As always, management leaned toward the positives. All expenses that can be controlled will be. Management expects to cut about $1 billion from full-year 2009 expenses from the full-year 2008 levels. The company's balance sheet is extraordinarily solid with more than $4.00 per share in cash and management says they will use this period to strengthen the company, courtesy of its weaker competitors.

What was surprising from my perspective was the degree of negativity that was already built into the stock. Despite the huge cut in expectations, shares the stock was off a modest 3% on the following day and by Friday, it had recouped all of its losses. It's being interpreted as "this is the bottom" and, while that may be the case, there's no real evidence to support that position. Right now, we'll just monitor the circumstances.

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• Clearwire's revenue was a little bit better than expectations and the loss per share was a little bit worse. However, despite the de-emphasis on marketing and subscriber growth, the metrics indicated some positive trends.

Notwithstanding its best efforts to the contrary, Clearwire saw its subscribers rise 35% from last year with a solid increase in average revenue per user. Churn popped up to 3% but that's to be expected as the economy deteriorates. While the corporate gross margin remains low at 27%, the company has 3,200 cell sites (out of 5,700 total) that are not generating revenue at this point as they are still in development.

The company's Initial 25 Markets included one big positive and one questionable point. The big plus is the ramp of the margin for earnings before interest, taxes, depreciation and amortization (EBITDA). The next step here will be profitability. The question I have (which no one asked about on the call) is: Why did subscribers decline by 1,000 in the June quarter? Maybe that's just the churn coming into play, but I would like an explanation.

Clearwire Metrics

	Total Company					Initial 25 Markets				
	Q3/07	*Q4/07*	*Q1/08*	*Q2/08*	*Q3/08*	*Q3/07*	*Q4/07*	*Q1/08*	*Q2/08*	*Q3/08*
Revenue (Millions)	$41.3	$45.4	$51.5	$58.6	$60.8	$22.7	$23.7	$24.9	$26.5	$27.4
Year/Year Change	118%	91%	76%	65%	47%	75%	52%	38%	25%	21%
Subscribers	348k	394k	443k	461k	469k	206k	215k	226k	227k	226k
Year/Year Change	115%	91%	72%	54%	35%	59%	42%	29%	18%	10%
	49k	47k	48k	18k	8k	14k	9k	11k	1k	(1k)
Year/Year Change	49%	7%	-8%	-56%	-83%	-36%	-57%	-54%	-94%	*nm*
Avg. Rev/User	$37.41	$36.09	$36.86	$39.28	$40.43	$37.64	$37.04	$36.90	$38.56	$39.68
Year/Year Change	6%	-3%	3%	4%	8%	5%	1%	2%	2%	5%
Churn	2.3%	2.4%	2.2%	2.6%	3.0%	2.2%	2.3%	2.1%	2.3%	2.7%
Year/Year Change	2.4%	2.0%	1.6%	2.0%	2.3%	2.1%	1.9%	1.7%	1.8%	2.2%
Cost/Gross Add	$462	$477	$393	$404	$360	$391	$428	$343	$329	$293
Year/Year Change	9%	-7%	15%	-14%	-22%	-6%	-1%	8%	-18%	-25%
Covered POPs (Millions)	14.8	16.3	16.6	16.8	16.9	4.3	4.4	4.4	4.4	4.6
Year/Year Change	124%	70%	64%	45%	14%	8%	7%	5%	5%	7%
Gross Margin	29%	16%	26%	28%	27%	74%	76%	77%	77%	77%
EBITDA Margin	--	--	--	--	--	10%	11%	21%	34%	37%

Source: Company reports

The merger with **Sprint** (S) remains on track for closure by the end of the year. The last two major hurdles include the shareholder vote on Nov. 21 and the approval by its creditors.

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The entire mobile WiMAX food chain is preparing for a big push. Clearwire noted, as did **Alvarion** (ALVR) last week, that 80 different OEMs have 480 different devices in development. While Clearwire has disclosed plans to roll out mobile WiMAX in four markets (Portland, Atlanta, Grand Rapids and Las Vegas), the company is also trolling for network implementation staff in Dallas, Denver, Houston, Los Angeles, Miami, San Antonio and San Francisco. Added to the seven-plus Xohm markets and the new Clearwire will have markets under development with close to 100 million in population (known as POPs).

The push will start early in the first quarter of 2009.

• **Netlist** also delivered a mediocre quarter and burned about half of its net cash position in doing so. Revenue was in line with expectations but the loss per share of $0.37 was dramatically worse. Fortunately, most of that was due to a non-cash tax charge that the company needed to take as it prepares to establish a valuation of its deferred tax assets.

The company experienced lower demand than anticipated for most products as virtually all customers reduced purchases. This placed significant pressure on gross margin, which came in at half of last quarter's amount. However, the expense controls the company has put in place enabled Netlist to reduce its negative operating margin.

The cash position was only down $1.6 million but the company also expanded the use of its line of credit by $6.6 million; hence, the decline in the net cash position to $0.47.

Netlist has been reducing its expenses and still has room to go with only 90% of its operations in China in the quarter. Although the outlook is uncertain, one positive on the horizon has yet to kick in. With the announcement by several memory manufacturers to cut output, the industry will see 12%-15% of capacity taken offline. The very first of those decisions are only now starting to take place. As this happens, we should see the pricing improve. I believe the company is executing well in a very difficult environment.

• **Qualcomm's** earnings report is confusing to say the least because excluding the **Nokia** (NOK) payments, the company "missed" on operations in the quarter and provided disastrous guidance for fiscal 2009. However, like Cisco, the negativity built into the stock prior to the call led to an "up day" following the call.

Adjusting for the $560 million payment from Nokia, revenue was $2.77 billion, up 20% year over year and flat with the prior quarter. Pro forma EPS were $0.63, including $0.20 from Nokia. (Generally accepted accounting principles, or GAAP, came in at $0.52.) This was well above the anticipated range of $0.07-$0.13, which is the figure the company provided on the last call. The one-time gain was offset by $0.14 of asset impairment charges on its investment portfolio. So the pro forma EPS from operations were actually $0.57 compared with the Street's expectation of $0.60.

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Qualcomm Technology Licensing's (QCT) chip business was $1.76 billion (53% of revenue), up 24% year over year and flat sequentially. Operating margin in this segment was 25.5%, a decrease of 440 bps year over year and 210 bps vs. the third quarter. Chip shipments were 86 million units with the average selling prices (ASPs) essentially flat with the prior quarter. QTL's royalties revenue came in at $1.37 billion, reflecting the catch-up payments from Nokia.

The main "issue" I've had with Qualcomm over the last year has been inventory, and that has now come back to bite the company. For at least the last year, management has commented that channel inventory has been at the high end of the "normal" 15-20 week range. During this same general time frame, Qualcomm's own inventory was allowed to grow rather dramatically. Through the June quarter, it has increased by 147% over seven consecutive quarters while QCT revenue increased only 54% over the same time period. Combined, the Qualcomm supply chain contained an incredible six months of inventory which, to me, is an unusually high figure.

When customers began cutting back orders to reduce their own inventory, Qualcomm's outlook for fiscal 2009 darkened dramatically.

The fallout from all this is that first-quarter and full-year guidance for 2009 is well below the current consensus. In the first quarter, revenue is expected to be $2.3 billion-$2.5 billion (down 6% to up 3% year over year); pro forma EPS of $0.46-$0.50; MSM chip shipments of $60 million-$65 million; and royalties on devices of $121 million-$126 million. This compared to consensus at the time of the call for revenue of $2.92 billion and pro forma EPS of $0.62.

For fiscal 2009, revenue is expected to be in the range of $10.2 billion-$10.8 billion with pro forma EPS of $2.00-$2.10. Street consensus for full-year 2009 was for revenue of $12.19 billion and pro forma EPS of $2.60.

Despite posting this gloomy outlook, Qualcomm's stock closed up 8% the following trading day. Go figure!

Emerging Market Handset Demand

I mentioned in last week's newsletter that there had been a snapback in new handset subscribers in India. You can see that quite dramatically in the graph below. In the month of September, they jumped to 29% year over year after declining for four consecutive months.

Unfortunately, new subscriber growth in China continued to decline. In September, new subscribers increased only 4%, the third consecutive month of 10% growth or less. Virtually all of this weakness is stemming from China Unicom (which is down 58% year over year) with China Mobile growth up 19% year over year.

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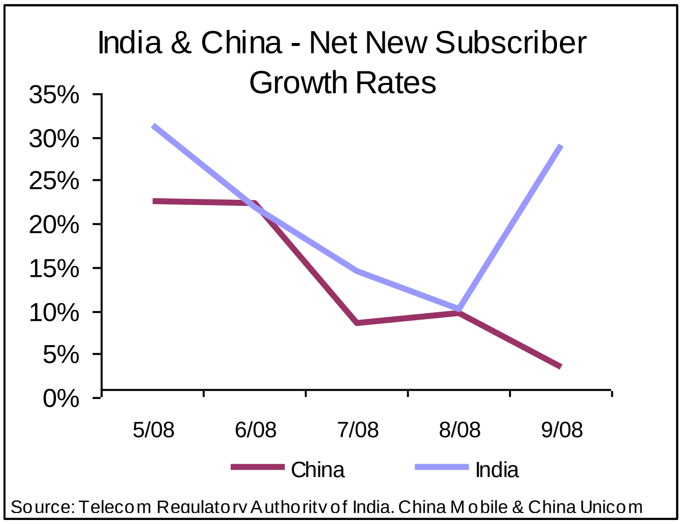
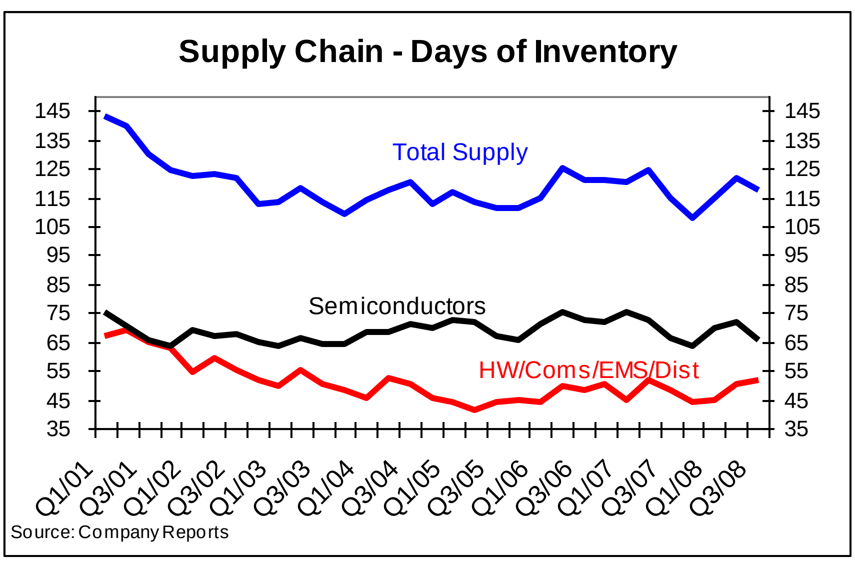
While there is some softening in China's wireless market, the pronounced weakness is undoubtedly related to the restructuring that took place at China Unicom on Oct. 2. With the company's wireless networks now split between China Unicorn and China Telecom, I would hope that next month's numbers will begin to show some improvement.



Inventory Remains the Same

There has been no change in the inventory data this week either at the aggregate level or within the two component groups. The total inventory days number remains at 118 with semiconductors at 66 days and the customers at 52 days. Consequently, I'll simply post the graph and hold the commentary since there's nothing of significance to talk about. Keep in mind, that I do believe another one to two days will drop off before the cycle is completed.



Model Portfolio Reporting Schedule and Results

As always, I've updated the reporting schedule with the available data and the results for the companies that have reported over the past week.

Model Portfolio Earnings Reporting Schedule With Estimates, Results						
			Current Consensus Estimates		Actual Results	
	Date	Conf. Call Time (EDT)	Revenue	EPS	Revenue	EPS
Advanced Micro Devices (AMD)	Oct. 16	5:00 p.m.	$1.48B	($0.40)	**$1.78B**	**($0.11)**
Apple (AAPL)	Oct. 21	5:00 p.m.	$8.05B	$1.11	**$7.90B**	**$1.26**
Alvarion (ALVR)	Nov. 3	9:00 p.m.	$75M	$0.04	**$74M**	**$0.05**
Clearwire (CLWR)	Nov. 10	11:00 a.m.	$56M	($0.96)	**$61M**	**($1.01)**
Cisco (CSCO)	Nov. 5	4:30 p.m.	$10.32B	$0.39	**$10.33B**	**$0.42**
Cypress (CY)	Oct.16	11:30 a.m.	$575M	$0.30	**$600M**	**$0.30**
Dell (DELL)	Nov. 20	4:30 p.m.	$16.80B	$0.36	--	
First Solar (FSLR)	Oct. 29	4:30 p.m.	$339M	$1.02	**$349M**	**$1.26**
Google (GOOG)	Oct.16	4:30 p.m.	$4.06B	$4.82	**$4.04B**	**$4.92**
Level 3 Communications (LVLT)	Oct. 23	10:00 a.m.	$1.07B	($0.08)	**$1.07B**	**($0.08)**
Motorola (MOT)	Oct. 30	8:00 a.m.	$7.84B	$0.02	**$7.48B**	**$0.05**
Micron (MU)	--	--	--	--	--	--
Netlist (NLST)	Nov. 6	5:00 p.m.	$29M	($0.03)	**$29M**	**($0.37)**
Qualcomm (QCOM)	Nov. 5	4:45 p.m.	$2.87B	$0.60	**$3.33B**	**$0.63**
Research In Motion (RIMM)	--	--	--	--	--	--
Riverbed Technology (RVBD)	Oct. 23	5:45 p.m.	$84M	$0.14	**$86.5M**	**$0.15**
SunPower (SPWRA/SPWRB)	Oct.16	1:30 p.m.	$350M	$0.56	**$378M**	**$0.60**
Microtune (TUNE)	Oct. 23	5:00 p.m.	$29M	$0.06	**$31.9M**	**$0.08**

Source: Yahoo! Finance

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The Telecom Connection Portfolio

Company Name	Date Initiated	Cost Basis per Share	No. of Shares	Amount Invested	Current Price	% Gain/Loss	IXTC at Buy Date	IXTC Return
Apple AAPL	2/15/06	$100.56	300	$30,168.00	90.12	-10.38%	235.36	-40.20%
Alvarion ALVR	2/22/07	$8.98	2,510	$22,538.00	3.01	-66.48%	244.90	-42.53%
Clearwire CLWR	11/12/07	$13.50	500	$6,750.00	6.67	-50.59%	257.91	-45.43%
Cisco Systems CSCO	3/30/05	$22.51	800	$18,009.00	16.55	-26.48%	223.36	-36.99%
Cypress Semiconductor CY	7/10/08	$5.36	2,000	$10,720.00	3.92	-26.87%	230.96	-39.06%
Dell (call options) DLYAD – 20 contracts	12/6/07	$6.80	2,000	$13,600.00	0.04	-99.41%	259.97	-45.86%
First Solar FSLR	8/28/08	$263.55	150	$39,533.00	110.06	-58.24%	239.62	-41.27%
Google GOOG	2/9/06	$494.76	75	$37,106.70	291.0	-41.18%	243.87	-42.29%
Level 3 LVLT	6/19/08	$3.76	3,000	$11,280.00	0.78	-79.26%	263.91	-46.67%
Netlist NLST	2/14/08	$1.46	3,500	$5,095.00	0.36	-75.27%	232.75	-39.53%
Qualcomm QCOM	8/14/08	$55.02	500	$27,510.00	32.57	-40.80%	256.15	-45.06%
Research In Motion RIMM	11/19/07	$113.82	200	$22,763.75	43.20	-62.04%	247.44	-43.12%
Riverbed Technology RVBD	7/26/07	$32.56	450	$14,654.25	9.67	-70.31%	244.32	-42.40%
SunPower SPWRA	2/14/08	$89.70	300	$26,910.00	24.72	-72.44%	239.54	-41.24%
SunPower SPWRB	9/29/08	$70.95	548	$38,880.60	19.15	-73.01%	190.17	-25.99%

(The model portfolio continues on the next page)

Microtune TUNE	2/8/07	$5.23	2,500	$13,075.00	2.15	-58.89%	244.96	-42.55%
Micron (call options) WGYAZ – 125 contracts	8/28/08	$2.26	12,500	$28,250.00	2.80	23.89%	251.83	-44.11%

The Telecom Connection Portfolio – Performance

Total Average Return	- 51.04%
2008 YTD Return	- 58.79%

Performance results listed here reflect values of stocks as of the close of the most recently completed trading day, and do NOT take into account dividends paid, interest earned or commissions. Results are updated overnight and posted prior to the market open the following business day. Sales are taken from the most recent purchase of that stock unless otherwise stated. The 2008 YTD Return figures reflect changes since the beginning of 2008. The Total Average Return figures reflect changes since inception on 8/14/2001.

Nasdaq Telecom Index Performance

	Portfolio Inception	Open Level	Current Level	% Gain/Loss Since Portfolio Inception	2008 YTD Return
Nasdaq Telecom Index (IXTC)	8/14/2001	262.84	140.74	- 46.457%	- 41.92%

At the time of publication, Mr. Faulkner was long CLWR, CY, MU, NLST, TUNE, TUNE calls.

To see the full Telecom Connection model portfolio, including closed positions, visit http://www.thestreet.com/k/tc/portfolio.html

Bob Faulkner
The Telecom Connection
An Insider's View into the Telecom Industry
TheStreet.com

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