Issue 347: Wednesday, December 10, 2008

In This Issue

Telecom Overview: Ruminating on Rumors and News

In this week's edition of *The Telecom Connection*, I'll take a look at the **Apple** (APPL) rumors that have been circulating in a number of newspapers and blogs. The most prominent one is a $99 4GB iPhone to be sold at **Wal-Mart** (WMT) stores. Who knows if it will happen, but I'll give you my 2 cents on the subject and its implications.

There has been a flood of news, most of it bad, coming from technology and telecommunications companies during the past week. I'll highlight a number of announcements from companies in the model portfolio, as well as from several other prominent players in the industry.

Last, I will take a look at the wireless subscriber growth in India and China. There are a couple of surprises in the data, which are the first available since the sale of the CDMA business by China Unicom to China Telecom.

Let's start off with the Apple rumors.

Apple's Rumor Mill

The rumor mill has been going strong with expectations that Apple will introduce a $99 4 GB iPhone model at mega-retailer Wal-Mart in late December. I saw comments about it in last Friday's *San Jose Mercury News* as well as on numerous blogs. Also making the rounds, but with less "certainty," is the expectation of a 32 GB model in early 2009.

So what's the likelihood that any of this will happen? I'd say pretty good.

In a column I wrote for *RealMoney* last week, I highlighted what I thought was going to win Apple the No. 1 position in the smartphone arena: applications. The company has more than 5,000 applications available on its App Store Web site and, as management noted on its last conference call, downloads of those applications have already reached more than 200 million.

(Continued on the next page)

Independent software developers (ISDs) are generally not into doing charity work. They're in business to make money selling as many copies of their creativity as possible. In order to do that, ISDs usually start with the platform that has the largest installed base to give them the most opportunities for success.

By extending the iPhone platform to a 4 GB model, something along the lines of an entry-level model, Apple dramatically expands the demographic that will consider purchasing the iPhone. By selling the model at Wal-Mart, Apple will then have access to the single largest retail distribution channel in the world and one that focuses primarily on the value buyer.

What a $99 iPhone will do for Apple is possibly put some pressure on margins, depending on how successful the product is. The only apparent change vs. the 8 GB model (priced at $199) is in the level of NAND flash. The $100 price differential is certainly not offset by 4 GB of NAND flash when a module is selling for less than $2.00. The screen, the plastic housing and all of the other electronics are still the same, so you can see quite readily that the gross margin will be significantly lower. However, given price elasticity, the total gross profit dollars may well wind up being significantly higher if the entry-level model is a major success.

One way for Apple to offset some of that margin pressure in the entry-level model is to expand the high end with a 32 GB model, which was recently rumored to be a possibility. The exact same "forces" that put pressure on margins at the low end will benefit the company on the high end, depending on the price of the 32 GB model. Note that 32 GB parts are already on the market, and they are basically four times the price of those for the 8 GB model. Therefore, the incremental cost to Apple will be limited (i.e., it will see higher margins), but the advantage of vastly increased storage for pictures, music, files and applications will be attractive to the high-end user.

The ability to attract the best application developers will be most important going forward for the iPhone. It becomes a virtuous circle. The developers gravitate to the largest installed base because they're interested in making money, and consumers buy more units in part because the platform offers the widest selection of applications -- thereby increasing the installed base.

What we're seeing here is the evolution of a platform. Apple is adding varying amounts of storage to create different price points, but the basic architecture is unchanged. The existing Samsung applications processor used by the iPhone supports 128 MB of synchronous DRAM (SDRAM), which is of sufficient size to run small- to mid-sized applications. It wasn't all that long ago when we were using personal computers with 128 MB of main memory and doing just fine. Competitive offerings, such as **Texas Instruments'** (TXN) OMAP applications processors, can already address 1 GB of memory, so it's inevitable that the Samsung processors or others that fill the slot will see it increase over time just as it has on the PC. And with those changes will come increasing functional gains for the iPhone platform.

(Continued on the next page)

Issue 347: Wednesday, December 10, 2008

News: Bad, Less Bad and Nuts

Over the course of the past week, several companies of note reported difficult quarters, reduced guidance, and/or announced cost reduction programs in light of the weakening economy. I have highlighted a number of names that I have a direct interest in or are bellwethers in some form.

• **Alvarion** (ALVR) made two announcements during the past week. First, at a Latin American trade show the company announced that it was seeing a steady increase in its business in the region. Given the current worldwide economic concerns, this news was one of the few positive trends of late.

Second, the company announced an 11% headcount reduction along with a number of other cost-saving measures expected to reduce total annual expenses by about $15 million. While Alvarion is not seeing any order cancellations or push-outs, it is seeing extended sales cycles.

The shekel-dollar exchange rate has continued to move in Alvarion's favor, another 14% thus far in the fourth quarter alone (as the shekel side is weakening). With the company sitting on $2.26 per share in net cash, I much prefer that it reduces its break-even point than eats into its cash position. The company's WiMAX business is built for the long haul, but at this juncture, the steps it's taking are quite prudent given the overall uncertainty

• **Level 3 Communications** (LVLT) announced that it will be reducing its workforce by 8%, or approximately 450 people. This is to be completed by the end of the calendar year and will create a $12 million to $15 million charge in the December quarter. What is interesting is that the company's content delivery network (CDN) operation is apparently unaffected by this decision, suggesting that it might be performing better than expected.

• **National Semiconductor** (NSM) reported results for its fiscal second quarter this week. The company had already negatively preannounced in early November, but the actual results came in at the low end of revenue expectations and well below consensus earnings per share (EPS).

About one-third of National's business is derived from its mobile device operations, primarily cellular handsets. While its quarter started out as expected, the outlook from its customers declined steadily from about mid-September onward. Revenue from the top-five handset OEMs (LG, **Motorola** (MOT), **Nokia** (NOK), Samsung and Sony Ericsson) declined 15% sequentially in the quarter during what is normally a seasonally strong period. The one bright note is that business from National Semiconductor's two leading smartphone OEMs (Apple and **Research In Motion** (RIMM)) was up sequentially.

National Semiconductor's overall orders were down a staggering 33% from the first fiscal quarter. As a result, the company is anticipating that third-quarter revenue will be down 30% sequentially, approximately $100 million below Street consensus. Fortunately, rather than allow inventory to build, the company is taking the earnings hit by cutting wafer starts rather dramatically at its manufacturing facilities.

(Continued on the next page)

• Texas Instruments provided its regularly scheduled midquarter update and, like many of its brethren, reduced its outlook rather severely. Revenue is expected to be in the $2.30 billion to $2.50 billion range vs. the original expectation of $2.83 billion to $3.07 billion. EPS are now expected to be 10 cents to 16 cents vs. 30 cents to 36 cents from the original guidance.

The decline is being led by wireless but is quite broad-based, as demand has continued to decline. The company is proactively cutting wafer starts and, as a result, factory utilization will drop from the mid-60% area in the third quarter to the mid-40% area. This will send gross margins down to about 37% to 42% vs. 52% in the third quarter. As is the case with National Semiconductor, Texas Instruments is taking the margin hit rather than allowing a massive increase in inventory to head to the balance sheet. The company is also reducing its distribution channel inventory by about $70 million, which is twice the reduction that occurred in the third quarter.

• Hynix, the No. 2 supplier of DRAM, announced that as part of an arrangement with its creditors, the company will close its remaining 200mm fabrication plants (which represent about 30% of their total capacity). However, offsetting this is the opening of a new 300mm facility, which is estimated to add back about 25% of capacity. So it looks like a net reduction of about 5% from Hynix, or about 1% to 2% of industry capacity. Hey, every little bit helps!

• From the "Department of the Bizarre," a number of the Taiwanese DRAM companies have argued for a government-led bailout of their companies using rather unique logic. According the DigiTimes, the local DRAM companies prevent the South Korean behemoths from monopolizing the DRAM markets and pushing prices through the roof. This in turn protects the Taiwanese PC companies.

Using that logic, losing money hand over fist is a good thing and the government should give them more money to lose. Hmmm?

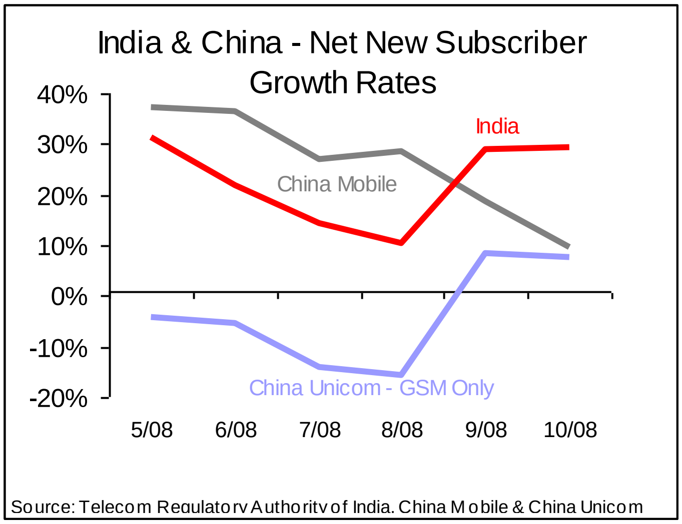
Emerging Market Wireless Subscribers

As most readers know, I regularly watch the growth (or lack thereof) in net new subscribers in India and China. Given the recent restructuring of the Chinese service providers, I'm not able to do the analysis in the same manner as before. However, there are more than a couple of interesting data points that have come out.

Obviously, all of the negative commentary on handsets from companies in the supply chain should carry over to weaker growth in new subscribers. What's interesting is that we have seen steady deterioration in the dominant supplier in China -- China Mobile -- to where the growth rate has essentially fallen by 50% over the past two months. China Unicom's GSM-based business has recovered somewhat, but growth remains in the single digits. The surprise is from India, which posted another strong (a gain of 29%) new subscriber growth month in October. Are they attempting to buck the worldwide trend?

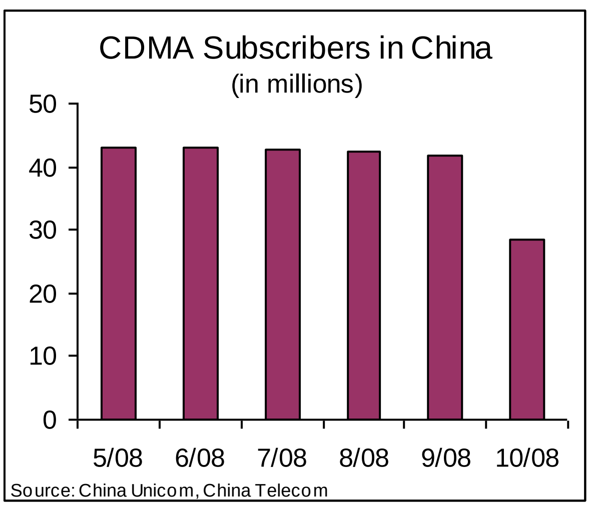
Unless someone repeals the laws of economics, this number cannot continue to grow at the current level. We don't have to see it fall to zero, but 30% year-over-year growth is a tad much to expect in the current environment.

(Continued on the next page)



What I found most interesting had to do with the CDMA business that China Unicom sold to China Telecom. I have noted in the past that China Unicom paid little attention to its CDMA network and, as a result, the subscriber churn eroded the installed base. Now it turns out that China Unicom is mathematically challenged when it comes to counting its installed base. When Unicom sold the CDMA assets to China Telecom on Oct. 1, it seems as if there were about 13 million fewer CDMA subscribers then the company had been reporting.

Overall, I don't expect this to change China Telecom's plans or the outlook as it benefits **Qualcomm** (QCOM). However, they both obviously start from a smaller base.



Issue 347: Wednesday, December 10, 2008

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	98.21	-2.34%	235.36	-37.24%
Alvarion **ALVR**	2/22/07	$8.98	2,510	$22,538.00	3.95	-56.01%	244.90	-39.69%
Clearwire **CLWRD**	11/12/07	$13.50	500	$6,750.00	4.49	-66.74%	257.91	-42.73%
Cisco Systems **CSCO**	3/30/05	$22.51	800	$18,009.00	17.33	-23.02%	223.36	-33.87%
Cypress Semiconductor **CY**	7/10/08	$5.36	2,000	$10,720.00	4.56	-14.93%	230.96	-36.05%
Dell (call options) **DLYAD – 20 contracts**	12/6/07	$6.80	2,000	$13,600.00	0.03	-99.56%	259.97	-43.19%
First Solar **FSLR**	8/28/08	$263.55	150	$39,533.00	119.68	-54.59%	239.62	-38.36%
Google **GOOG**	2/9/06	$494.76	75	$37,106.70	308.82	-37.58%	243.87	-39.43%
Level 3 **LVLT**	6/19/08	$3.76	3,000	$11,280.00	0.77	-79.52%	263.91	-44.03%
Netlist **NLST**	2/14/08	$1.46	3,500	$5,095.00	0.38	-73.90%	232.75	-36.54%
Qualcomm **QCOM**	8/14/08	$55.02	500	$27,510.00	34.47	-37.35%	256.15	-42.34%
Research In Motion **RIMM**	11/19/07	$113.82	200	$22,763.75	38.43	-66.24%	247.44	-40.31%
Riverbed Technology **RVBD**	7/26/07	$32.56	450	$14,654.25	11.05	-66.07%	244.32	-39.55%
SunPower **SPWRA**	2/14/08	$89.70	300	$26,910.00	32.01	-64.31%	239.54	-38.34%
SunPower **SPWRB**	9/29/08	$70.95	548	$38,880.60	24.05	-66.10%	190.17	-22.33%

(The model portfolio continues on the next page)

Microtune TUNE	2/8/07	$5.23	2,500	$13,075.00	2.12	-59.46%	244.96	-39.70%
Micron (call options) WGYAZ – 125 contracts	8/28/08	$2.26	12,500	$28,250.00	0.95	-57.96%	251.83	-41.35%

The Telecom Connection Portfolio – Performance

Total Average Return	- 52.90%
2008 YTD Return	- 60.35%

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	147.70	- 43.81%	- 42.76%

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

Contact **Info**

- **Customer Service:**
  Please email ***members@thestreet.com***, or call 1-866-321-TSCM (8726) Mon. – Fri. 8 a.m. to 6 p.m. ET; or outside the U.S. and in Canada, call 1-212-321-5200.
- **Reader Feedback and Questions:**
  Please send an email directly to Mr. Faulkner. Again, please direct all account-related inquiries to customer service.

Legal **Information**