Issue 348: Wednesday, December 17, 2008

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Telecom Overview: Wrapping Up Earnings

The holidays are fast approaching, yet in this week's edition of *The Telecom Connection*, we still have some earnings reports to look over. A steady stream of preannouncements and/or guidance reductions continues, but over the course of the next seven days, we'll see real numbers for **Research In Motion** (RIMM) and **Micron** (MU).

Research In Motion has already preannounced, so the surprise is over. However, more details on the factors impacting the miss will be interesting to hear. We know foreign exchange is a biggy but just how much late shipments affected that number could be critical to what happens to the stock.

Over at Micron, the gloom is in the stock. The numbers will be worse than the Street expects and estimates will come down for the next quarter as well. But, like all self-correcting industries, efforts are underway to take capacity offline and bring some common sense to the forefront.

I've added a few quick notes in a Tech Bits 'n' Bytes segment this week as well. Nothing earth shattering, just a few observations from the field.

Lastly, with Research In Motion and Micron on the clock, I've updated the model portfolio reporting schedule with the latest data.

Now let's see how the earnings outlook is shaping up.

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Earnings Outlook for the Next Week

Over the next seven days, two remaining names in the model portfolio will be reporting. Research In Motion delivers results on Thursday after the close followed by Micron on Tuesday, also after the close. Here are my thoughts on each as well as on other rumblings in the market.

• Research In Motion will announce its fiscal third quarter but the company's pre-announcement on Dec. 3 took all the fun out of it.

For those who don't remember the story of the last two quarters at Research In Motion, management elected to "invest" in a number of areas in order to expand its market. Although revenue has been strong over that six-month period, the "investments" have been a drag on earnings. That was expected to wind down as the fiscal year ended. It looks as if management wasn't anticipating revenue to wind down as well.

Before exiting its last conference call, management issued guidance for revenue to be in the $2.95 billion to $3.10 billion range (up 76%-85%, year over year). However, gross margin was expected to decline to about 47% because the introduction of new units has a higher cost of goods, which is estimated to put gross margin in the "mid-40%" level for the foreseeable future. Operating expenses were expected to grow 11%-12% from fiscal second-quarter levels or below the level of sequential revenue growth. The tax rate was expected to be in the 29%-30% range, which put pro forma EPS in the $0.89-$0.97 range. At the time of the call, consensus estimates were for revenue to be $2.93 billion and pro forma EPS to be $0.98. Once again, revenue guidance was stronger than expected, but earnings were below the consensus.

Fast forward to Dec. 3 and the company negatively preannounced. Revenue guidance was reduced to a range of $2.75 billion to $2.78 billion or up 64%-66% year over year. Gross margin was now thought to be in the 45%-46% range. While no guidance was provided for operating expenses, pro forma EPS are expected to be $0.81-$0.83. New subscribers were also ratcheted down to 2.6 million from the original estimate of 2.9 million.

The rationale for the reduced guidance was threefold. First, about one-third of the miss is due to negative foreign exchange shifts vs. the U.S. dollar. The remaining impact was attributed to two items: the overall economy and the late introduction of new products. Neither of these catalysts was quantified.

Most of the anecdotal commentary following Black Friday weekend and since has suggested that, although cell-phone demand is weak due to the economy, smartphones are definitely gaining market share. Initially, the new Blackberry Bold and the Blackberry Storm were seeing a lot of activity; however, I'm not so certain that this trend has continued.

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The Storm in particular caught a lot of positive commentary when it first hit the market. **Verizon** (VZ) is dying for it to succeed given the dent applied by the iPhone, as **AT&T** (T) is its proprietary service provider. However, as consumers and reviewers have had time to grow accustomed to the Storm, the commentary has been less glowing.

While nearly everyone gives the tactile response to the virtual key pad a thumbs-up, the general feeling is that its overall performance is “sluggish.” That could be due to a number of factors and it’s a very common complaint in the first release of any product. However, one area that does concern me is the possibility that the problem is due to the use of the most recent version of Research In Motion’s operating system.

The decision to use version 4.7 of its operating system enabled the Blackberry Storm to have access to the wealth of applications that had already existed for the Blackberry line of products. However, none of those had previously used a touch-screen interface. How the company enabled the utilization of a new feature on an operating system that wasn’t built to support it could be an issue. That’s something that we should see confirmed or refuted in a relatively short period of time.

The lack of WiFi support is the other factor that I believe will hurt the initial version of the Storm.. That decision was clearly driven by Verizon in its attempt to protect its own data services. But the inclusion of WiFi on the iPhone turned out to be a huge winner for AT&T. iPhone users treat their handset as a portable computer; this is evident in their demand for data. So this decision relative to the Storm is a marketing driven blunder from my perspective.

Despite the preannouncement, the company’s stock was actually up 6% the following day. Much of this had been built in based on the weakness in the preceding months.

For now, all eyes are going to be on the company’s outlook. The Street consensus is for revenue of $3.0 billion, or up 59% year over year, and 6% sequentially with pro forma EPS of $0.84. I don’t think anyone still believes in those numbers at this point, but if management’s guidance even comes close, the stock will likely rally.

• Micron will be reporting its first fiscal quarter into the teeth of some pretty strong pricing headwinds. However, those same weak prices have generated action on the part of the industry.

Over the last three months, the industry has seen contract prices for DRAM fall 47% and those for NAND flash decrease by 38%. That compares with declines in the last quarter for Micron specifically of flat average selling prices (ASPs) in DRAM and a decline of 20% for NAND flash.

In the last quarter, the company was once again able to cut costs by 5% on the DRAM side and by 15% on the NAND flash side. While I expect the same will be true this quarter, nothing will offset the average price reductions.

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Micron lost $0.45 per share last quarter on what was nearly $100 million more in revenue than is expected this quarter. Somehow, given the pricing pressure, I see them losing substantially more than $0.45 per share this time around.

Look for another writedown (it was $205 million last quarter) to inventory but the critical issue I'll be watching is the cash from operations. Micron, despite the losses for most of the last two years, has been able to consistently generate cash from operations over that same period.

Right now, the Street consensus for the second fiscal quarter is for revenue to be $1.27 billion with a loss per share of $0.37. Here again, I don't see the loss improving on lower revenue but I don't put much credence in these numbers at this point anyway.

What's important to watch with the memory markets in general is not where we've been but where we are going. This industry has not seen pain like this in many years. Even during the last recession earlier in the decade, conditions were not this bad.

As a result, I have been highlighting a steady stream of changes that have been made over the last few months starting with dramatic reductions in capital spending plans from the various constituents. Lower capital spending has cut future production and as the prices have remained weak, we have seen manufacturers lose money at the gross margin line. This resulted in the reduction of wafer starts at wafer fabrication facilities at some of the smaller, marginal players

When those actions did not stem price weakness, the panic really began to spread and a number of the Taiwan companies are desperately lobbying their government for subsidies to stay in business. The desperation has carried over to a number of the larger suppliers with the closure of 200mm wafer fabrication lines that, despite the equipment being fully depreciated, are no longer profitable at current prices.

Most, if not all companies in the memory industry are shutting capacity down during the holidays (through the Chinese New Year). Toshiba joined that group with an announcement of a temporary closure as well as an announcement that on restart, it will only open up about 70% of its existing NAND flash capacity suggesting that the company will idle its 200mm lines at its Yokkaichi operations.

From my perspective, Micron remains one of the strongest companies in the memory industry. Unfortunately, there are far too many weak companies begging to be salvaged. Nothing would be better than allowing one or more of the Taiwanese players to falter -- and the same is true for **Qimonda** (QI). The industry needs for there to be less capacity and the only way for that to happen quickly is to allow the sick to die.

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Tech Bits ’n’ Bytes

• **Clearwire** (CLWRD) will be launching its mobile WiMAX service in Portland, OR on Jan. 6. This will be the company’s second mobile WiMAX offering after Baltimore (from the Xohm acquisition from **Sprint** (S)).

• **Palm** (PALM) is hoping to make a big splash at the Consumer Electronics Show in Las Vegas in January. Don’t fall for it. I’ve written about it here and on *RealMoney*: The name of the game at this point is going to be applications. Palm is too late to the party to attract independent software developers to its platform. They are already gravitating to the iPhone, Blackberry and Android platforms. I’ve said it before: These guys want to make money, so they go where the biggest opportunity lies.

• **Alvarion** (ALVR) announced that it has been awarded a contract to provide mobile WiMAX equipment to Instituto Costarricense de Electricidad (ICE) the leading service provider in Costa Rica. The company continues to win business as others such as **Alcatel-Lucent** (ALU) (a former OEM partner) announce that it will no longer devote resources to the technology due to its restructuring decisions.

Alcatel-Lucent still wants to “play” in the business so look for them to partner with another OEM like Alvarion once again. (I’ve written an article about this that is scheduled for publication on *RealMoney* Thursday morning – those who subscribe may want to check it out.)

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Model Portfolio Reporting Schedule and Results

As the last two model portfolio names are reporting within the next week, it was time to bring back the earnings spreadsheet with the updated information.

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 a.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	**$15.16B**	**$0.37**
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 (LVLT)	Oct. 23	10:00 a.m.	$1.07B	($0.08)	**$1.07B**	**($0.08)**
Micron (MU)	Dec. 23	4:30 p.m.	$1.34B	($0.43)	--	--
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)	Dec. 18	5:00 p.m.	$2.82B	$0.81	--	--
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

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	89.16	-11.34%	235.36	-37.48%
Alvarion **ALVR**	2/22/07	$8.98	2,510	$22,538.00	3.53	-60.69%	244.90	-39.92%
Clearwire **CLWRD**	11/12/07	$13.50	500	$6,750.00	4.13	-69.41%	257.91	-42.95%
Cisco Systems **CSCO**	3/30/05	$22.51	800	$18,009.00	16.84	-25.19%	223.36	-34.12%
Cypress Semiconductor **CY**	7/10/08	$5.36	2,000	$10,720.00	4.50	-16.04%	230.96	-36.29%
Dell (call options) **DLYAD – 20 contracts**	12/6/07	$6.80	2,000	$13,600.00	0.02	-99.71%	259.97	-43.40%
First Solar **FSLR**	8/28/08	$263.55	150	$39,533.00	141.94	-46.14%	239.62	-38.6%
Google **GOOG**	2/9/06	$494.76	75	$37,106.70	315.24	-36.28%	243.87	-39.66%
Level 3 **LVLT**	6/19/08	$3.76	3,000	$11,280.00	0.72	-80.85%	263.91	-44.25%
Netlist **NLST**	2/14/08	$1.46	3,500	$5,095.00	0.28	-80.77%	232.75	-36.78%
Qualcomm **QCOM**	8/14/08	$55.02	500	$27,510.00	35.10	-36.21%	256.15	-42.56%
Research In Motion **RIMM**	11/19/07	$113.82	200	$22,763.75	40.67	-64.27%	247.44	-40.53%
Riverbed Technology **RVBD**	7/26/07	$32.56	450	$14,654.25	11.62	-64.32%	244.32	-39.78%
SunPower **SPWRA**	2/14/08	$89.70	300	$26,910.00	36.82	-58.95%	239.54	-38.57%
SunPower **SPWRB**	9/29/08	$70.95	548	$38,880.60	29.30	-58.70%	190.17	-22.63%

(The model portfolio continues on the next page)

Microtune TUNE	2/8/07	$5.23	2,500	$13,075.00	2.38	-54.49%	244.96	-39.93%
Micron (call options) WGYAZ – 125 contracts	8/28/08	$2.26	12,500	$28,250.00	0.95	-57.96%	251.83	-41.57%

The Telecom Connection Portfolio – Performance

Total Average Return	- 51.93%	
2008 YTD Return	- 59.54%	

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	147.14	- 44.02%	- 41.57%

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

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