

Palm Inc. (PALM) – Hold

PALM: Palm Learns About on The Job Training

Palm's third quarter can be summed up in two numbers. The company shipped 960,000 units into the carrier channel. But only 408,000 units were shipped out, down from 573,000 in the second quarter. As a result, the fourth quarter is bound to be bloody. We're cutting our estimates, but maintaining our hold rating.

- Palm reported revenues of \$366 million, modestly higher than its preannouncement guidance, and a non-GAAP loss of \$0.61 per share. But the results were a lot worse than it appears. Shipments out of the carrier channel of 408,000 units were less than half of the 960,000 units shipped into the channel. The carriers' eyes were clearly bigger than their stomachs.
- To work off this inventory, Palm will ship only around 425,000 units into the channel in the fourth quarter, translating into revenues of around \$150 million and a loss in the neighborhood of \$0.70.
- The most identifiable culprit for the shortfall was a lack of visibility, especially in Verizon's (N/R) carrier stores. Beginning in February, Palm embarked on intensive in-store training, seeding many of the sales people with Pre models.
- The sequential decline in sales calls into question our previous upward and onward forecast. Palm's WebOS operating system and Pre smartphones can theoretically compete with any competitor. But rising above the growing noise surrounding Google's Android platform, not to mention the momentum behind the iPhone and BlackBerry, could prove to be challenging.
- In response to the decline in sales-out, we've reduced our 2010 earning per share estimate from a loss of \$1.25 to a loss of \$2.05 and our 2011 estimate from \$0.40 to a loss of \$0.40.
- Were it not for the elegance of WebOS and its potential, we would downgrade the stock to an underperform rating.

EPS Change

Market Data	
Price (03/18/10)	\$5.65
12-Month Price Target	N/A
52-Week range	\$17.46-5.37
Shares Out. (MM)	167.9
Market cap (MM)	\$948.6
Avg. daily volume (000)	15,030.8
Financial Data	
Total Debt/Cap.	101.6%
Price/LTM Rev.	
Tangible BVPS	(\$3.01)
Net Cash Per Share	\$1.22

Palm Inc. is a provider of mobile computing solutions worldwide. The company offers Palm Treo smartphones, Palm LifeDrive mobile managers, Palm handheld computers, as well as software, services, and accessories.

	FY	FY		FY	
	05/31/09 A	05/31/10 E		05/31/11 E	
	Old	New	Old	New	
Rev. (MM)	\$1,381.9	\$1,181.7	\$2,632.5	\$1,811.3	
Growth	0.0%	0.0%	90.5%	53.3%	
Op. Mar.		(25.7%)		(4.4%)	
EPS: 1Q	(0.24)	(0.24)A	(0.11)	(0.27)	
EPS: 2Q	(0.48)	(0.48)A	0.03	(0.18)	
EPS: 3Q	(0.31)	(0.61)A	0.14	(0.09)	
EPS: 4Q	(0.23)	(0.69)	0.27	0.08	
EPS: Year	(1.25)	(2.05)	0.40	(0.40)	
Growth	0.0%	0.0%	(132.2%)	80.7%	
P/E Ratio	0.0x	nm	14.0x	nm	

Note: Pro forma earnings estimates displayed above do not include one-time items or any stock compensation expenses.



Disclosures applicable to this security: B, G.
Disclosure explanation on the inside back cover of this report.

Discussion

When Palm unveiled its WebOS operating system and the Pre smartphone at the 2009 Consumer Electronics Show, positive reviews followed. The consensus view was that the Pre was the first worthy challenger to the iPhone. It has not turned out that way.

Since the Pre launch on the Sprint (N/R) network in June 2009 and the Palm Pixi launch in the fall, Palm sold just 1.57 million WebOS phones by year-end, according to IDC. These shipments represented slightly more than 1% of the smartphone market. The Pre and Pixi launched on the Verizon network this winter. But disappointing sales caused Palm to preannounce that revenues in the third quarter ending in February would be materially lower than guidance.

What's striking is that despite our initial belief that WebOS and the Pre could not possibly live up to the pre-launch hype, WebOS proved us wrong. It turned out to be an intelligently designed operating system that actually lived up to the hype. So what went wrong?

For one, the Sprint network has far fewer subscribers than either Verizon or AT&T (N/R). So the Pre started out with a smaller installed base to target. A second problem is that Palm did not have its software development kit ready at the time of launch. This created a perception problem because application hysteria was just beginning to build on the heels of the stunning success of the iPhone App Store. Whether justified or not, the world believed that the number of software applications running on a smartphone operating system was a necessary ingredient for its success. Palm belatedly launched its developer program at the Las Vegas Consumer Electronics Show in January. To provide developers with more control over the marketing of their applications, Palm allows them to distribute their applications over the web in addition to the Palm App Catalog. The number of applications had exceeded 1,000 at the time of the development kit's formal unveiling. But this paled in comparison with the over 100,000 applications available on the iPhone at the time.

In our opinion, however, the major reason for the tepid start of the Pre and Pixi is they were simply drowned out by the noise and hype that began building in the fall with the launch of Motorola's Droid (N/R) and HTC's Droid Eris (N/R) on the Verizon network. What's interesting in this regard is that both BlackBerry and the iPhone managed to cut through this noise. However, the BlackBerry is a well-established platform while the iPhone was riding the coat tails of its phenomenal applications store. Palm, in contrast, had yet to rebuild its brand. Palm was once considered a leader in the smartphone market along with Windows Mobile. But Palm's brand value collapsed, as did the company's financial performance when the company failed to advance the Treo platform after the iPhone launch in 2007. Incompetent management before the arrival of Jon Rubinstein in 2007 was largely responsible for the debacle.

Going a step further, it all comes down to money, and Palm simply did not have enough of it. Palm's GAAP operating income plunged from \$127 million in fiscal 2006 to a loss of \$265 million in fiscal 2009. Two stock sales and a further infusion from Elevation Partners still left the company short of funds to adequately market and advertise the new brand embodied in Web OS and the Pre. Palm did spend \$56 million in the first quarter following the Pre launch, \$75 million in the second and \$98 million in the third. But these amounts pale in comparison with the marketing spend of Palm's key competitors. Research in Motion will have spent close to \$1.9 billion on sales, marketing and administration in fiscal 2010, when it reports fourth quarter financial results on March 31st. Apple's comparable number was \$1.5 billion in fiscal 2009. Nokia (N/R) spent \$2.4 billion on sales and marketing in 2009 while Verizon's sales, marketing and administrative expenses were over \$33 billion in 2009. Obviously, this is an apples and oranges comparison. But the order of magnitude differences between Palm's marketing budget and those of its competitors underscore the company's plight in cutting through the marketing noise.

Palm appears to be in a no win situation. The company could invest even more in marketing the Pre and Pixi. But it's unclear whether Palm could ever spend enough to reach a position where Pre and Pixi sales were sufficient to cover its marketing bill and return the company to profitability. In the mean time, time is running out. Supported by an increasing number of smartphone manufacturers, the Android juggernaut is continuing to gain steam. And the day when Microsoft (N/R) launches Window Phone 7 and rejoins the spending party is drawing closer.

The popular recommendation is that someone should acquire Palm to provide it with the financial resources to complete its journey. But it's unclear who the acquirer might be. Microsoft was a candidate. But when it unveiled Windows Phone 7 at the Mobile World Conference in Barcelona last month, the company effectively signaled that it was going it alone. Nokia has been mentioned as a possible acquirer because the Symbian operating system on which Nokia phones run is long in the tooth. Although we can't dismiss this possibility, the company announced at the Barcelona event that it was teaming up with Intel to build a modern Linux-based smartphone operating system. So the odds that Nokia will acquire Palm have diminished. Even Dell has come up on the acquisition screen. But the company appears comfortable building phones running on Android and Windows Phone 7. So it may be that Palm has nowhere to go. But we could be surprised.

Palm Non-GAAP Financial Forecast

(\$ in millions)

	Actual				Estimated					
	Aug '09	Nov '09	Feb '10	May '10		Aug '10	Nov '10	Feb '11	May '11	
	2010/1	2010/2	2010/3	2010/4	2010	2011/1	2011/2	2011/3	2011/4	2011
Sales	\$361.2	\$302.0	\$366.0	\$152.5	\$1,181.7	\$315.0	\$393.8	\$472.5	\$630.0	\$1,811.3
Cost of sales	\$260.5	\$225.3	\$302.5	\$119.5	\$907.8	\$225.7	\$281.3	\$336.5	\$447.3	\$1,290.7
Gross profits	\$100.6	\$76.7	\$63.5	\$33.0	\$273.8	\$89.3	\$112.5	\$136.0	\$182.7	\$520.5
Operating expenses										
Sales and marketing	56.0	75.0	98.0	76.3	305.3	78.8	78.8	80.3	81.9	319.7
Research & development	43.7	52.9	51.3	53.4	201.3	53.6	55.1	56.7	56.7	222.1
General & administrative	16.3	16.1	18.0	15.3	65.6	14.2	14.8	14.2	15.1	58.2
Amortization of intangibles	8.7	0.4			9.1					
Restructuring charges		1.4			1.4					
Total	\$124.7	\$145.8	\$162.0	\$144.9	\$581.2	\$146.5	\$148.6	\$151.2	\$153.7	\$600.0
Non-GAAP operating earnings	(\$24.0)	(\$69.0)	(\$98.5)	(\$111.9)	(\$303.4)	(\$57.2)	(\$36.1)	(\$15.2)	\$29.0	(\$79.5)
Impairment of auction rate securities	(2.0)									
Interest & other income (expense)	(4.2)	(4.0)	(4.1)	0.0	(12.3)	0.0	0.0	0.0	0.0	0.0
Gain on series C derivative										
Non-GAAP pretax income	(\$30.2)	(\$73.0)	(\$102.6)	(\$111.9)	(\$315.8)	(\$57.2)	(\$36.1)	(\$15.2)	\$29.0	(\$79.5)
less: income taxes	0.1	0.2	(3.2)		(2.9)	(17.1)	(10.8)	(4.6)	8.7	(23.8)
Tax rate		NM	NM			30.0%	30.0%	30.0%	30.0%	
Non-GAAP net income	(\$30.3)	(\$73.2)	(\$99.4)	(\$111.9)	(\$312.8)	(\$40.0)	(\$25.3)	(\$10.6)	\$20.3	(\$55.6)
Preferred dividends	\$3.4	\$3.4	\$3.4	\$3.4	\$13.6	\$3.4	\$3.4	\$3.4	\$3.4	\$13.5
Non-GAAP applicable to shareholders	(\$33.6)	(\$76.7)	(\$102.8)	(\$115.2)	(\$326.4)	(\$43.4)	(\$28.7)	(\$14.0)	\$16.9	(\$69.1)
Non-GAAP earnings per share	(\$0.24)	(\$0.48)	(\$0.61)	(\$0.69)	(\$2.05)	(\$0.27)	(\$0.18)	(\$0.09)	\$0.08	(\$0.40)
Shares outstanding	141.0	159.9	167.9	168.0	159.2	160.0	160.0	160.0	220.0	175.0
Year-over-year sales growth	NA	NA	NA	NA	NA	-13%	30%	29%	313%	53.3%
Percent of sales										
Gross profits	27.9%	25.4%	17.3%	21.6%	23.2%	28.4%	28.6%	28.8%	29.0%	28.7%
Sales and marketing	15.5%	24.8%	26.8%	50.0%	25.8%	25.0%	20.0%	17.0%	13.0%	17.7%
Research & development	12.1%	17.5%	14.0%	35.0%	17.0%	17.0%	14.0%	12.0%	9.0%	12.3%
General & administrative	4.5%	5.3%	4.9%	10.0%	5.6%	4.5%	3.8%	3.0%	2.4%	3.2%
Operating expenses	34.5%	48.3%	44.2%	95.0%	49.2%	46.5%	37.8%	32.0%	24.4%	33.1%
Non-GAAP operating income	-6.7%	-22.9%	-26.9%	-73.4%	-25.7%	-18.1%	-9.2%	-3.2%	4.6%	-4.4%
Interest and other income	-1.2%	-1.3%	-1.1%	0.0%	-1.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Pretax income	-8.4%	-24.2%	-28.0%	-73.4%	-27.6%	-18.1%	-9.2%	-3.2%	4.6%	-3.8%

Note: Includes stock-based compensation

Palm Inc.

(\$ in MM, except per share data)

Fiscal Year Ending May 31	Annual		Quarterly			
	FY 5/30/2008	FY 5/31/2009	Ending 5/31/2009	Ending 8/31/2009	Ending 11/30/2009	Ending 2/28/2010
BALANCE SHEET						
ASSETS						
Cash & Short-term Investments	258.7	255.1	255.1	211.8	590.0	591.9
Receivables	116.4	66.5	66.5	76.6	72.4	104.0
Inventory	67.5	19.7	19.7	27.8	38.8	30.6
Other Current Assets	97.4	12.3	12.3	117.4	208.0	16.3
Current Assets	540.1	353.6	353.6	433.7	909.1	742.8
Property and Equipment	39.6	31.2	31.2	31.0	32.8	32.9
Goodwill and Intangibles	229.0	215.2	215.2	212.7	210.1	207.5
Long-term Marketable Securities	0.0	0.0	0.0	0.0	0.0	0.0
Other Assets	371.5	43.3	43.3	116.6	175.0	24.0
Total Assets	1,180.3	643.2	643.2	794.0	1,326.9	1,007.2
LIABILITIES AND SHAREHOLDERS' EQUITY						
Current Liabilities	411.3	342.4	342.4	703.1	848.1	601.1
Short-term Debt	0.0	0.0	0.0	0.0	0.0	0.0
Long-term Debt	394.0	390.0	390.0	389.0	388.0	387.0
Shareholders' Equity	111.0	(413.9)	(413.9)	(738.9)	(439.4)	(297.9)
Total Liabilities + Shareholders' Equity	1,180.3	643.2	643.2	794.0	1,326.9	1,007.2
INCOME STATEMENT						
Revenue				361.2	302.0	366.0
Gross Profit				100.6	76.7	63.5
Operating Income				(24.0)	(69.0)	(98.5)
Pretax Income				(30.2)	(73.0)	(102.6)
Net Income				(30.3)	(73.2)	(99.4)
Shares Outstanding				141.0	159.9	167.9
CASH FLOW STATEMENT						
Depreciation and Amortization						
Cash Flow from Operations						
Capital Expenditures						
CASH MANAGEMENT*						
DSOs				17.8	22.2	21.7
Inventory Turns				8.2	13.3	10.3
Inventory Days				34.2	50.3	54.2
Days Payable				(8.2)	(14.8)	(22.2)
Cash Conversion Cycle						
PROFITABILITY						
Gross Margin				27.9%	25.4%	17.3%
Operating Margin				(6.7%)	(22.9%)	(26.9%)
Net Margin				(8.4%)	(24.3%)	(27.2%)
Return on Assets*				(16.8%)	(27.6%)	(34.1%)
Return on Equity*				21.0%	49.7%	107.9%
Total Debt/Capital	51.8%	138.3%	138.3%	(596.9%)	163.8%	101.6%
PER SHARE DATA						
Tangible Book Value				(6.75)	(4.06)	(3.01)
Cash				1.50	3.69	3.53
Net Cash				(1.26)	1.26	1.22
EPS (Pro Forma)				(0.24)	(0.48)	(0.61)
EPS (Pro Forma Including Option Expenses)				(0.24)	(0.48)	(0.61)
EPS (GAAP)						

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Price, Rating, and Price Target History: Apple Inc. (AAPL/NASDAQ) as of 3-18-10



Source: Factset (Prices) / Needham (ratings and target price)

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Price, Rating, and Price Target History: Google, Inc. (GOOG/NASDAQ) as of 3-18-10



Source: Factset (Prices) / Needham (ratings and target price)

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Price, Rating, and Price Target History: Research in Motion (RIMM/NASDAQ) as of 3-18-10



Source: Factset (Prices) / Needham (ratings and target price)

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Strong Buy	6	5
Buy	57	8
Hold	32	4
Under Perform	1	0
Rating Suspended	3	17
Restricted	<1	50
Under Review	0	0

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