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May 8, 2006

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## MOVERS & SHAKERS

By Lauren Keyson

### IT Best Performing Sector in Q1

But S&P Has a Neutral Rating on It

Exclusive TTB Interview with Sam Stovall  
Chief Investment Strategist, Standard & Poor's

According to Sam Stovall's recent *Investment Outlook*, the first quarter was a very good one. The S&P 500 gained more in three months than it did in all of 2005, and it posted the best first-quarter performance since 1999. The S&P SmallCap 600 index outpaced the large-cap 500 by a more than three-to-one margin, and all but one of the 10 sectors in each of the S&P large-, mid- and small-cap benchmarks posted advances in the quarter.

Mr. Stovall believes that driving forces for the equity markets' advances included a surge in M&A activity, erratic economic reports that gave investors hope of an accelerated end to the Fed's rate-tightening program, and moderating oil prices. Other driving forces included improving consumer confidence and the expectation that Q1 2006 S&P 500 operating earnings will post their 16th consecutive quarter of double-digit advances.

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## KEEPING UP

By John Filar Atwood

### Strong Earnings Reports Can't Unseat Analysts' Caution

March-quarter reports are coming in, and they are surprisingly strong for a number of companies. Analysts appear unmoved, however, recommending a cautious approach until companies demonstrate that they can sustain the positive momentum. Weakness in the mainframe space hurt companies across several industries. All news was not bad, however, as **Google (GOOG)** released numbers that seemed to justify its rich share price. Here's a look at analysts' reaction to recent earnings reports and other news from around the industry.



#### Semiconductors

**Xilinx (XLNX)** beat March-quarter expectations with earnings per share of \$0.33 on \$427 million in revenue. The company showed strength across many product lines, particularly consumer products where revenues were

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## TECH POINTS

Q2 Average Performances and Frequencies  
of Market Outperformance  
Q1 1990 — Q1 2006

	Average	
	% Chg.	F.O.
<b>S&amp;P 500 Sector</b>		
Information Technology	4%	69%
S&P 500	3%	NA
<b>Top Two Tech Sub-industries with</b>	<b>Average</b>	
<b>Best Q2 Track Records</b>	<b>% Chg.</b>	<b>F.O.</b>
Systems Software	7%	75%
Semiconductor	5%	63%

Source: Standard & Poor's



## TECH IN THE NEWS

By Ira Gamm

### Computer Culture Drives New Avenues of Growth

#### Intel Plans Major Revamping to Save \$1 Billion

**Intel (INTC)** is planning a sweeping reorganization aimed at greater efficiencies and reduced costs in an effort to get back on track after reporting another quarter of declining profit and lost market share, both the *New York Times* and *Wall Street Journal* are reporting. The company said it is reviewing every aspect of its operations and will begin making changes immediately. Paul S. Otellini, the company's chief executive, said the overhaul would focus, among other things, on manufacturing costs and identifying weak business units. While the company would not comment directly about potential layoffs, it will seek personnel reductions by attrition. Intel already has imposed a hiring freeze in the current quarter.

#### Google, Yahoo! Go Local to Attract Customers

Internet titans **Google (GOOG)** and **Yahoo! (YHOO)** are rushing to add more consumer information to their local services – Yahoo! Local and Google Maps, according to a story in the *Wall Street Journal*. Yahoo! is constructing virtual town squares, where users can share local knowledge about the best bars, the most reliable plumbers, or nice places to take a walk. Google is focusing on adding more information pulled from its listing service, Google

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MOVERS & SHAKERS

**Lauren Keyson (The Tech Briefing):** In your recent report, "Is Everybody Happy?", international equity markets advanced 4% to 20% in dollar terms year to date through March 31, 2006.

**Sam Stovall (Standard & Poor's):** Yes, worldwide equity market returns in the first quarter should have made everybody happy. Here in the U.S., the equity market did better in the first three months of the year than it did during all 12 months of 2005. That said, returns in the U.S. were pretty light compared to the rest of the world.

**LK: So only fixed-income investors saw red?**

**SS:** That's right. Certain fixed-income areas did decline in the first quarter. Beyond that, however, if you looked at real estate, or even metals and energy, you would have seen that a variety of asset classes did exceptionally well.

**LK: I noticed from your table [see "Tech Points" on page 1] that tech also performed well – averaging a 4% increase. So what does history say about what lies ahead?**

**SS:** Historically, the average performance for the S&P 500 has been strongest in the fourth quarter of the year, while the third quarter is by far the worst performer. Of course, past performance is no guarantee of future results. The first and second quarters have seen so-so results on average. The old adage "sell in May and then walk away" indicates that, on average, investors will get better returns in the last quarter and first quarters of the year, with the weakest returns closer to the summertime, as more people focus on their tans rather than their portfolios.

**LK: In the accompanying table [see "Tech Points" on page 1], it shows that in the first quarter one of the best-performing sectors was information technology. Do you recommend IT going forward?**

**SS:** S&P recommends a market weighting for the tech sector. Our feeling is that as an entire sector, tech is likely to keep pace with the S&P 500, but not exceed it. Certainly, however, there are areas within tech that we favor.

**LK: What about delayed disappointments?**

**SS:** I was trying to think of reasons that would cause the market to go down. In the second quarter, I think we are still going to see a lot of carryover of this euphoria that we saw in the first quarter. Mainly that's because I don't think we will be disappointed until the third quarter - should the Fed decide to continue to raise interest rates. Originally, I forecast that oil prices would not skyrocket until after June, because we move into the peak summer driving period that would cause gasoline prices to rise. Also, we're heading into the hurricane season, which should possibly push investor anxiety higher because of the potential for supply disruption similar to what we saw last year from Katrina.

**LK: What about elevated anxiety? You said that market corrections are triggered by unexpected events....**

**SS:** Either that or triggered by already known events where the concern about them has accelerated.

**LK: All in all, you think the S&P will reach 1325 by mid-year?**

**SS:** Yes, and 1360 by year end. That would be a 6% advance in the first six months, and three additional percentage points in the second half of the year. If we end up with a pretty strong fourth quarter, then that means we probably could survive, in a sense, a bit of a correction in the third quarter. ◆

*Note: If you would like to be interviewed in this Movers & Shakers column or know someone who should be interviewed, please send the name and contact information to Lauren Keyson at LKeyson@keysonpublishing.com with Movers & Shakers in the subject line. We are always looking for new ideas.*

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Your Key to IT Investing

**Publisher**

Lauren Keyson  
LKeyson@keysonpublishing.com

**Editorial**

John Filar Atwood, Editor-in-Chief  
Shannon Swingle, Senior Editor  
Ira Gamm, Staff Writer

**Analyst**

Charlie Grainger

**Production & Design**

Laura Medley, Internet/Production Manager

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**For Questions or Comments:**

LKeyson@keysonpublishing.com

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New York, NY 10023

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## KEEPING UP

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up 13%. John Lau of Jefferies & Co. raised his fiscal 2007 earnings estimate to \$1.12 and upped his price target to \$31. However, he reiterated his Hold rating, given the stock's high valuation and the lack of a sustained revenue catalyst.

## COMMUNICATIONS EQUIPMENT

The quarter is shaping up as a very strong one for equipment vendors. **Qualcomm (QCOM)** had already pre-announced solid numbers, and now **Nokia (NOK)** reports that handset sales are pacing well ahead of expectations. In addition to sales, NOK's average sales prices increased from the previous quarter. Prudential's Inder Singh thinks the sales process may come under pressure later this year, but he reiterated his Overweight rating on NOK, based on the company's new joint venture with Sanyo.

## Computer Hardware

**Lexmark (LXK)** cut back on inkjet printer sales, which helped it to post first-quarter EPS well ahead of expectations at \$0.78. Revenues were in line, but the reduction in inkjet sales decreased the drag on gross margins. Needham's Charlie Wolf raised his 2006 EPS estimate to \$3.30 from \$2.90 on the belief that LXK will continue the new strategy through the end of the year. He maintained his Hold rating, however, based on the likelihood that the price war in the printer market is not over.

## Technology Distributors

Strong component demand drove Q1 earnings for **Arrow Electronics (ARW)** to \$0.68 per share, which was \$0.08 better than Street estimates and a 50% increase year over year. A company restructuring and three recent acquisitions also contributed to the outperformance. Deutsche Bank's Carter Shoop increased his 2006 EPS estimate by \$0.50 but maintained his Hold rating on ARW. The intermediate-term outlook is good, but he is not convinced the momentum is sustainable.

## Application Software

**Compuware (CPWR)** pre-announced March-quarter results at the low end of expectations. The company's core businesses, including the mainframe market, are still under pressure. The company's inconsistent execution should drive fiscal 2007 revenue up only 4%, according to Zaineb Bokhari of Standard & Poor's. He expects fiscal 2006 revenues to be down 2%, and he reiterated his Hold rating on CPWR shares.

## Systems Software

A weak pre-announcement by **Computer Associates (CA)** is another indication that the computer mainframe market is struggling. **IBM (IBM)** has said that the growth of its mainframe business is decelerating, and **Compuware (CPWR)** pre-announced similar troubles. CA's revenues are now expected to come in 5% below previous guidance, with EPS about \$0.08 lower. Revenue growth is slowing, despite the inclusion of some acquisitions. Kevin Buttigieg of A.G. Edwards reiterated his Hold rating on CA, following the pre-announcement.

## IT Consulting and Other Services

**CAI International's (CAI)** disappointing third quarter and reduced guidance could be a bad sign for other federal government IT services companies. Contract work has been delayed, leading to a deceleration in revenue growth. William Loomis of Stifel Nicolaus notes that demand is still healthy and that fiscal 2007 growth prospects look good for CAI. He reiterated a Hold rating on the stock, noting that the federal space is bottoming. However, he believes the outlook should improve heading into 2007.

## Computer Storage and Peripherals

**Avid Technology (AVID)** pre-announced significantly lower earnings and revenues, based on poor sales of broadcast systems due to competition. The company also is experiencing weakness in Europe, based on product-quality issues. Oppenheimer's A. Sasa Zorovic downgraded AVID to Neutral from Buy. He believes the difficulties could impact EPS for a number of months. He cut his fiscal 2006 EPS estimate to \$0.90 from \$1.55.

## Home Entertainment Software

The outlook for **Take-Two Interactive (TTWO)** has improved slightly, based on strong sales of *Elder Scrolls* and expectations that games, such as *Table Tennis*, will beat sales projections. Gary McDaniel of Standard & Poor's upgraded the stock to Hold from Strong Sell on the news. He also lowered his risk premium on TTWO, because the company appointed a corporate governance expert and a former judge to its board of directors. McDaniel upped his 12-month price target to \$20 from \$13.

## Electronic Equipment Manufacturers

**Coherent (COHR)**, which had fallen short of revenue projections last quarter,

beat March-quarter EPS estimates by \$0.04 on an 11% increase in revenues. Demand from microelectronics customers drove most of the upside. Needham's John Harmon reiterated his Strong Buy rating on COHR and raised his price target to \$50 from \$42. He believes the company is executing well and will benefit from the impending completion of its acquisition of Excel.

## Electronic Manufacturing Services

**Sanmina-SCI (SANM)** reported in-line Q2 numbers on solid demand in its core business, other than PCs. Forward guidance was optimistic, based on its improving customer base and product pipeline. Needham's Richard Kugele upgraded SANM to Buy from Hold, following the report. He believes the completed restructuring is starting to yield tangible benefits for SANM. He also thinks the stock's valuation is very attractive at 10 times his fiscal 2007 earnings estimate.

## Semiconductor Equipment

**Lam Research (LRCX)** beat earnings expectations in the recent quarter and released guidance that exceeded Street estimates. Bookings were up 29%, to \$510 million, and shipments grew 30% from the previous quarter, to \$511 million. Gavin

## INTERNET SOFTWARE AND SERVICES

First-quarter revenues grew 19% from the previous quarter at **Google (GOOG)**. The company gained share in both domestic and international markets with balanced growth. Youssef Squali of Jefferies & Co. is bullish on GOOG's growth prospects both in search and branded advertising. He reiterated his Buy rating and upped his fiscal 2006 revenue estimate to \$6.97 billion from \$6.5 billion, and his EPS estimate to \$9.61 from \$9.10. He also increased his price target to \$500.

Duffy of A.G. Edwards maintained a Buy rating on LRCX while raising his fiscal 2006 EPS estimate to \$2.38 from \$2.21. He also raised his price target to \$55 from \$50.

## Data Processing and Outsourced Services

**Automatic Data Processing (ADP)** sold its claims services business to Solera for \$975 million. The company said it might use the \$480 million in net proceeds to buy back some of its shares. Dylan Cathers of Standard & Poor's lowered his fiscal 2006 EPS estimate slightly to reflect the sale. However, he reiterated a Strong Buy rating and held his 12-month price target at \$54. ◆

TECH IN THE NEWS

cont from pg 1

Base, and comparison shopping engine, Froogle. By enhancing the local resources, both companies hope to build hubs of consumer activity that, in turn, will be magnets for advertisers, including millions of small business at the heart of the \$100 billion U.S. local-advertising market. Many of those businesses have never advertised online, but the search companies hope to change that by developing new formats and better advertising tools.

Microsoft May Buy Technology Ad Company

Microsoft (MSFT) is negotiating to buy Massive Incorporated, which makes technology that inserts advertisements into video games, the *New York Times* reports. Massive acts as a kind of advertising agency for video games, placing virtual billboards, logos and other promotions for companies like Coca-Cola (KO), 20th Century Fox and Panasonic in games made by the major game publishers, like THQ (THQI), Ubisoft and Activision (ATVI). The deal would give momentum to the idea of advertising in video games. Advertisers and publishers are trying to exploit Internet technology that would allow

them to insert and update ads automatically in games played on personal computers and game consoles that are connected to the Internet. Microsoft's interest in Massive could indicate that more ads are on the way.

Viacom Acquires Online Game Service

Viacom (VIA) has acquired Xfire, a Silicon Valley company that makes an instant-message system used by video game players, according to the *New York Times*. Viacom, which is the parent of MTV Networks, will pay \$102 million in cash for Xfire, which is privately held. Xfire makes a program similar to other instant-message systems in that it lets users communicate with each other while they are online. The system, however, is designed for people who play game software on their own computers. Users can see which games their friends are playing and automatically link to join them in playing the game online. Viacom said Xfire would stay focused on building a community for game players, but its technology might be adapted for broader network services. ♦



# TECH UPS AND DOWNS

The following companies received ratings changes between April 17 and April 28:

## Upgrades

Company	Consensus Rating	Consensus Target Price
SonicWALL (SNWL)	Outperform	\$9.83
Sanmina-SCI (SANM)	Hold	\$5.58
Zoran (ZRAN)	Outperform	\$29.18

## Downgrades

Company	Consensus Rating	Consensus Target Price
Komag (KOMG)	Hold	\$52.22
PDF Solutions (PDFS)	Buy	\$20.92
Citrix Systems (CTXS)	Outperform	\$43.74

Source: Reuters Estimates



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