

BLYTH FUND

Date: 01-24-02
Proposal: Sun Microsystems Sell Proposal
Ticker: SUNW
Current price: 11.27 (close 01-23-02)
Analyst: Charles Najda
Profile: Sun Microsystems, Inc. (Sun) is a worldwide provider of products, services and support solutions for building and maintaining network computing environments. Sun sells scalable computer and storage systems, high-speed microprocessors, and a comprehensive line of high-performance software for operating network computing equipment. The Company also provides a broad range of services, including support, professional services and education. The Company's products are used for many commercial and technical applications in various industries including telecommunications, financial services, manufacturing, government, education and research, retail, health care, digital media and entertainment. Sun utilizes open industry standards, the Solaris Operating Environment and the UltraSPARC (Ultra Scalable Processor Architecture) microprocessor architecture. (From *Yahoo! Finance*)

The Numbers:

Shares Outstanding:	3.24 bln	Market Cap:	\$36.53 bln
P/E	N/A	PEG Ratio	N/A
Sales Growth (02)	-29.7%	EPS Growth - 5 years	20.0%
Sales Growth (03)	23.3%		
P/book	3.59	P/sales	2.56
Gross Margins	36.6%	Net Margins	N/A
Cash:	\$1.85 bln	Debt/Equity	0.27
ROA:	-3.17%	ROE:	-5.41%
EPS (02)	\$-0.08	EPS (03)	\$0.22
Dividend	N/A	Dividend Yield	N/A

Reasons to Sell:

Falling Revenues:

- The market for servers, although strong, has been adversely affected by the slowing economy. Moreover, the Internet bubble and the inflated demand for servers that accompanied it have produced a large supply of relatively new second hand servers.
- The server market **plunged 30 percent** in the third quarter of 2001, with IBM the least damaged and Hewlett-Packard edging to within a fraction of Sun's lead in the key Unix server segment.
- In the overall market, IBM sales dropped 6.1 percent to \$2.8 billion, but its market share rose 6.5 percent. Much of that gain took place at the expense of rival Sun Microsystems, which lost 6.3 percent of market share and saw revenue plunge **53 percent** to \$1.3 billion, according to IDC, a respected market research firm.
- Recent data suggests that IBM is making inroads at the high end, with its huge services division essentially subsidizing the hardware divisions. Likewise, Dell is aggressively going after the low-end server market with the support of industry giants Microsoft and Intel.

Earnings:

- This week Goldman Sachs lowered revenue estimates from 16 to 10 cents per share for Sun's next fiscal year. The stock traded down ten percent on the news. The reason for the cut was very interesting. Goldman cut its estimates because Sun won't earn enough interest from its cash. If I didn't know that Sun made servers I would have thought the company was a bank.
- The included charts (see the last two pages) dramatically show the sharp rise in the share of earnings coming from interest income. It is quite concerning that a technology company is making almost as much money from cash as it is from the technology that it is supposed to be selling.

Market Share:

- In the Unix market, Sun had 28.8 percent of the market in the third quarter, with sales of \$1.33 billion. HP had 28.5 percent with sales of \$1.31 billion, IDC said. IBM, in third place, had \$960 million in sales for 20.9 percent of the market.
- In the overall market, Compaq Computer was in second place with 16.3 percent of the

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market and a revenue drop of 34.7 percent to \$1.75 billion. HP was in third place with 15.2 percent and revenue that dropped 29.7 percent to \$1.64 billion. Dell, in fifth place with 7.9 percent of the market, had a revenue drop of 5.8 percent--the smallest of the top companies--with revenue of \$847 million.

- Sun had in the past been successful at beating back competition from HP and IBM; however, Sun's competitors are aggressive and will continue to be aggressive, which will adversely affect Sun's margins, if Sun doesn't lower its production costs. In fact, Sun's gross margins dropped some 11% this past year (3% the same period last year) due to market conditions and increased competition.

New Competition:

- Competition for Sun in the server market goes beyond its traditional server competitors. SonicWALL sells a relatively new type of hardware device called an SSL accelerator, which is a transaction security product. The device provides high performance execution of processor intensive SSL transactions.
- A server running SSL transactions runs on average 90% slower than a server handling other types of processes. SonicWALL SSL products offload SSL transactions and process them much more efficiently and at a much lower cost. For example a single SSL-R6 can handle 30,000 simultaneous transactions, at an accelerated speed versus a conventional server.
- Online retailers like Amazon and Wal-Mart, since a large percentage of their server capacity is dedicated to processing SSL transactions, will replace servers with dedicated SSL products as the servers age, which means a recovery of the server market will take longer than anticipated.

Margins:

- Gross margins were 36.6 percent in the second quarter (Dec, 01), off about 11 points from the year-ago quarter, when Sun was humming. The decline in gross margins was higher than most analysts were expecting.
- Sun's margins are unlikely to recover very quickly due to the slow economy as well as the fact that numerous Internet companies will no longer be using Sun's support services. Services have high margins; moreover, since services provide continuous revenue flow, the loss of these customers has a multiyear effect on Sun's revenue.

Valuation:

- Over the last ten years Sun has traded at an average price/sales ratio of 2. Sun is currently trading a ratio of over 2.5. Given that Sun had a ratio of two during its best and fastest growing years, Sun is hardly a bargain at its current price.
- The price sales ratio quoted in this proposal is ttm starting at the quarter ended September 30th. Thus given the drastic decline in revenue for the December quarter it's only natural that the ratio will rise closer to 3 when it's recomputed.
- Sun will no longer deliver the stellar growth that it had during the late 90's. Instead, analysts expect SUNW to grow earnings at a rate of 20% the next five years. This figure may be optimistic given the huge decline in the server market that occurred last quarter, and uncertainty over Sun being able to maintain its market leading position.
- Even a more conservative investor should view Sun's sales problems and high valuation as signs that Sun is at least fairly, if not over valued.
- SUNW is still the market leader in Unix servers, but is barely still number one.
- Sun is a large cap tech and as such enjoys a large following of individual investors who want to invest in technology, but with less risk.
- Historically the margins in the server market have been higher than in the PC market. This past Spring Sun's net margins were 14.9% compared to 8.4% for Dell Computer. Sun still has a dominant position in the server market. Earlier this year, Sun leaped from a fifth-place ranking to a close second in the high margin HPC market, where it has 20% of the market. Sun has over 40% of the midrange server market, for which it has just released new servers based on the new UltraSpark III processor.
- Mike Lehman the CFO at Sun stated that Sun is paring back general and administrative costs, but is growing R&D spending at 20%.
- Sun by no means is a "bad" investment, but the fund would benefit from reallocating its holdings to maximize the return of the fund.

Reasons to Hold:

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1-Year Chart:

Sun Microsystems Inc
as of 23-Jan-2002

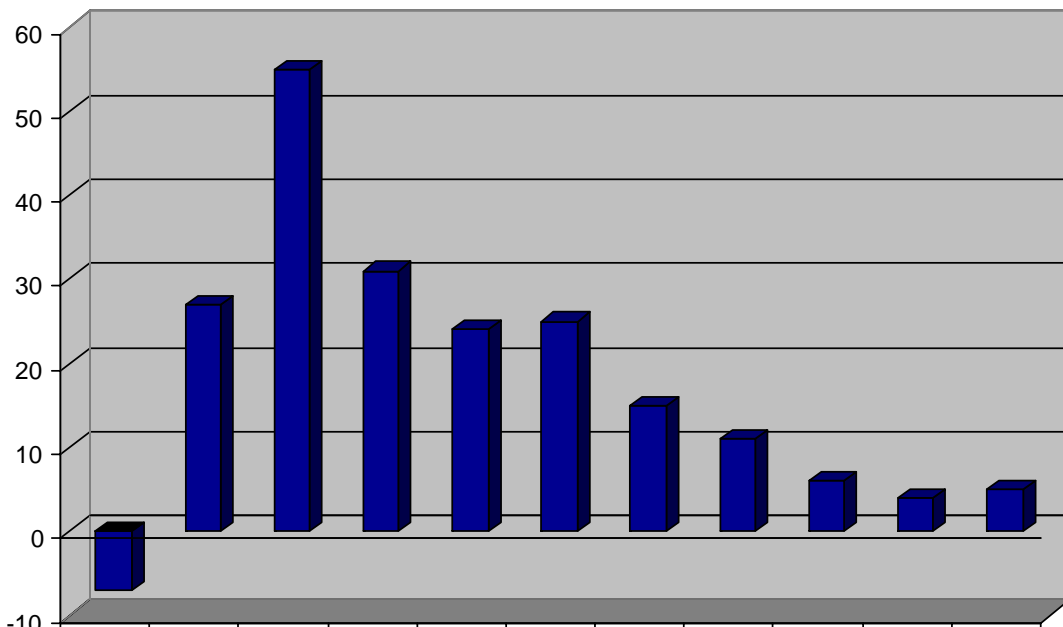
Splits: ▼



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EPS (cents)



	2002 (est)	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
■ EPS	-7	27	55	31	24	25	15	11	6	4	5

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