

**DECLARATION OF GAIL K. JOHNSON  
IN SUPPORT OF  
REPLY MEMORANDUM  
IN SUPPORT OF MOTION TO DISMISS  
FIRST AMENDED CONSOLIDATED COMPLAINT**

Master File No. C-01-3667 CW

**EXHIBIT B**

# DESK NOTES

**CREDIT SUISSE** | **FIRST BOSTON**

CREDIT SUISSE FIRST BOSTON CORPORATION

**Equity Research**

Americas

PC and Enterprise Hardware

October 19, 2000

**BUY**  
USD 20.13

## Apple Computer

AAPL

LARGE CAP

### Bruised, But Not Rotten

- As preannounced, Apple reported disappointing Q400 EPS of \$0.30 on \$1.87 billion in sales. In addition to the revenue shortfall, channel inventory levels increased during the quarter from 5 weeks to 8 weeks.
- Apple's quarter and product sell-through were negatively impacted by weak education sales, a disappointing debut of the new G4 Cube, and poor PowerMac sales mix.
- In order to normalize inventory levels in one quarter, Apple reduced expectations for Q101 sales and profitability. We are reducing our FY01 revenue estimate to \$7.75 billion from \$9 billion and EPS to \$1.10 from \$1.75. We are reducing our FY02 EPS estimate to \$1.45 from \$2.10
- We are maintaining our Buy rating, recognizing 1) the value inherent in the stock's current level; 2) Apple's technology franchise; 3) industry trends; and 4) takeout dynamics. Our target price is \$29.

Price 10/18/00 <sup>1</sup>	Target (12 Months)	Dividend	Yield	Mkt. Value (Millions)	52-Week Price Range	
USD 20.13	29.00	0.00	None	\$7,347.5	75.19-19.13	
	Annual EPS	Prev. EPS	Abs. P/E	Rel. P/E	EV/ EBIT	EBIT/ Share
09/02E	1.45	2.10	13.9X	NA	7.9	1.25
09/01E	1.10	1.75	18.3	85%	11.5	0.86
09/00A	1.69	1.70	11.9	51%	5.7	1.72
	December	March	June	September	FY End	
2001E	0.00	0.37	0.38	0.35	September	
2000A	0.50	0.44	0.45	0.30		
1999A	0.39	0.30	0.34	0.25		
ROIC (09/00)	NA	Total Debt (09/00)		300	Book Value/Share (09/00) \$11.35	
WACC (09/00)	NA	Debt/Total Capital (09/00)		6.8%	Common Shares 365	
EP Trend <sup>2</sup>	NA	Est. 5-Yr EPS Growth		15%	Est. 5-Yr. Div. Growth 0%	

<sup>1</sup>On 10/18/00 DJIA closed at 9975.02 and S&P 500 at 1342.13.

<sup>2</sup>Economic profit trend.

Apple Computer designs, manufactures and markets microprocessor based personal computers and related personal computing and communications solutions for sale primarily to education, creative, home, creative business and government customers. Apple also manufactures software applications and utility tools.

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## Investment Summary

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### Bottom Line

As expected, Apple reported disappointing Q4 earnings of \$0.30 versus \$0.25 a year ago on \$1.87 billion in sales, up 40%. Unfortunately, about 3 weeks of sales or approximately \$500 million of revenues represented channel fill at the end of the quarter. In order to reduce the current 8 week inventory levels to the normal 5 weeks, Apple will reduce December (Q1) quarter shipments that will lead to little or no Q1 profit and will reduce full year revenue and earnings projections.

We are reducing our FY01 revenue estimate to \$7.75 billion from \$9 billion and earnings to \$1.10 from \$1.75. For FY02 our new earnings estimate is \$1.45, down from \$2.10. While the magnitude of the earnings reduction is greater than expected, we believe these new numbers represent a worst case scenario. We believe Apple's stock has largely discounted most of these changes. The shares are currently selling around 18x forward 12-month earnings and less than 1.7x net cash per share. During Apple's dark days in 1997 when the stock hit an all time low following a \$1 billion loss and talks of bankruptcy, Apple's stock bottomed at 3x net cash per share.

We are maintaining our Buy rating and believe Apple's stock represents remarkable value at current levels. We believe this stock is one "hit-product" away from a double. Our conservative price target is \$29.

### Why Apple Remains a Buy

**Value** – It is usually a bad sign when a tech analyst talks value. However, Apple's stock is trading less than 1.7x net cash per share compared to 3x net cash per share when the company was considered a bankruptcy candidate in 1997. Apple remains profitable and posted \$860 million in net earnings in fiscal 2000. The company is also cash flow positive and has more than 300 million shares remaining in its share buy back program.

**Franchise** – Apple has one of the most enduring franchises in the history of the technology industry. Apple experienced a meaningful market share recovery following the launch of the iMac in 1998. The company plans the broadest product upgrade in history during 2001, in which nearly every product line for each market segment will be upgraded. Long-awaited OS X will ship in January, making Apple more competitive against Microsoft-based machines. All it took was a fruity colored desktop (iMac) to launch Apple from near extinction in 1998 to the best performing PC stock in 1999, a ten-fold appreciation.

**Not alone** – Apple poorly executed this quarter and experienced the first product flop (G4 Cube) since Jobs re-arrived in 1997. But Apple's problems are not completely Apple-only problems. Dell (\$26.25-HOLD), Intel (INTC, \$38.19-BUY), IBM (\$95.44-HOLD) and other tech companies have missed numbers recently and lowered forward guidance. Demand for PCs overall stumbled in September and now fights macroeconomic issues that have spooked tech consumers.

**Take-out** – CEO Steve Jobs and his financial and development team have been rightly credited with rescuing Apple in 1998 with incredibly successful and innovative new products. They recognized that the model had changed, and that growth in Internet computing allowed Apple to differentiate and be embraced rather than excluded. Steve Jobs has too much pride to fail. He would rather sell the company at an attractive price than be forever pinned with the label "Couldn't finish what he started."

### Analysis of Q400

Apple's quarter showed a fundamental and fairly comprehensive dropoff in demand. The slowing in demand showed up in two ways: first, channel inventory levels ballooned from 5 weeks at the start of the quarter to 8 weeks exiting the

quarter, indicating weak end consumer sell through; and second, Apple missed its own sell-in expectations by \$120 million (noting that education product is sold direct), meaning that if Apple had shipped enough product into the channel to hit revenue expectations channel inventories might have approached as much as 9.5 weeks, by our calculations. Even with the reduced expectations for next quarter, Apple has a fairly significant challenge ahead: to sell not just the guided \$1.6 billion worth of product but also an additional \$450 million worth to work inventories back down to acceptable levels. This brings Apple to about \$300 million less than last year's blowout holiday season revenues, when presumably inventory levels were stable; with the announced promotions, this should be achievable.

The demand shortfall was broad-based but impacted different product lines unevenly. The **education** shortfall, accounting for \$60 million of the total \$180 revenue miss, was caused by a poorly timed transition from a third-party educational reseller model to a direct Apple representative-based model. The transition came in July, at the height of the K-12 selling season, and many educational institutions were disaffected by the change from familiar, local resellers to new, often inexperienced, and distant Apple representatives. We believe that by next season the new model will be successful for Apple, but this year it caused Apple to lose share in the education market, primarily we believe to Dell. Educational institutions tend to buy at the lower end of the product lineup, meaning iBooks and iMacs. Of the three problem areas this quarter (education, the G4 Cube, and PowerMac mix), this was the least contributory to the channel inventory expansion, as education product is sold direct. iMac sales missed our expectation by about \$16 million, and iBook sales missed our expectation by about \$30 million; a good portion, if not all, of these shortfalls was probably directly tied to education.

The **G4 Cube** represented Apple's first attempt to go outside the established 4-product market/form factor quadrant (consumer desktop/laptop; professional desktop/laptop) since it was established, introducing a new desktop across both the professional and consumer markets. It didn't take long before the product was siloed as a very high-end consumer box, due to the product's G4 chip, limited expandability, and form factor. Unfortunately, at \$1,799 without the expected flat-panel monitor, it was priced in the professional range, thereby missing the effective target market. The product sold 107,000 units into the channel, short of our original 150,000 estimate, causing a \$90 million revenue shortfall for the product. To address the pricing issue, Apple is now offering a \$300 rebate on the Cube when purchased with a monitor, pricing it \$100 below the entry price for the G4 PowerMac.

The third problem was an unexpected mix skew toward the low end of the **G4 PowerMac** professional desktop line. This was a new development – typically, on all of Apple's product lines, mix skews to the high end. However, the high end of the PowerMac lineup is the dual-processor model, which adds little in performance over single processor models because the current incarnation of the Macintosh OS, 9.0, cannot fully take advantage of two chips. Only with OS X early next year comes such functionality as SMP (symmetric multiprocessing, or the ability to assign and spread computing tasks over multiple chips), which is necessary to fully enjoy the advantages of multiple chips. Priced \$1,000 above the next lower single processor model, the dual-chip G4 offers poor price-performance in front of OS X. Rather than spur sales with a promotion, Apple will probably wait until OS X ships in Q201 to see better PowerMac mix.

The quarter's gross margin, at 25%, was down from 29.8% in Q3 and 28.7% a year earlier. The problems leading to weak sell-through and missed sell-in expectations contributed to the margin weakness. In addition to the G4

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PowerMac mix skew, margins were hurt by the sales promotions as well as component cancellation charges. Going forward, management guided to abnormally low margins in Q1 to enable the sales promotions and expanded channel costs involved in selling through 3 extra weeks of inventory in one quarter.

**Looking forward**

Apple's decision to "take the medicine" and reduce channel inventories to normalized levels over the course of a single quarter paves the way for the rash of products that will arrive next year. We believe that the stock currently discounts the ugliest of the last quarter and the brutality of the medicine, but not the recovery afterwards. In the future, the Street may pause before instantly believing that product introductions will be successful, given the Cube's hiccup. But we believe Apple's management team will learn from product mistakes while retaining the design genius that delivered all the other product successes, meaning that the stock will ultimately respond to future products that deliver earnings. We expect that next year will yield such products.

**Internet Computing Plays to Apple's Strengths**

The Internet is driving Apple's transformation in two ways. First, the Internet has become the ultimate "killer app", sending people who have never used a computer before to local electronics stores in droves, desperate not to miss out on what is clearly a computing revolution. Although computer use has exploded in the United States, there are still 50 million U.S. households without a PC, along with an additional tens of millions of homes in developed nations abroad. Further, the rapid decline in PC pricing combined with growing product simplicity has led to an increase in the number of households with multiple PCs. The total consumer PC unit opportunity worldwide is measured in hundreds of millions of units compared to total consumer shipments of 35 million units in 1999. Apple has recognized and taken advantage of these demographic trends, and has successfully marketed itself as the best tool for getting on the Internet. Nearly 90% of all iMac purchasers attach to the Internet.

The Internet also obviates the operating system software battle between Windows and the Mac OS. For years, Apple struggled to support its more advanced, but proprietary, operating system in an increasingly Microsoft-dominated world. Users generally preferred the Mac's "look and feel" to Windows, but Apple's decision not to license Mac OS to clone developers limited third party application developer support. As more software applications move to the Internet, the requirements for underlying operating systems will shift from network standards support to portability and user-friendliness. We believe the Internet levels the OS playing field, which provides a major opportunity for Apple.

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