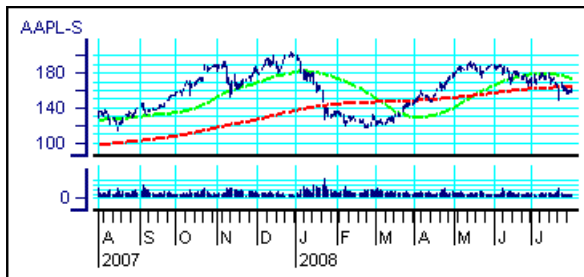


## 130 30 Fundamentals

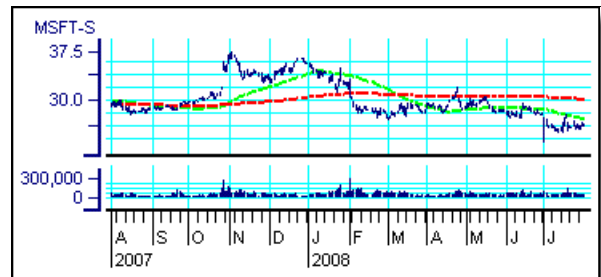
### Long / Short Combo

07/31/2008

**LONG Apple Inc. \$159 Yield 0.00%**



**SHORT Microsoft \$26 Yield 1.71%**



Industry: Technology

Recommendation: LONG Apple Inc.  
SHORT Microsoft

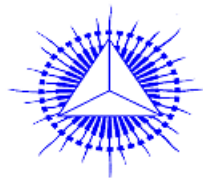
AAPL Included in S&P 500 Index at market cap weighting near 1.3%  
MSFT Included in S&P 500 Index at market cap weighting near 2.2%

Apple Inc. demonstrates dynamic growth as demand for proprietary iMac computers, iPods and new iPhones drives exceptional revenue growth. Offering a sturdy alternative to Windows computers, Apple appears poised to gain long term market share in PCs.

Microsoft sees Windows Vista slowing at a time when new low cost computers provide Internet options previously unavailable below \$500. Linux and Apple iMac computers appear set to continue to gain market share at expense of Microsoft Windows operating system.

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973 263 2333

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LONG:

**Apple Inc. Valuation**

Price	\$159
09/30/2008	\$5.25
09/30/2009	\$6.15
P/E 2009 Estimate	25.8
Mkt Cap (\$MM)	\$143,564
Annualized Revenue	\$29,856
Mkt Cap \ Annualized Revenue	4.9

**Apple Inc. Quarterly Results**

FY Ending	09/30/2008
Next Quarterly Report	09/30/2008
Expected Report Date	10/20/2008
Revenue Estimate	\$8,100 vs \$6,217
EPS Estimate	\$1.12 vs \$1.02
Previous Quarter EPS	\$1.19

**Recent Comments:** Apple reported revenues of \$7.5 billion for 3Q FY 2008, up 38% from the previous year. While gross margin eroded (2.1%) from the previous year to 34.8%, reflecting a lower mix of iPods, operating margin was stable at 20.4%. Pro forma EPS of \$1.19 per share increased 33% from the previous year. Apple shipped 2.5 million iMacs, (up 41%), 11.0 million iPods (up 12%), and 717,000 iPhones (for cumulative shipments of 6.1 million units since introduction in June, 2007).

Apple's international revenue growth indicates exceptional potential for continued rapid growth. Americas saw revenues increase 28% for 3Q FY 2008 (ended June, 2008), while revenues in Europe increased 41% and in Japan 41%. Apple-branded retail stores are another source of rapid revenue growth for Apple, with revenues up 58% for 3Q FY 2008.

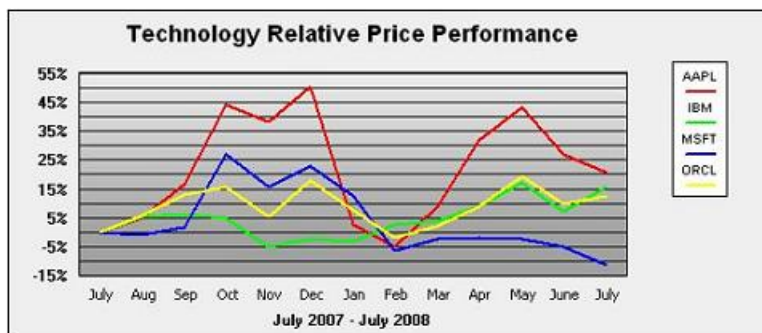
iMac computers are the most important source of revenue for Apple, accounting for 48% of revenues for 3Q FY 2008 (ended June, 2008), as shown in the pie chart on page 6 of this report. iPods and music contribute 33% of revenue, and iPhones 6%, with the remainder of revenue provided by computer peripherals (including printers, audio equipment, and headphones) and software services.

**Special Considerations:** Market share for iMacs is less than 10% of the worldwide PC market, with education as the only market fully penetrated by Apple. We view iMac as an attractive alternative to new Windows Vista PCs, as the computing power and software for Apple offer a compelling package at a comparable price to notebooks and laptop computers running Windows Vista. Compatibility of files is no longer an issue, as standard translation software enables conversion at low cost. Certain iMac models run Windows Vista as an option for a dual operating system.

Apple's financial strength, with powerful cash flow and no balance sheet debt, would enable dividend payments or share repurchase as an alternative to acquisitions or new product development, if management priority to optimize growth should ever change. Operating cash flow was \$5.3 billion for the first 9 months of FY 2008 (ended June, 2008), up more than 40% from the previous year. Apple has balance sheet cash of \$20.8 billion as of June, 2008.

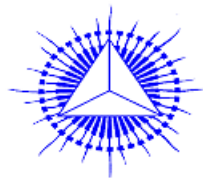
Management stability ensures continuity. CEO Steven Jobs has long provided visionary leadership to ensure that Apple's new product development offers technology appeal with functional features. Industrial designer Jonathan Ive provides consistent product "look and feel" that makes it clear that all Apple products, from iMac to iPod, the iPhone and even Apple retail stores are instantly recognizable with Apple's current logo and cool translucent design.

**Latest 12 Month Price Action:** Apple leads the performance of the largest cap technology stocks in the S&P 500, as shown in the relative price performance chart and table shown below. Apple stock price increased 21% for the 12 month period from July, 2007 to July 2008, compared to 16% for IBM and 13% for Oracle. Microsoft stock price decreased (11%) for this period.



APPLE INC	AAPL	21%
IBM	IBM	16%
ORACLE	ORCL	13%
MICROSOFT	MSFT	-11%

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SHORT:

**Microsoft Valuation**

Price	\$26
06/30/2009	\$2.15
06/30/2010	\$2.47
P/E 2010 Estimate	11.2
Mkt Cap (\$MM)	\$241,254
Annualized Revenue	\$63,348
Mkt Cap \ Annualized Revenue	3.8

**Microsoft Quarterly Results**

FY Ending	06/30/2009
Next Quarterly Report	09/30/2008
Expected Report Date	10/20/2008
Revenue Estimate	\$14,800 vs \$13,762
EPS Estimate	\$0.47 vs \$0.45
Previous Quarter EPS	\$0.46

**Recent Comments:** Revenues for 4Q FY 2008 (ended June, 2008) increased 18% to \$15.8 billion. Operating margin of 35.9% increased 6.1% from 29.8% for the previous year (a period that was impacted by unusual charges relating to Xbox). EPS of \$0.46 per share increased 18% from EPS of \$0.39 per share for the previous year.

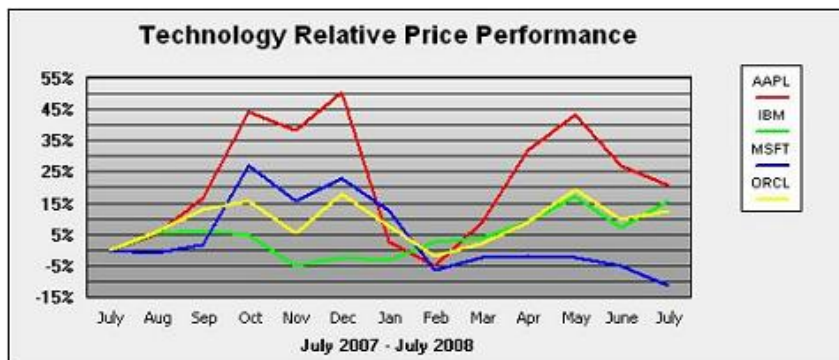
Microsoft's Windows Vista has noticeably stalled, with more than 180 million Windows Vista placements as of June, 2008. Client OEM revenues increased only 15% for 4Q FY 2008 (ended June, 2008). Other Microsoft divisions provided more rapid growth, with server and tools revenue up 21% and consulting and support revenue up 30%. Online services at MSN saw revenues increase 24%, due to 18% increase in advertising revenues and the benefit of the aQuantive acquisition in August, 2007. Entertainment and Devices division increased revenue 37% for 4Q FY 2008, as Xbox 360 installed base increased to more than 20 million units. Entertainment contributed significantly to profit growth for FY 2008 (ended June, 2008), generating operating income of \$426 million, compared to operating loss of (\$2.0) billion for the previous year.

In the last 2 years, Microsoft invested \$9.3 billion in acquisitions, including the \$5.9 billion purchase of aQuantive and the \$500 million acquisition of Danger in 2007, the most recent examples of diversification to bolster performance in areas where Microsoft has not excelled. Microsoft's unsuccessful attempt to acquire Yahoo! for \$3.5 billion indicates the need for another online acquisition to gain scale for MSN.

**Special Considerations:** Microsoft's financial strength will support many years of share repurchase to support EPS growth at a time when Windows revenues are in retreat. Microsoft accelerated share repurchase during 4Q FY 2008 (ended June, 2008) in response to market opportunities, investing \$5 billion to repurchase 171 million shares. During FY 2008 (ended June, 2008), Microsoft invested a total of \$12 billion in share repurchase. Since June, 2005, Microsoft has repurchased 23% of total shares outstanding. Cash flow from operations of \$21.6 billion for FY 2008 indicates Microsoft's ability to continue share repurchase, while still having significant funds available to make acquisitions and fund capital expenditures. Microsoft has \$23.7 billion in balance sheet cash available as of June, 2008.

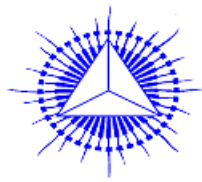
Our recommendation to SELL Microsoft recognizes there is no follow-on product ready to replace Windows Vista as a growth driver at this time. Microsoft Office upgrades that accompanied Windows Vista have already reached peak sales, and the availability of free OpenOffice.org software running Microsoft compatible files offers an easy alternative for cost conscious businesses and consumers. Microsoft's server and tools business is seeing steady demand growth from enterprise customers, but the same cannot be said for MSN (Microsoft's online business, driven by the highly competitive Internet search business). Xbox 360 (having recently reported its first profitable 6 months) faces a difficult comparison for the holiday season of 2008, as Sony's PS3 was late to the market during 2007.

**Latest 12 Month Price Action:** Microsoft stock dramatically underperformed other large cap technology issues for the 12 months from July, 2007 to July, 2008, as shown in the relative price performance table and chart shown below. Microsoft stock declined (11%) for this period, compared to a gain of 21% for Apple, 16% for IBM and 13% for Oracle. Except for the 4 month period from October, 2007 to January, 2008, Microsoft still appears locked into a long term trading range of \$26-\$30 per share.



APPLE INC	AAPL	21%
IBM	IBM	16%
ORACLE	ORCL	13%
MICROSOFT	MSFT	-11%

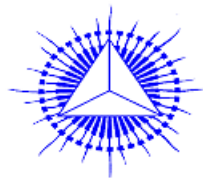
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## Technology Industry Key Variables

- **Growth in IT Spending.** IDC reported in December, 2007 that worldwide IT spending is decelerating from 6.9% for 2007 to a range of 5.5%-6.0% for 2008. Forrester Research puts IT spending growth (including depreciation on equipment) at only 5% for 2007, down from 8% for 2006. The trend to IT services outsourcing in India has had a major moderating impact on growth in US IT budgets.
- **Penetration of New Technologies.** Penetration of new software technologies, such as ERP (enterprise resource planning), CRM (customer resource management), and SCM (supply chain management) has enabled higher productivity for US office workers, enabling lower expense growth and faster response time. Achievement of payback on investment in these systems has been a key focus for CIOs (Chief Information Officers) for the past 15 years. We now expect the focus of CIOs to shift to technologies that integrate all of these productivity systems, expanding their reach beyond the enterprise walls to encompass suppliers, customers, and vendors as key information sources and participants in enterprise decision making. This new focus will drive investment in clustered networks and Internet-enabled information systems, with accelerated investment in applications supported by "middleware" and distributed databases. This trend favors Oracle's RAC systems and Fusion Middleware, IBM's WebSphere, SAP's NetWeaver and BEA's WebLogic Server, all expected to see continued rapid growth within the slower growing total market for IT spending.
- **Shift to Open Systems.** Open systems enable lower cost and rapid cross-platform deployment to enterprise customers, leading many to choose open source software as the preferred option for new investment. Linux continues to gain market share from UNIX and proprietary operating systems such as those traditionally emphasized by IBM, Sun Microsystems (Solaris) and Microsoft (Windows). According to IDC, Linux now represents more than \$16 billion of total hardware and software sales, including 10% of US server revenue. As revenue for each Linux server may be less than 40% of a typical Windows or UNIX server, we estimate Linux has achieved 40%-45% market share of server unit shipments. Linux has the full support of IBM, Oracle, and Sun Microsystems, all offering Linux-based applications. Red Hat has emerged as a new contender on the enterprise scene in the past 5 years due to its devotion to Linux server software, now supplemented by its acquisition of JBoss for SOA (service oriented architecture) open systems applications development. New Linux application server developments competing with JBoss include Gluecode (acquired by IBM in 2005) and GlassFish, an open source development project sponsored by Sun Microsystems.
- **Impact of Windows Vista.** The introduction of Windows Vista for corporate customers in November, 2006 has proven to be less of a disrupting factor for IT spending on larger system commitments than previously feared, with more than 180 million Windows Vista placements as of June, 2008. We view the transition to Windows Vista as presenting an irritant to systems software vendors that may prove to be a long term benefit, as corporate customers may see the benefit of open systems and Internet enabled software to minimize cost of transition in desktop software. Novell, with its openSUSE 10.2, and Ubuntu, a free Linux desktop operating system, provide low cost alternatives in delivering Internet access to the desktop for selected functional areas.
- **PC Market Share.** Long term, we are convinced Microsoft will lose market share on PCs. Apple's iMacs will make inroads into the high end of the market, probably becoming the preferred platform for business professionals, as well as the first choice of IT engineers. At the low end, new PCs priced under \$500 from Toshiba, Lenovo and Acer offer low cost Internet access, with email, web browsing and basic text and graphic manipulation tools supplemented by a broad choice of web-based applications. Windows Vista is too bulky to run on these low cost PCs. For many users, this low cost Internet access is enough, making it clear there is no need to purchase a full scale PC. Use of Internet options on cell phones and PDAs has created a population of users tolerant of Internet access on a small screen. Acceptance of the small keyboard sold with these devices will surely follow.
- **Impact of Internet Delivery.** US corporate investment in the Internet for delivery of services is still in its infancy. Investment in the corporate web site will move beyond presentation of basic information, as tools such as paid search, online advertising, online multimedia conference and "click-to-call" links evolve into platforms for truly integrated sales and marketing. Other functions, including product design, manufacturing, supply chain control, distribution, and customer service all require similar Internet-enabled functionality to handle demand for online access to goods and services.
- **Appeal of ASP.** Long term trends to deliver applications software over the Internet, instead of for exclusive use installed on a local PC or a corporate network, offer both an opportunity and a threat to established software companies. Many Internet users find little benefit to PCs other than to access the Internet. Small business applications and some enterprise functions are now available on the Internet in an ASP (application services provider) mode that offers users convenience, low capital cost, and no maintenance expense. We expect all applications software vendors to identify this market as an opportunity to develop versions of their best selling software to run in an ASP mode.

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### Technology Valuation Comparison

COMPANY		PRICE	FY	EPS ESTIMATES			P/E	ANN REV	#SHS OUT	MKT CAP	MKT CAP/ANN REV
		07/31/2008		2007	2008E	2009E	09E				
APPLE INC	AAPL	\$159	09/30/2007	\$3.93	\$5.25	\$6.15	25.8	\$29,856	903.2	\$143,564	4.8
			CAL	\$4.56	\$5.27	\$6.17					
MICROSOFT	MSFT	\$26	06/30/2008	\$1.87	\$2.15	\$2.47	11.2	\$63,348	9,380.0	\$241,254	3.8
			CAL	\$1.71	\$2.05	\$2.30					

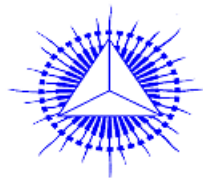
### Technology Fundamental Comparison

COMPANY	MOST RECENT QTR	REVENUE GROWTH YR/YR	GROSS MARGIN	PRO FORMA* OPER MARGIN	ROE	DEBT as a % of TOTAL CAPITAL	DEFERRED REVENUE % ANN REV
APPLE INC	06/30/2008	38%	34.8%	20.4%	24%	0%	14%
MICROSOFT	06/30/2008	18%	81.9%	35.9%	47%	0%	24%

### Microsoft Software Competitors

Type of Software	Competes with	Source	Comments
<b>Operating System:</b>			
Linux	Windows XP	Ubuntu	free download, most popular desktop Linux today
		Novell	SUSE Linux 10.3, \$59.95, more than 1.0 million downloads of 10.2 to date
		Red Flag	free download, hundreds of millions of PCs installed in China
		Red Hat	Red Hat Desktop now sold only as part of Linux server developer pack
<b>Office Productivity Suite</b>			
OpenOffice	Microsoft Office	OpenOffice.org	free download, millions of users running Windows XP or Linux supported by Sun Microsystems
SmartSuite 9.8	Microsoft Office	IBM	includes Lotus 123, WordPro, Freelance, \$117-\$306 list price discounted online to \$25-\$150, available only for Windows XP
StarOffice 8	Microsoft Office	Sun Microsystems	download price \$69.95, available for Solaris or Windows XP
<b>Internet Browser</b>			
Mozilla Firefox	Internet Explorer	Mozilla	free download, now claims 15% market share
Netscape	Internet Explorer	AOL, Time Warner	free download, set to Netscape portal
AOL Explorer	Internet Explorer	AOL	free download, set to AOL portal
Google Toolbar	Internet Explorer	Google	free download, set to Google portal
<b>Desktop Tools</b>			
Google Pack	Windows Desktop	Google	includes Firefox browser with Google Toolbar, Google Desktop, Google Earth, Google Pack Screensaver, Google Talk, Norton Antivirus, Lavasoft Ad-Aware, Picasa photo organizer, RealPlayer audio and video player, Trillian IM platform
Google Desktop	Windows Explorer	Google	free download, indexes workstation, network, and e-mail files

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### Quarterly Trends

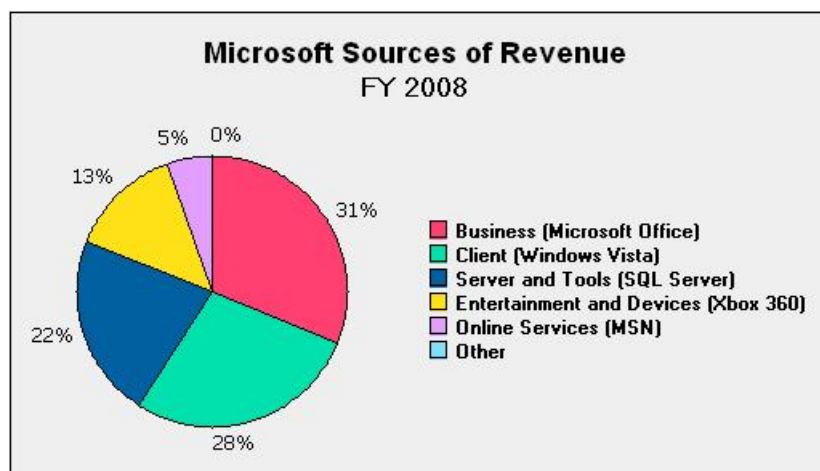
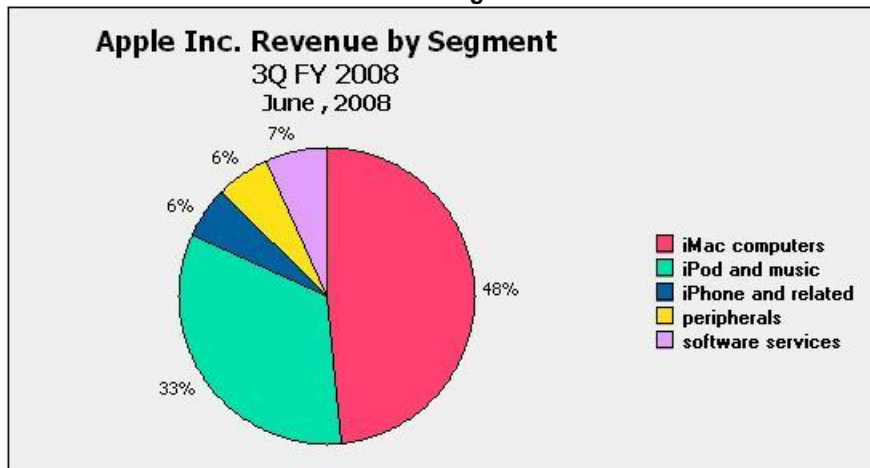
#### APPLE INC Quarterly Trends

	3Q 07 06/30/2007	4Q 07 09/30/2007	1Q 08 12/31/2007	2Q 08 03/31/2008	3Q 08 06/30/2008
<b>Sales</b>	\$5,410	\$6,217	\$9,608	\$7,512	\$7,464
% change yr/yr	24%	29%	35%	43%	38%
<b>Gross Margin</b>	36.9%	33.6%	34.7%	32.9%	34.8%
<b>Pro forma operating Margin</b>	20.4%	18.1%	23.3%	19.3%	20.4%
<b>PF EPS</b>	\$0.97	\$1.07	\$1.84	\$1.26	\$1.29
<b>GAAP EPS</b>	\$0.92	\$1.01	\$1.76	\$1.16	\$1.19

#### MICROSOFT Quarterly Trends

	4Q FY 07 06/30/2007	1Q FY 08 09/30/2007	2Q FY 08 12/31/2007	3Q FY 08 03/31/2008	4Q FY 08 06/30/2008
<b>Revenues</b>	<u>\$13,371</u>	<u>\$13,762</u>	<u>\$16,367</u>	<u>\$14,454</u>	<u>\$15,837</u>
% change yr/yr	13%	27%	16%	-0%	18%
<b>operating margin</b>	29.8%	43.0%	39.6%	30.5%	35.9%
<b>EPS - PF</b>	\$0.39	\$0.45	\$0.50	\$0.47	\$0.46
<b>EPS - GAAP</b>	\$0.31	\$0.45	\$0.50	\$0.47	\$0.46

### Revenue Segments



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