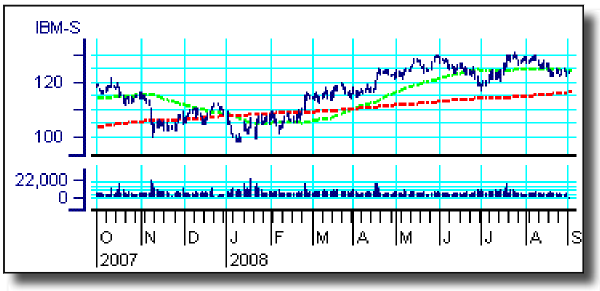
130 30 Fundamentals

08/29/2008

Long / Short Combo

SHORT IBM $125 Yield 1.60%



LONG Oracle Corp. $23 Yield 0.00%

Industry: Software

Recommendation:	SHORT	IBM	IBM	Included in S&P 500 Index at market cap weighting near 1.50%
	LONG	Oracle Corp.	ORCL	Included in S&P 500 Index at market cap weighting near 1.00%

IBM has enjoyed accelerating revenue growth, but lags far behind Oracle in both top line growth and profitability. With a business mix concentrated in IT services and software, IBM should no longer be perceived as the dominant computer hardware company. IBM lost market share in key database sales to both Oracle and Microsoft. Slowing growth for IT services industry during 2008 and 2009 may impact perception of upside potential for IBM. We think IBM stock at best may perform in line with the S&P 500 Index over the next 18 months.

Oracle is now #1 in software worldwide, surpassing IBM and SAP with annualized software revenues of $29 billion as of May, 2008. Acquisitions of applications software companies, most recently BEA Systems, adds to Oracle's dominance of database with increasing sales of applications software and middleware. We see more than 100% upside to Oracle's stock price over the next 18 months.

Anne K. Anderson, CFA
Atlantis Investment Co., Inc.
aanderson@atlantisinvestment.com
973 263 2333

SHORT:

IBM Valuation

Price	$125
12/31/2008	$8.25
12/31/2009	$9.30
P/E 2009 Estimate	13.1
Mkt Cap ($MM)	$167,987
Annualized Revenue	$115,464
Mkt Cap \ Annualized Revenue	1.5

IBM Quarterly Results

FY Ending	12/31/2008
Next Quarterly Report	09/30/2008
Expected Report Date	10/20/2008
Revenue Estimate	$23,600 vs $22,000
EPS Estimate	$1.45 vs $1.21
Previous Quarter EPS	$1.98

Recent Comments: IBM's revenues increased 13% to $26.8 billion for 2Q 2008, with revenues in constant currency up 6%. Revenues from the Americas increased 8% to 41% of total revenues, while revenues from Europe, Middle East and Africa increased 16% to 37% of total revenues and Asia Pacific increased 16% to 20% of total revenue. Pretax margin improved 1.0% to 14.2%, as faster growth for software (with revenues up 17%, up 9% in constant currency) contributed to a favorable business mix. EPS increased 32% (excluding the gain on sale of the printer division from the previous year) to $1.98 per share.

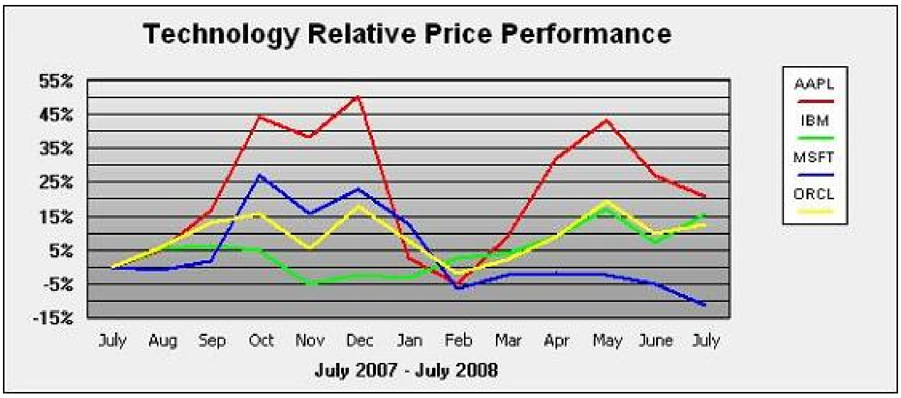
Share repurchase supports EPS growth. IBM is a powerful cash flow generator, with excess cash available to fund acquisitions and repurchase shares. Cash flow from operations for the first 6 months of 2008 totaled $8.5 billion, with free cash flow of $6.5 billion after capital expenditures of $2.0 billion. IBM invested $5.9 billion in acquisitions (including $5.0 billion for Cognos in January, 2008 and $885 million for Telelogic in April, 2008). IBM repurchased 62 million shares for investment of $7.2 billion during the first 6 months of 2008, retiring 5% of total shares outstanding. IBM invested more than $100 billion in share repurchase since the mid-1990s. Cash of $9.8 billion is retained on the balance sheet, available to continue share repurchase, with $8.9 billion remaining share repurchase authorization.

Special Considerations: While many investors still think of IBM as the premier computer hardware company, for years IBM's business has been dominated by software and services, with a slow growth hardware business concentrated in servers and storage. For 2Q 2008, IBM's revenues were drawn 57% from global services (both IT services and business outsourcing), 21% from software, 19% from hardware (categorized as systems and tech) and 2% from global financing, as shown in the pie chart on page 5 of this report. Profits are even more concentrated in the software sector. IBM's software business contributed 38% of profits for 2Q 2008, with services contributing 44% of pretax income. Systems and tech contributed only 11% of pretax income for 2Q 2008.

IBM lost market share to both Oracle and Microsoft in databases and now faces a daily battle against Oracle, SAP and CA for dominance in applications software and middleware. Like Oracle, IBM benefited from acquisitions in applications and middleware, particularly the acquisitions of Tivoli, Lotus and Rational, with the acquisitions of ISS (Internet Security Systems) and FileNet indicating an increasing focus on security and storage issues. Most recently, IBM acquired software companies Cognos (providing business intelligence and management software) and Telelogic (providing solutions to automate software development practices) during 2008. IBM divested printers to Lexmark and PC manufacture to Lenovo. Comparison of IBM to Oracle is most relevant only for the software portion of IBM's business, as global IT services is more akin to the services business of EDS (soon to be acquired by HP) and Accenture than to Oracle.

We view IBM as a slower growth and less profitable vehicle than Oracle within the large cap technology segment of the S&P 500 Index. Oracle's concentration in software drives high margins and fast growth unachievable for IBM, given its representation in global IT services and hardware. See the fundamental table on page 5 of this report to view the contrast in revenue growth and operating margin for IBM and Oracle.

Latest 12 Month Price Action: IBM's stock price performance surpassed Oracle over the past 12 months, up 16% for the period from July, 2007 to July, 2008, compared to a 13% gain for Oracle. IBM pleased investors with accelerating revenue and EPS growth, although unable to match Oracle for top line growth and profitability.



Technology Industry Relative Performance
Sort by Highest to Lowest
July 2007 - July 2008

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

LONG:

Oracle Corp. Valuation

Price	$23
05/31/2009	$1.50
05/31/2010	$1.75
P/E 2010 Estimate	13.1
Mkt Cap ($MM)	$114,760
Annualized Revenue	$28,956
Mkt Cap \ Annualized Revenue	4.0

Oracle Corp. Quarterly Results

FY Ending	05/31/2009
Next Quarterly Report	08/31/2008
Expected Report Date	09/20/2008
Revenue Estimate	$5,420 vs $4,529
EPS Estimate	$0.26 vs $0.22
Previous Quarter EPS	$0.47

Recent Comments: Revenues for 4Q FY 2008 of $7.2 billion increased 20% from the previous year, with new software license sales of $3.1 billion, up 27% from the previous year. Database and middleware revenues increased 23%, applications software revenues increased 30%, benefiting from the April, 2008 acquisition of BEA Systems. Service revenues increased 18%, combining to create one of the strongest 4Q results ever for Oracle. Operating margin of 41.0% increased 0.9% from the previous year. Pro forma EPS of $0.47 per share increased 27% from the previous year, setting Oracle apart from the competition with exceptional EPS growth at a time of economic uncertainty.

Results for 4Q FY 2008 (ended May, 2008) saw the strongest growth for international markets. Revenues increased only 4% for the Americas (representing 50% of total sales), but increased 35% for Europe and the Middle East (representing 37% of total sales) and 21% for Asia Pacific (13% of the total). Movement of IT services to low cost offshore locations contributes to faster growth in international venues for Oracle and other software vendors.

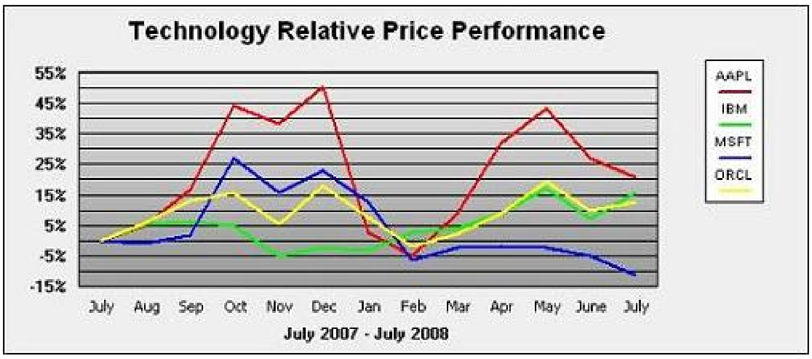
Oracle's financial strength supports its acquisition strategy. Free cash flow totals $7.2 billion for FY 2008 (ended May, 2008). Cash totals $11.0 billion as of May, 2008, offset by $10.2 billion in long term debt. Oracle invested $5.9 billion in share repurchase for FY 2008 and FY 2007, retiring 4% of total outstanding shares.

Special Considerations: Oracle has gained market share to become the #1 software company in the world with 49% of the database market, according to Gartner, compared to only 22% for IBM. Oracle is the top worldwide competitor for both SAP ($16.0 billion software sales for 2007) and IBM ($20.0 billion software sales for 2007), with total annualized revenues of $29.0 billion for 4Q FY 2008 (ended May, 2008). Oracle's database revenue provides stability, while applications and acquisitions drive growth. (See revenue pie chart on page 6 of this report.)

Acquisitions over the last 4 years made significant contributions to Oracle's total market share. Acquisition of BEA Systems for $8.5 billion in April, 2008 is the latest addition. BEA Systems is expected to contribute more than $1.5 billion to annual revenues for Oracle, with $50-$60 million in new software license sales in the pipeline for 1Q FY 2009 (ending August, 2008). Oracle expects the BEA Systems acquisition to add $0.01-$0.02 per share to Oracle's annual EPS. Oracle's merger with Hyperion Solutions in April, 2007 and Siebel Systems in February, 2006 built on the previous merger with PeopleSoft in January, 2005, creating a leadership position in both database and application software. Transition to the new Oracle 11*g* database during FY 2008 (ending May, 2008) stimulated new database sales among former PeopleSoft and Siebel Systems customers.

Oracle is far more profitable than comparable software companies, as shown in the table of fundamental ratios on page 4 of this report. Operating margin (43.0% for FY 2008) now should stabilize in the 40%-43% range as Oracle consolidates acquisitions.

Latest 12 Month Price Action: Oracle's stock price performance lagged IBM slightly over the past 12 months, up 13% for the period from July, 2007 to July, 2008, compared to a 16% gain for IBM. IBM pleased investors with accelerating revenue and EPS growth, although far below Oracle's top line growth and profitability.



Technology Industry Relative Performance
Sort by Highest to Lowest
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Software 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. 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.

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.

Consolidation of Software Vendors. Acquisitions have played a key role in the growth of all major software companies, as customers pare down their vendor lists, demanding software that works across their key platform commitments. IBM's acquisitions of Cognos in 2007, Rational in 2003 and Lotus in 1995 contributed to growth of their software business. Oracle acquired AG Edwards in 2004, PeopleSoft in 2005, Siebel Systems and Sunopsis in 2006, and Hyperion Solutions in 2007. Acquisitions for CA include Wily Technology and iLumin in 2006 after a long string of acquisitions adding products to Unicenter, CA's Unix systems center. Novell's mergers with SUSE Linux and Ximian in 2004 provided a path to restore growth through Linux. Red Hat's acquisition of JBoss was required for a small company to expand from its niche in server software to offer applications development tools in order to maintain customer focus on its open source Linux platform.

Storage and Security. Storage and security remain key areas for customer investment. Recent acquisitions by IT players indicate convergence of software with hardware in meeting the needs for secure data storage and personnel access to corporate property residing in the IT system. IBM acquired both Internet Security Systems and FileNet in October, 2006, indicating security functions are now viewed as a critical component of an integrated enterprise offering. EMC acquired RSA Security in September, 2006. CA added to security features with the acquisition of Netegrity in 2005 and Qurb in 2006, while bolstering its BrightStor family of storage products acquired from Cheyenne Software in 1996 with records management acquired from MDY Group International in 2006. Red Hat acquired Sistina in 2004 with a view toward the use of Linux in clustered storage systems. Demand for Linux as a replacement for Unix in SANs (storage area networks) could drive long term investment from a slow moving source, the 10% of IT spending devoted to storage systems.

Technology Industry Valuation

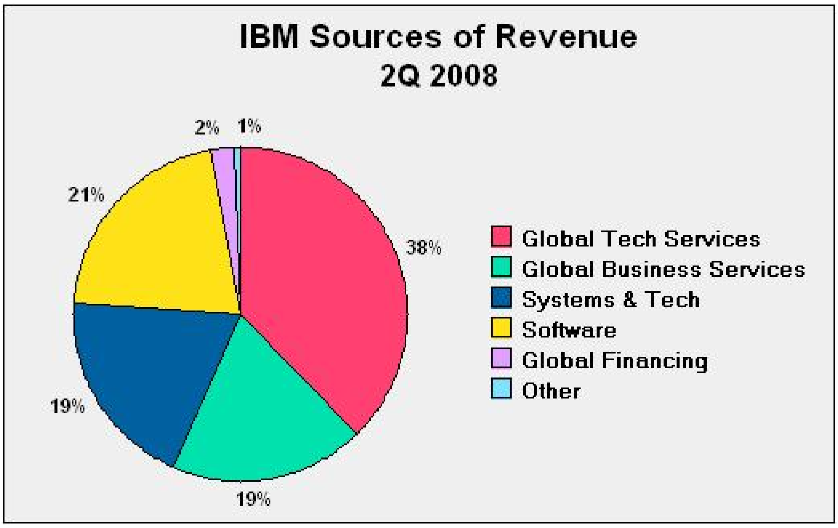
COMPANY		PRICE 08/28/2008	FY	EPS ESTIMATES 2007	2008E	2009E	P/E 09E	ANN REV	#SHS OUT	MKT CAP	MKT CAP/ ANN REV
APPLE INC	AAPL	$174	09/30/2007	$3.93	$5.25	$6.15	28.2	$29,856	903.2	$156,922	5.3
			CAL	$4.56	$5.27	$6.17					
MICROSOFT	MSFT	$28	06/30/2008	$1.87	$2.15	$2.47	12.1	$63,348	9,380.0	$262,077	4.1
			CAL	$1.71	$2.05	$2.30					
ORACLE	ORCL	$23	05/31/2008	$1.30	$1.50	$1.75	13.5	$28,956	5,233.0	$118,475	4.1
			CAL	$1.15	$1.42	$1.68					
IBM	IBM	$125	12/31/2007	$7.13	$8.80	$9.75	12.8	$107,280	1,404.0	$174,910	1.6
Industry Average							**16.6**				**3.8**

* EPS estimates are based on pro forma EPS, excluding stock based compensation, amortization of intangibles, amortization of debt issuance cost, and gain (loss) on investments.

Technology Industry Fudamentals

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%
ORACLE	05/31/2008	24%	81.5%	49.0%	42%	31%	16%
IBM	06/30/2008	13%	43.2%	13.6%	9%	22%	13%

* Operating profit defined as operating income excluding stock based compensation expense and amortization of intangibles.



IBM Quarterly Trends

	2Q 07 06/30/2007	3Q 07 09/30/2007	4Q 07 12/31/2007	1Q 03/31/2008	2Q 06/30/2008
Revenues	$23,772	$24,119	$28,866	$24,502	$26,820
% change yr/yr	9%	7%	10%	11%	13%
Operating margin	11.7%	12.9%	18.6%	16.2%	13.6%
Pro forma EPS	$1.50	$1.68	$2.80	$1.65	$1.98
GAAP EPS	$1.55	$1.68	$2.80	$1.65	$1.98

Oracle Quarterly Trends

	4Q FY 07 05/31/2007	1Q FY 08 08/31/2007	2Q FY 08 11/30/2007	3Q FY 08 02/28/2008	4Q FY 08 05/31/2008
Total Oracle Revenues - GAAP	$5,828	$4,529	$5,313	$5,349	$7,239
% change yr/yr	20%	26%	28%	21%	20%
Operating Margin	39.1%	36.6%	41.3%	41.3%	41.0%
EPS-Pro Forma	$0.37	$0.22	$0.31	$0.30	$0.47
EPS-GAAP	$0.31	$0.16	$0.25	$0.26	$0.39