Sun and it’s microsystems

Business, Company

With an employee workforce of four, Sun Microsystems was incorporated in 1982 by Andreas Bechtolsheim, Vinod Khosla, Bill Joy, and Scott McNealy. Originally began for Stanford University Network, Sun Microsystems has been a global leader in innovating products, services and support solutions for constructing and maintaining network computer systems. The first system built by Sun, the Sun-1 was introduced in late 1982 and was a high performance, UNIX based computer constructed of inexpensive materials. Within a year of incorporation Sun was operating in Europe, and soon spread throughout the world.

From Sun" s birth, there was always a corporate emphasis on the power of the internet and networking. A belief that the internet was the future was inherent in the corporatecultureand was built into the company framework through the mission statement:

" We enable customers to create breakaway business strategies by using our network computing products, solutions and services.

In an age where information is power. Sun provides thetechnology, innovation and partnerships that enable individuals or entire organizations to access information . . . from anywhere . . . to anything . . . on any device . . . allowing users to better differentiate and more effectively create breakaway business products and services."

This strong belief is reiterated in Sun" s vision statement:

" Sun is network computing. Everything we bring to the market is predicated upon the existence of the network, where Java is on every client and every server.

Sun" s vision is for a networked computing future driven by the needs and choices of the customer. It is a vision in which every man, woman, and child has access to collective planetary wisdom that resides on the network."

These strong networking and internet beliefs made Sun the prime company when, in 1994, there was a huge surge in internet usage. At that time, roughly 30% of servers were made by Sun.

Sun is a leading supplier of enterprise network computing products, and has a full range of services and support. The company" s products are used for commercial and technical applications worldwide. As a global competitor, Sun is subject to exchange rate risks.

There are a few markets Sun should be especially cautious of, including: Japanese Yen, British Pound, French Franc, and German Marc. Sun holds a large position in these potentially volatile markets. Despite its current recovery, Sun should be wary of the Japanese Market. Any major shift in this market could negatively impact its revenues. Another consideration it the value of the dollar. As the dollar strengthens in the US, the dollar value of non-US dollar based sales abroad decreases. In order to hedge these risks, Sun routinely uses options & futures contracts in foreign countries.

Currently, revenues outside the United States are increasing. This is primarily due to the continued market acceptance of Sun" s network

computing and product services. Approximately one half of the increases in revenue are due the continued strong demand for enterprise and work group servers, as well as increased revenues for their storage products division. Recently, the company has made an overall shift to premium service and support contracts in the service division. This change is advantageous due to the large installed base of high-end server products, and is primarily responsible for the increased unit sales in the service division. Sun has also experienced increased revenue from their professional and educational products.

The company continuously evaluates the competitiveness of its products and service offerings. These evaluations could result in re-pricing actions adversely affecting revenues in the short term. This is due to the company" s belief that to keep the competitive edge in the market place, a company must continually improve existing products as well as introduce new ones. The company will achieve this even if it means the cannibalization of existing products.

Financial Statements and Ratio Analysis

After reviewing the company" s annual reports and other historical figures, we can evaluate the current stock pricing trends and financial well being of the company. Based from this information, the company" s net revenues have continuously increased over the last five years reaching 11. 726 billion in fiscal year June 30, 1999. A common-size income statement analysis of the company shows us that Sun" s cost of sales as a percentage of net revenues has decreased in 1999.

In the technology sector, prices for products can often fall faster than manufacturing costs to produce them. Tight control over costs of sales is a positive sign for a company in this industry. This shows us that Sun is maintaining their competitive position in this area. The expenditures on research and development have increased slightly in 1999. This can be attributed to the continuous development necessary to stay competitive in this industry. Tech companies tend to grow much faster than companies in other industries. Because of this, R&D expenditures are especially important in the long termhealthof technology companies. Sun appears to be adequately using funds in this area.

The selling, general, and administrative expenses have increased in dollar value but remain constant as a percentage of revenue. Some reasons for the increases in SG&A are attributed to its continuous improvement of internal business processes, increased marketing costs, and increased head count needed to meet rising demand. However, it is imperative that the investments in SG&A should not rise as a percent of revenue for the company to remain competitive. The purchased in-process R&D line on the income statement reflects the amount of write-offs associated from newly acquired companies.

The information provided from the annual report for year ending 1999 however, is somewhat misleading. Two months after the annual report was filed with the SEC, Sun acquired Star Division Corp. on August 5, 1999. All the capital stock of Star Division shareholders was converted to the right to receive cash. The total purchase price of the company was approximately 60

million. No extraordinary expenses or the associated changes will show until the new annual report is filed for fiscal year 2000. Because of this, any assumptions made based on the 1999 figures will be distorted until the final effects of the merger can be evaluated.

It is Suns belief that the Star division will increase revenues with the introduction of new software later this year. Star" s current direction in software development is consistent with Suns software architecture including the use of portal technologies. These technologies will allow users to access office applications via a single server using the Internet from many different devices including cell phones & personal data assistants. Sun believes they can harness synergies from this merger to amplify stockholders returns. The future success of this operation may greatly impact the companies competitive position. On a cautious note however, the company should be careful to not neglect the continuous development needed of existing products to remain competitive.

Both the company" s quick ratio of 1. 94 and current ratio of 2. 44 far surpass its industry (Diversified Computer Systems) average of 1. 33 & 1. 71 respectively. This shows us that Sun maintains an advantage over its competitors by having substantially more assets compared to liabilities. The 1999 annual report also boasts of having almost no debt compared to equity. However, we know that with the merger of Star Division, Sun has picked up some long term debt raising its debt to equity ratio to . 36 from 0. Even with the added debt, Sun is still beating the industry average of . 44. This shows

much internal strength for the company, but raises some concerns that debt leverage may not be currently utilized to its full potential.

The companies ROA and ROI ratios are continuously beating the industry. These values indicate signs of good management from within the firm. The firm received large returns on investment for fiscal year ending 1999. This however, may not be representative of future performance as it is not income generated by the firms primary operations. As such investors and management alike should be cautious. The company" s ROE is slightly trailing the industry. This is probably due to the lack of debt leverage currently being utilized. The company" s asset and inventory turnover ratios are lower than its industry.

This can at least be partially explained by the company" s dependence on its suppliers. Sun frequently enters into large contracts that are non-cancelable to retain its suppliers. This results in stockpiling and more importantly wasted or obsolete inventory. The technology sector is continuously changing & any inventory not immediately sold runs the increased risk of becoming obsolete in the future. This is an area where Sun could use some refinement. One possibility would be the use of JIT manufacturing or a more vertical integration with its suppliers.

The company" s gross margin of 51. 96% represents increased demand of higher-end market servers. The operating margin is also solid at 13. 86% compared to 10. 23% for its industry. This can be attributed to the tight controls on costs of sales as compared to the increasing revenues. Sun" s net profit margin is 9. 75%. Although seemingly small compared to the S&P 500,

this margin significantly beats the industry average of 7. 23%. The low profit margins throughout this industry characterize this highly price competitive market as it converts product to revenue.

Sun" s stock is rated by Wall Street Analysts as a strong buy. It has been forecasted to perform better than average on 2000 & 2001. The companies EPS forecast for fiscal year 2000 is $0. 90 and judging from its first two quarters, it appears to be right on track. Although Wall Street has high confidence in Sun, the next earnings release will be April 13, 2000 and any significant variation from expected earnings could have very adverse affects on the price of stock.

The P/E ratio skyrocketed from just 53. 8 in June of 1999 to its current price of 122. 16 as of March 15. This indicates that investors are willing to pay a significant premium for Sun" s earnings (about $122 for every dollar of earnings). Both the Sales and EPS growth rates also indicate investors are paying large premiums for growth relative to Sun" s peers. These premiums may indicate an inflated stock price.

One of the best ways to value a company can be to forecast future cash flows & then discount them back to today" s net present value. Using this technique, we projected earnings 10 years into the future using the net income from the 1999 annual report and a growth rate of 20%. The 20% rate is consistent with the company" s historical growth rate. Next we discounted those future cash flows at a rate of 15% to compensate for changing markets and the cost of capital. By doing this we were able to arrive at a NPV from those cash flows. Finally by subtracting long term debt and dividing by the

number of current shares outstanding we were able to arrive at the companies intrinsic value of about $35. 00. By comparing this value to the current stock price of $89. 81, we can see that Sun appears to be overvalued by investors at this time. This is probably due to the investor excitement from the increased revenues and its strong ROA and ROI.

Sun" s management will need to be very cautious of any unexpected changes in earnings. These changes could trigger an adverse affect on the current stock price and curb investor excitement in the company. This could have a negative consequence on the company" s future operations. Management must always look at how the firm is valued from outside sources if it is to continue the goal of maximizing shareholder value.

Hewlett Packard (HP) is a leader in the computer industry. They got their start out of a garage in 1938. Considered to be innovators their business has grown over the years. The main focus of Hewlett Packard is to be a global provider of computing and imaging solutions for business and home. This takes into account the rapidly growing internet with an emphasis on e-business. While HP" s performance is strong they are not as volatile as Sun because they own a big chunk of the printer market. They are competing with Sun in the huge server market. Hewlett Packard realizes the expansion of the internet and they will be a competitor for a long time in the future.

Next we have Big Blue International Business Machine (IBM) and they have been a global force for many years. Their main focus is to provide customers with solutions through the use of advanced information technology. These solutions include technologies, systems, products, services, software and

financing. IBM is a stable company that is trying to maximize shareholder wealth and at the same time recognizes the key to the future. They will be a big competitor of Sun" s due to the growing demand for internet solutions.

IBM has formed alliances with Cisco, Intel, Motorola, Nokia, and Palm to start e-service. This is to combat the wireless revolution. IBM in 1998 started to create an infrastructure to take advantage of the fast growing internet. The mission for them is access anytime anywhere. The key to IBM getting more involved is because Experts say that in the near future there will 1 billion wireless subscribers. Everything digital is due to double in the coming years. IBM as well as Sun does not want to be left in the dust.

Our third major competitor is Compaq Computer. They were incorporated in 1983. They currently sit as the #2 computer company in the world. They began their onslaught on e-business back in 1988. They use a company called Electronic Data Interchange (EDI). This gave them a direct portal to get information to their customers faster over communications lines. They also use a Just in Time process to cut costs, reduce cycle times. Overall this improves their cycle times. Their main focus is to design, develop, manufacture and market hardware, software, and services to individuals.

Don" t let Compaq" s numbers fool you. Compaq has had their problems in the past of growing too fast, and are rebuilding for e-commerce. They are poised and confident that they will lead consumers to a paperlessenvironment.

Silicon Graphics is a leader in digital media solutions. They accomplish this through large servers. Their key to success is to engage in production of a broad range of visual computing systems. These systems deliver advanced 3D graphics and computing capabilities. They have a definite power in providing audio and video over the internet. Huge servers store the enormous amounts of data needed to accomplish these types of applications. Clearly they are in a growing mode. There systems have been recognized just recently at the Academy Awards for the Phantom Menace, Stuart Little, and The Matrix. To this point Silicon Graphics is in the red but with the growth available to them, they could steal market share. Sun really has to watch out for this mover and shaker.