

# Research<sup>2.0</sup>

*Technology Analysis for Business & Investment*

## Company Positioning Thoughts

### What should Motorola do?

Kris Tuttle - January 24, 2010

It's been 10 years since the technology bubble ended in 2000 and a combination of growth and consolidation has reshaped the technology company landscape. Amazon, Apple, Cisco, Google, HP, IBM, and Salesforce.com have emerged as leaders while prior leadership names including Dell, eBay, EMC, Microsoft, Nokia, Oracle, Research in Motion, and Yahoo scramble to catch up or stay even with market leaders.

The implications in terms of valuation are profound with "leaders" having total mean market values 3.6x revenues and 22x EBITDA versus the "followers" at 2.6x and 10x respectively. (MOT numbers are 0.6x revenues and 12x)

Motorola is facing an opportunity to reposition the company. This may result in dramatic changes in valuation if they are wise choices are made and implementations are robust (fast, decisive and governed by insight & quality.) With fairly conservative assumptions MOT stock should be worth \$20 share today if management would take some of the right steps to shift the positioning of the company in the markets and with investors.

This report looks at Motorola from a positioning standpoint to analyze what they could do for the shares to fetch \$20 in the market.

## **PATHS TO HIGH VALUATION**

Our view is that there are several well-proven paths to improved valuation for public companies. We'll start with a review before delving into the specifics of what Motorola might consider doing given the situation they are facing.

### **NUMBERS**

If there is a “holy grail” or “magic elixir” for institutional investors it is the combination of accelerating revenue growth and expanding operating margins that is based on sustainable long-term trends. It's important to note that these markets don't need to be “sexy.” For example Compuware enjoyed more than a 5x increase in market value in 1997/8 (well in advance of the “bubble”) because they were able to increase prices on their critical mainframe software while selling a little bit more each quarter. This combination generated rapidly accelerating earnings growth in a “sleepy” industry.

### **LEADERSHIP**

The leading firms in technology get a major premium based on investor perceptions of management and the potential for the company to maintain their leadership in an attractive market. Names like Bezos, Jobs, Chambers, Benioff and even Hurd inspire the investor confidence for a large, long-term portfolio position. Notably though it's possible to have a franchise and a management culture that works without a strong individual leader as with Google and IBM.

### **MARKET PROXIES**

Many investors like to invest thematically and favor “pure plays” or proxies on the growth of a given market. In this way companies are owned as “one way” investments in that as long as they continue to lead they will be key holdings to play large themes these include: Salesforce.com = Software as a Service, Amazon.com = online sales, Google = online advertising, Apple = online entertainment, Cisco = IP Networks, Red Hat = Open Source Software, etc. Companies that can be positioned in this way get the extra benefit of being “must own” stocks in thematically-driven portfolios.

### **CLEAR AND CONSISTENT EXECUTION**

Another “soft” quality needed for higher market valuation is the combination of clear communication and consistent execution of strategy. Investors don't expect HP to have the best computers or avoid dilutive acquisitions, but they do expect the company to be ruthless at improving margins while maintaining growth. Nobody expects IBM to have the best servers or be a software leader but they do expect IBM to dominate the giant and fragmented market for technology solutions and have whatever technology is required to maximize their margins in this business. Every leadership company has a clear, simple, measurable strategy and message for investors to follow. Incoherent actions and a complicated strategy mean lower valuation.

## MOTOROLA PERCEPTIONS & EXPECTATIONS

Investor ambivalence towards Motorola is clear from the relatively low valuation the company receives in the markets. Generally speaking this is rooted in a doubts about company culture, management organization and ability to execute. The fact that the company has multiple different lines of business doesn't help although this is not necessarily an obstacle to achieving a high valuation in the future.

On the flip side Motorola still benefits from a very positive if somewhat distant reputation as a company that can deliver superior products that offer a combination of strong design and quality. It's not uncommon for institutional investors to recall the success and even a personal fondness for the Razor phone. However the series of missteps in the mobile device space that translated into success for Research in Motion and Apple instead of Motorola is something that investors have a hard time letting go of.

New outside management for the mobile device division and the Android strategy was a major step in the right direction but the entry of Google and many third party makers like HTC into the space has diluted investor enthusiasm and hopes that this will lead to sustainable, higher margin leadership for Motorola. Perceptions hinge on Motorola having their own brand identity here or "simply being an Android VAR" in the market.

Expectations for Motorola, particularly in the longer term are already fairly robust. Current consensus calls for \$24B in 2010, \$26.3B in 2011 and \$28.4B in 2012. Earnings are forecast to expand rapidly due to margin improvements and are forecast to double in 2010 to \$0.35 and continue to improve to \$0.56 in 2011 and \$0.66 in 2012. In the very near-term expectations are for the company to report at the high end of their guided range (9c on \$5.9B) for the December quarter and to have shipped on the order of 1.2M or more Android-based mobile devices with a view that Q1 will be up (to around 1.5M) despite seasonal weakness.

Given the current expectations a reasonable expectation for company valuation would be in the \$12 based on our own Intrinsic Value methodology and even more naïve price target methods. The combination of low valuation and robust estimates suggests that by and large investors "don't believe the numbers" or have other current concerns that prevent them from owning the stock.

## LOOKING DEEPER

The current positioning of MOT as being a mix of very different and unrelated companies has not been helpful. *Most investors don't respond to stories of "value" and having "a call option" on the growth businesses of the company. Furthermore the investors that respond well to such stories are characterized as "value investors" which means they do little to drive enhanced valuations.* Such companies sometimes attract the label of "value trap" which forces them into dramatic actions and even a forced company sale by frustrated investors.

For better or worse (worse we think) Motorola has made public their plans to sell their home and networking businesses. This method creates more of a "distress sale" atmosphere, which is unnecessary given the company's current business and financial health. The overall question to answer is what should Motorola to do in order to maximize returns on invested capital with an eye

to four of five years out. As an outsider we don't have access to all the details we'd need for a complete analysis but this is probably how external investors would see it anyway.

The central issue is that *\$12/share is not very inspiring*. Although it represents a handsome short-term return it seems to leave large amounts of potential return "on the table" if the company can come up with a good plan and address execution and management issues. Because Motorola has a strong position in growth markets like Mobile Internet, it makes sense to consider more approaches to creating greater shareholder value than selling entire divisions at what may be low prices.

Each division does in fact have a very different personality and set of operating opportunities and challenges:

**Mobile:** Noted now as being the "growth opportunity" but not one currently generating meaningful income. The question begged is what level of margin might this division achieve in a few years given that other firms, notably Apple and Research in Motion, generate 20% and 30% operating margins respectively. We computed an IV of \$11/share based purely on the Mobile division assuming a doubling of the business by 2015 to \$22B, 40% gross and 15% operating margins. The key to achieving these results is a combination of design and software that meaningfully improved the user experience of non-iPhone smartphones. There are important gaps in the market like entertainment applications on top of Android and improved enterprise integration that can be addressed with a combination of proprietary software and partnerships. If there is one area where significant acquisitions and investment justified this is it. Proprietary software and services will be the key to success in this market and plenty of attractive acquisitions and partnerships are available. The industry is still wide open.

**Home:** At around \$4B of revenue and 10% operating margins the business is attractive but suffers from the view that the main channel has been and continues to be North American cable companies (75% by geography and 55% of end market revenue respectively.) The dire straights the cable companies find themselves in is a problem but could also be an opportunity. Cisco has made it no secret that they want greater penetration in the home networking application space. Internet-based TV units are in the market now and will be followed by much more network-based 3D and gaming devices. Although a "sale" candidate as articulate this division could get far more valuable with a focus on providing the next-generation infrastructure the cable companies need to survive (think granular multi-service, real-time provisioning) and/or delivering applications directly to consumers. Time and space don't allow for an adequate treatment of what investors are calling "the connected car" which is a bit of a hybrid between the Mobile and Home division markets that is currently not well-addressed. By executing a better growth strategy the division would be far more valuable over time. But without growth this division has an IV of about \$1.50/share or \$3.6B assuming that expenses can be reduced and drive operating margins up towards 16%.

**Networks:** Networks has been a problematic business and is perhaps seen as the best candidate to eliminate. It may be packaged with the Home division to make a sale more attractive but it has different characteristics. The networking business has a diversity of both geographic and technology segments. That position might be leveraged to generate broader success in these markets for other Motorola divisions. Mobile broadband is an area with major potential and strategic value. Would it be possible to sell off or otherwise eliminate the non-mobile broadband portion? Even at a low price the ability to focus on higher-growth mobile broadband would be a strong positive. A combination of mobile and semi-fixed broadband in the context of the mobile Internet

(smartphone, car & home) could be very strategic. However as a separate business networking carries very low multiples which suggests the value is about 1/2 of that for the Home division or about \$0.75/share and \$1.8B.

**Enterprise:** The Enterprise Mobility division is the hardest to figure out from an investor perspective. Assuming reasonable growth averaging 8% and steady operating margins of 18% this division as an IV of about \$13B or \$5.50/share today. So the business is very meaningful and the margins are supporting the whole company. However it's hard for investors to get a tight grip on this business and what the overall strategy is. There are simply too many things combined into one place. Public safety, municipal and security systems are important but hard to model and position thematically. Point of sale solutions are attractive and in some cases like with Micros Systems or Open Table, trade at attractive multiples. This is an onion that needs to be peeled and positioned more clearly for growth and improved valuation.

As can be shown with simple math many brokerage firms are performing a similar analysis and noting that the valuation for Enterprise, Home and Networks alone is worth more than the current market value of the company. Investors are getting a pile of cash and the Mobile business "for free" in the stock price today. No doubt this has contributed to the view that selling off these divisions is the key to "unlocking value" for MOT.

We'd tend to disagree with this analysis. A sale of any or all of these business units will beg new questions like "What is the company going to do with the money?" and "What will the growth and operating margins in these remaining divisions look like?" These are difficult for a company that doesn't have a great track record of deploying capital wisely to answer. As Microsoft discovered paying out a big one-time dividend doesn't lead to any long-term benefit in terms of multiples and share prices.

## CONCLUSIONS

We go back to the critical elements we look at that drive meaningful expansions in share prices:

**Numbers:** Motorola consolidated numbers should show accelerating growth and expanding margins overall and inside individual markets like smartphones the top-line growth should exceed the overall market. Major investments and or acquisitions in the software and services parts of the business could be used to accelerate growth and sustainably improve margins. This is hard to decree but should follow from other changes.

**Leadership:** A new organizational plan and/or new mantra is needed. Nobody views a Co-CEO structure as durable and the suspicion is that it will end badly and result in the company "backsliding" into old ways of doing business. (We don't have time to do a back-test but I'd be willing to bet that listed companies with Co-CEO structures underperformed their markets substantively in the past.) At the same time the company needs to make much more clear what the long-term strategy is. It will help if this is rooted more strongly in thematic trends plus a ROIC discipline rather than just rightsizing and cost containment.

**Proxy:** It's early to talk about Motorola as a proxy for anything but one thing that is clear is there isn't an answer today for a non-iPhone pure play on the Mobile Internet. Obviously Nokia and Research in Motion are going to work hard on achieving this positioning but they both have a way

to go, particularly with respect to user experience. Palm has some excellent ideas and good products but is too small to represent a proxy today.

**Execution:** In the near term Motorola is likely to benefit from a combination of improved execution and success in Mobile along with general economic improvements. At the same time a portion of this will be ascribed to “a rising tide lifts all boats” mentality and may not improve the positioning of the company or the valuation multiple. In order to do that some more clarity will be needed so that better execution can be benchmarked next to a higher-multiple valuation endpoint. Today investors may say “I’m not sure where you are headed but at least you’re driving there faster and hitting fewer things along the road.”

**Prescription:** Based on limited information and only a few hours of analysis we’d suggest the following:

1. Invest heavily in proprietary software and services in the Mobile space in general and Android in particular. Think about beating Apple in terms of entertainment and user experience and besting Research in Motion in terms of email and the enterprise. Using Android should provide leverage to do this even if major acquisitions are needed.
2. Consider refocusing the other divisions on applications rather than technologies and artificial categories. For example Home should be a good opportunity but doesn’t have a story or solution description around it. As “home” and “mobile” networking converge in special areas like the connected car, Motorola should be leading the way and demonstrating that it can identify, capture, and monetize these emerging markets.
3. Similarly the “Enterprise” segment should be examined and recast more granularly in terms of markets, applications and opportunities. For example the point-of-sale is blurring and both mobility and security are critical. Motorola would seem to have strong potential to succeed in this market.
4. Since nobody cares about the Network business it does make a good sale candidate. However the current approach used to unload both Home and Network isn’t a way to maximize value. We suspect that spinning off the Network segment in exchange for little or no cash value might improve the pro-forma financials of the overall company but don’t know for sure. It may also make sense to keep broadband networking but roll it into the Home segment to create applications and simply close down the rest.
5. With respect to management it’s pretty clear that nobody thinks the current structure is permanent and the fear is that the company will slip back into an insular and non-shareholder focused approach. It makes much more sense to have a single CEO/President to which the major opportunity areas of the company report. This provides much more opportunity to incent, measure and drive performance, which will greatly improve investor perceptions of the company.

The net result should be a company with three \$10-20B divisions generating 15% operating profits that investors can understand and love to the point where the mid-point of that objective would value the firm at \$80B.

# Research<sup>2.0</sup>

## ABOUT US

Research 2.0 analyses technology for business and investment. The two founders each have over 30 years of applied experience in emerging technology, research, capital markets and institutional investment practices.

Our clients consist of both institutional technology investors and technology companies themselves, both large and small, who receive ongoing advisory services from us by annual subscription.

We are open, honest, and accessible. Much of our work finds its way to thousands of institutional investors both directly and via distribution partnerships. We also freely share much with the general public via our syndicated blogs. Everyone with a legitimate interest in our work is invited to sign up for a free membership.

If there is anything we can do to help please don't hesitate to contact us directly via the website ([www.research2zero.com](http://www.research2zero.com)). We are also available for short consultations via Gerson Lehrman.

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