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## *Last Throw of the Dice*

CNBC Business News

Having taken a huge battering in recent years from Apple and BlackBerry, Palm is hoping its latest smartphone will finally reverse its fortunes. John Brandon reports

Striding onto a Las Vegas stage in January wearing a mile-wide smile and a bright orange shirt, Matías Duarte, announced he would "not do a magic show". Yet minutes later the jaws of those attending the press conference at the annual Consumer Electronics Show were hanging as if Siegfried & Roy had just made a white tiger vanish.

Duarte – then Palm's senior director of human experience and user experience and now the company's vice president of design – unveiled the Palm Pre, a touchscreen smartphone, he explained, that runs a new interface called webOS. It supported multi-tasking (where you can run multiple apps at once) and aggregated social networking content (for example, combining Facebook and Gmail contacts).

Since the Palm Pre's launch in June it has sold 300,000 units, according to Edward Snyder, an analyst at Charter Equity Research, in a little under one month. That's approaching Apple-like hysteria – indeed, the Wall Street Journal calls it the strongest rival to the Apple iPhone – and is helping to revive both Palm, which was on the brink of collapse, and Sprint, third largest wireless telecoms network in the US, which was wilting due to poor customer service and lack of a remarkable smartphone.

In recent years, the smartphone market has cannibalised the PC industry, leading to record sales – the iPhone 3G has sold almost 50 million units, and has 50,000 apps available. The Pre promises to put a computer in your pocket. "We chose not to take the complexity of the desktop PC with all it's resizable windows and cram it into a phone," says Duarte, in an exclusive interview with CNBC Business. "Nor did we believe that, because phones are small, you somehow want less of your internet life."

In designing the Pre, Duarte says the mission was to start over with a smartphone OS. Palm used a series of "mood boards" erected in each workspace. They posted a visual collage of nature photography, high-design furniture, and other stylish imagery. As they designed webOS, they would print out the screen and place it next to these photographs. If the screen design did not measure up aesthetically, they would start over. So far, the design has spurred vast media attention – and led to a limited inventory. Partnering with Sprint, Palm intentionally kept inventory low instead of manufacturing too many devices.

"Keeping up with demand is our top current challenge," says Sprint CEO Dan Hesse. "We have been able to manage the wait-time to about a week. Palm is producing Pres as fast as they can. We have also done minimal advertising so far, and we hope our new advertising will help keep the momentum going."

Palm, Inc., is based in Sunnyvale, California, in the heart of Silicon Valley. The company invented not only the smartphone category almost autonomously, but the pocket organiser itself, in the mid-90s.

In 2007 and 2008, the company's market share eroded as Apple emerged as the new kingpin. Sales of the popular Palm Treo stalled, and Palm's stock price plummeted below $3 a share. (Currently, Palm is trading at about $15 (€10) a share, and rising steadily.) The company needed a rebound. In 2007, Palm hired Jon Rubinstein, who worked on the original iPod at Apple and is now Palm's CEO. (During the transition, Rubinstein has turned down all media interviews.) With new funding from Elevation Partners and a smart-kid-on-the-block mentality, Palm went to work. The Pre is now the tech darling of the year, only partially obfuscated by the latest iPhone 3GS.

"We view the launch as a success due to overwhelmingly positive feedback from Sprint store managers and consumers for the Pre," says Michael Walkley, managing director and senior research analyst at Minneapolis-based Piper Jaffray. "We estimate about 600,000 Palm Pres will sell by the end of August."

Yet, for those following Palm closely, there are lingering questions: can they make a full rebound? Can the Pre actually save Palm? Most analysts agree that the Pre is a major success. At issue is whether the company can build more momentum, release additional products based on the webOS platform, and capture market share away from Apple and BlackBerry. Duarte is not a magician, but the company does need some magic.

"The Pre needs to have quick sales that lead to quick profits," says Ilya Grozovsky, equity research analyst at New York investment bank Morgan Joseph & Co. "The Pre brought Palm back from the abyss but it remains to be seen if they have the financial ability to endure."

To accomplish a complete turnaround, and reduce a heavy debt load – one that comes due in a few years – most leading analysts agree that Palm needs to diversify, and quickly.

"The issue for Palm isn't necessarily how successful the Pre is – which we think will likely be their most successful phone to date – but instead how well received the core webOS is," says James E Faucette, senior research analyst for wireless equipment at Portland-based Pacific Crest Securities (PCS). "Increasing the number of SKU's [stock-keeping units] based on the webOS has always been part of the roadmap and is of vital importance."

For now, Palm is focusing entirely on the Pre. The marketing spend has been minimal, due to the limited supply. Ads have just started to appear, featuring a young woman surrounded by mystical warriors, with close-ups of the webOS and finger-touch control of the interface – the major selling points.

"We believe total Pre marketing spend will be over $100m (€70m), but that the majority of this will be spent in the back half of this year and into 2010 to manage demand given current capacity constraints for the product," says Deepak Sitaraman, a financial analyst with New York-based Credit Suisse Group.

Spending more on marketing is risky business, however. The company has an extremnely high debt-to-earnings ratio. According to Matt Thornton, an analyst with Avian Securities in Boston, the Palm debt load comes due in 2014. To avoid financial trouble, the company needs more than just a single popular smartphone. Tsvetan Kintisheff, a financial analyst based in Sofia, Bulgaria, says he doubts the company will seek additional funding and that the solution is to raise earnings with new products and thereby create more cash flow.

"We expect Palm to become cash flow positive in the August quarter – about $30m [€20.8m] – and continue to generate positive cash flows going forward," says Sitaraman. "We expect the company to use the cash generated from operations to pay down debt [currently €275m] over the immediate term."

Another potential life-saver will be a European launch. In July, Palm announced a Europe-wide exclusivity contract with Spain's Telefonica, whose British subsidiary O2 will sell the phone to the pivotal UK market. No pricing information has been given, only a promise to be on sale before Christmas.

Even with the momentum, Jim Suva, a director at Citi Investment Research, rates Palm as a "hold", citing that the Palm exclusivity at Sprint will likely last only through 2009. "The Pre is a complex device and often cell phone launches need updates and improvements," he says.

Sitaraman sees a brighter future: "We see pro forma revenue growing from $1.1bn [€760m] to $2.1bn [€1.45bn] over the next two calendar years. Based on our proprietary analysis, we believe new products will drive meaningful average selling prices and gross margin accretion, resulting in calendar 2010 operating margin of 10.2% versus -14.0% in 2008. Our view is that additional liquidity will not be needed in the near term."

It's also possible that Palm could hold on for the ride: the Pre could gain more ground and become the tech story of the year. "The Pre is the first webOS product and we believe it is a compelling enough of a product to return Palm on a path to profitability," says Walkley.